

Signs of potential turmoil in global financial system

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Financial markets appear to have been enjoying a period of relative calm in the past year since they were shaken by the failure of three significant US banks in March 2023, requiring rescue operations by financial authorities.

But there are signs of turmoil building up beneath the surface. They centre on continuing possible liquidity problems in the \$26 trillion US Treasury market, the basis of the global financial system, signs of currency divergences and concerns over the growing role of private credit in the financial system.

Last week a tremor went through the Treasury market when there was what was characterised as a “shaky auction” for \$44 billion worth of seven-year US Treasury notes. The shortage of buyers mean that the big banks, which are crucial to the operation of their market as primary dealers, had to make up for the shortfall and purchase 17 percent of the debt, somewhat higher than the norm.

This followed an auction the previous day when there was subdued demand in an auction of two- and five-year debt.

The lack of demand, sending the price of debt lower, meant that the interest rate on the 10-year bond (the two move in the opposite direction), went to 4.63 percent, higher than it has been in some weeks.

The immediate cause is the realisation that the Federal Reserve is not going to make significant cuts in interest rates in the near future. At the start of this year, markets were pricing in as many as six rate cuts by the Fed in 2024. Now there are predictions there may not even be one.

The longer-term issue is the amount of debt which must be issued to finance the ever-growing US government deficits.

Back in March, in an interview with the *Financial*

Times (FT), the director of the Congressional Budget Office, Phillip Swagel, sounded the alarm on US debt saying it was on an “unprecedented” trajectory. He pointed to the Liz Truss experience of September 2022 when a proposal for unfunded major tax cuts by her government sent UK bond markets into a crisis requiring intervention by the Bank of England.

US government debt is now almost the equivalent of 100 percent of GDP, coming in at more than \$33 trillion, and is set to accelerate in coming years. Payments of interest have reached 3.3 percent of GDP, the highest level since 1940 following the Great Depression.

Speaking to the FT, Ronald Temple, a market strategist at the financial firm Lazard, said the fiscal situation was his “single biggest concern for the US economy” and that it would continue.

“I don’t see it as a Liz Truss moment,” he said, but warned that a gradual build-up of problems can lead to a crisis.

“It’s more of a frog in a boiling pot. That to me is why the market should be cringing every time we see these auctions. Auctions should be on everyone’s calendar as a risk factor.”

Treasury officials and leading financiers are still haunted by the experience of March 2020 when the US Treasury market froze for several days at the start of the pandemic when no buyers were to be found for US debt and the Fed had to step in to support virtually all financial markets to the tune of \$4 trillion.

The US debt market is highly dependent on foreign capital inflows, with Japan, China and the UK the main foreign holders of debt. The most significant move in this area has been the decline in Chinese holdings. From more than \$1 trillion, they have declined to just under \$800 billion, after a 40 percent reduction in the

past year, and are now sitting at a 14-year low.

Currency markets are also giving cause for concern. The rise of the US dollar relative to other currencies, due to the higher interest rates in the US, is putting downward pressure on other currencies, in particular the Japanese yen and the Chinese renminbi, also known as the yuan.

It is estimated that last month Japan spent \$62 billion to support the yen, which has fallen to a 34-year low against the US dollar.

The Bank of Japan has ended its policy of so-called yield curve control, under which it suppressed the interest rate on bonds, and has signaled that it wants to start to lift rates and return to a more normal policy.

The intervention in May arrested the slide of the yen but it is not a long-term solution because, as UBS economist Masamichi Adachi noted, the yen will not move higher “unless investors think that interest rates will seriously begin to rise.”

But Japanese financial authorities are in a dilemma because a rise in rates will further slow the economy, already described as “sluggish” because of low consumption spending.

The position of the renminbi is also coming in for attention. Last week it fell to a six-month low against the US dollar with indications that state-owned Chinese banks were intervening to prevent a further slide. At this stage it appears that Chinese authorities want to prevent a devaluation.

But the divergence between interest rates in the US and China is continuing to exert downward pressure.

An article in the *South China Morning Post* last month was headlined, “Is another Asian currency crisis coming? Keep an eye on China’s yuan.”

It said a bigger danger than a “collapsing yen” was “the possibility that an economically beleaguered China could be pushed into a devaluation of the yuan.”

In an article last week, the FT reported that market pressure was increasing on the People’s Bank of China (PBoC) to allow the renminbi to weaken because of the divergence of interest rates, with the yield on US 10-year bonds at 4.57 percent compared with 2.3 percent on their Chinese equivalent.

At present the PBoC is holding the line on the currency, no doubt recalling the turmoil that followed a devaluation in 2015.

A fall in the value of the renminbi would impact on

other countries, especially in Asia, which depend on the Chinese market, and could lead to stepped up action from the US, which has already accused China of dumping cheap products on the US and world markets. A devaluation would further lower the price of Chinese goods in the US and other markets.

But a one-off devaluation is a possibility because, as one Shanghai-based currency trader told the FT, there was “enormous downward pressure that has built up over the past few months.”

Another potential source of instability, already pointed out by the International Monetary Fund and other financial institutions, is the growth of private credit funding.

Last week Jamie Dimon, the head of JPMorgan Chase, warned “there could be hell to pay” because of problems in this area.

He said some of the fund providers were “brilliant” but others were not and problems were often caused by the “not good” ones.

In a reference to the situation which developed in the lead-up to the global financial crisis of 2008, when highly risky products in the sub-prime mortgage markets were given top marks by credit rating agencies, he pointed to the emergence of similar issues today.

“I’ve seen a couple of these deals that were rated by a ratings agency, and I have to confess it shocked me what they got rated. It reminds me a little bit of mortgages.”



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