Extreme Tension Spans The Financial Markets

by Lothar Komp in Wiesbaden

Every new and broader shock could be the doom of several banks and insurance companies. The global financial system found itself in a catastrophic condition already before the outbreak of the war in Iraq. Some of its pillars, like the stock markets, have already thoroughly crashed. Permanent intervention by the central banks, now open and public as often as hidden, is demanded to preserve the 15-digit dollar volumes of reciprocal obligations. And with each new day of war, the potential grows for new tectonic convulsions in the financial system.

So, the stock markets do not see an end to the horror. For more than three years now, the exchanges have plunged almost without uninterruption. First it was the favorites of the Internet and telecom bubble. But for a long time now, banks and insurance companies have been at the center of the implosion of financial values. Stocks of enterprises like Allianz or Munich Re, once the most solid holdings imaginable in the German-speaking regions, have come to be traded as one would treat the carriers of contagious diseases. Just in the first quarter of 2003, the stock prices of Allianz, Munich Re, and Hypovereinsbank have halved once again, after two or three previous halvings in the past couple of years.

"It is unclear how many additional strains the EU [European Union] banking system can still absorb," warned a private study of the European Commission, revealed by *Der Spiegel* magazine. The German banks had just required a "special alert," as both their earnings and their stock prices have been pulled sharply down. It is in light of the global structure of the banking system, that one must see the danger cited in the study, that "the problems of one member-state can quickly spread to another."

But by worldwide measures also, the financial experts of the European Commission see rapidly growing "imbalances" and "downward risks": "The international financial system, which in the past year has been struck by a series of negative events, looks to be vulnerable to further shocks." The disposition of the stock markets remains "fundamentally negative." Banks, insurance companies, and pension funds are being forced by this to sell their holdings. This could come to further "fire sales," and these could have "grave effects upon the equities markets, and bring on a downward spiral of capital values, and further selling."

'Exceedingly Great Challenge' for Governments

Additional danger threatens through the building of new debt bubbles, the study warned—as in mortgages and real estate—as well as through the dependence of the world economy on American exports financed by foreign obligations. A flow of capital out of the United States would be "a meaningful risk not only for the U.S. economy, but for the entire world economy." The risks for the global financial system would be "substantial," and the challenge for governments "exceedingly great," especially since they have long since used up their "classical" arsenal of means for reviving their economies.

That such fears are in no way being expressed only in private banking papers, is proven by the new study of global financial stability by the International Monetary Fund (IMF). At the presentation of the bi-annual "Global Financial Stability Report" on March 27 in Frankfurt, Germany, Gerd Häusler, IMF Director for the International Capital Markets Department, and responsible for the report, warned against the illusion that the worldwide financial and economic crisis would simply disappear after the end of the Iraq war. One must assume that even more after the war, the weight of "post-conflict uncertainties" and increasing geopolitical risks will afflict both the markets and the world economy, he said. On the financial markets, according to Häusler, even if one makes the assumption that the Persian Gulf region could stabilize rapidly after the war and avoid more terrorist attacks, each deviation from this rosy scenario will, for certain, further weaken the already-shaken trust of investors and cause further plunges of the stock markets. He concluded that the question is, how many additional shocks the battered banks and insurance companies in America, Europe, and Japan can still withstand.

Häusler noted, "After three years of losses, many financial institutions are weakened—in particular, the European insurance firms, which are more and more heavily invested in stocks. This poses the danger of a 'Devil's crisis': The insurance companies, selling stocks into a falling market in order to shore up their liquidity, thereby worsen their solvency measures." This could then bring about the failure of one of the large insurance companies. From the standpoint of the stability of the financial system, this would probably not be as dangerous as the collapse of a large bank. But Häusler stressed that as a consequence of the vastly expanded volume of financial derivatives contracts between banks and insurance companies—he referred particularly to so-called credit derivatives—the fall of a single large insurance company could definitely become a risk for the financial strength of several banks.

In view of the rapidly growing market for credit derivatives, one has to seriously worry, according to Häsler, that with these risky contracts, market participants who wrongly estimate the risks of the highly complex derivatives could tumble. This applies all the more to this unregulated market, as it not only has to do with banking and insurance, but also with speculative undertakings which are regulated by no public authorities.

End Is Nigh for the Carry-Trade

The IMF sees a further danger for global financial stability in the rapid spread of the so-called "carry-trade" contracts of the big banks, especially in the United States. Through this mechanism, the financial institutions have incurred enormous levels of debt with (currently) low-interest securities, and against them, purchased (currently) higher-interest financial securities. This trade is lucrative—until the point when suddenly the entire financial structure changes. Thus, market participants from the whole world invested very heavily in the "yen carry-trade" during the late '90s, since interest rates in Japan were near zero, and the yen at the same time was tending to lose value. However, when the yen suddenly shot up in October 1998, a global financial panic broke out.

Today, interest rates for short-term credit are at their lowest level in the last 40-50 years, not only in Japan, but also in the United States and Europe. The new form of the "carry-trade" lies in borrowing with short-term paper, to buy long-term investments—above all, government bonds and mortgage credit. In this connection, an extremely dangerous situation has developed, especially for the American mortgage financiers Freddie Mac and Fannie Mae. Should there be unexpected changes in interest rates, such as another rise in short-term interest rates, this could have dramatic consequences for both these U.S. financial institutions, and with that, for the entire American housing market. To be sure, Freddie Mac and Fannie Mae were created by government initiative; however, they were not provided with any explicit government guarantee.

Considering the unusually sharp warnings from the European Commission and the IMF, the question is posed directly: What recommendations do both these institutions really have to contribute for overcoming the worldwide financial emergency? The answer is loud and clear: None at all. This is really no surprise, for all the governments of the Group of Seven "industrial" nations ignored the global financial breakdown for a long time, with catch-phrases and emphasis on the "sound fundamentals," to go along with "hope for better times."

The dirty work, at this point, falls on the central bankers: Money is pumped into the financial system in ever more fantastic forms, in order to delay a total financial collapse. In this way, it resembles the way that the destruction on the battlefields in the Near East is simply raised to a higher degree every day. An end of the horror can only happen through the operation of goverments, which recognize the complete failure of the current methods, and shift onto a radically different track: a New Bretton Woods global financial reorganization.