Financial Tsunami?

Martin Khor

In recent days, the United States' financial system has been going through tumultuous times, with one major problem or crisis following another.

Because US finance is so large, with tentacles throughout the world, a tsunami-type situation may be building up in the global financial system as well.

On Monday (17 March), the stock markets in Asia and Europe took a big tumble. Tokyo closed 3.7% down, Hong Kong 5.2% and Mumbai 6.5%. The indices were also down for Frankfurt (4.1%), London (3.9%) and Paris (3.5%).

The immediate trigger was the collapse of America's fifth biggest bank, Bear Stearns. It had to be temporarily rescued last Friday (14 March) by US Federal Reserve emergency funds channeled through another bank, JP Morgan.

Then on Sunday (16 March), it was announced that JP Morgan would purchase Bear Stearns for the basement price of $2 a share (or $230 million in total), as a part of a package deal also involving the Federal Reserve.

The Federal Reserve moved into intervention mode, with three emergency measures announced on Sunday. First, it will provide up to $30 billion in loans to bolster Bear Stearn's balance sheet by funding illiquid assets (including $13 billion of net exposure to toxic mortgage-related securities), thus reducing the risk to JP Morgan, a condition for JP Morgan's take-over. To minimize its own risk, the Fed will take direct control over Bear Stearns's huge portfolio of financial assets.

Second, the Fed also announced a new lending programme, making funds available to the 20 large investment banks that serve as "primary dealers" and trade Treasury securities directly with the Fed. The Fed will reportedly hold as collateral a wide variety of securities that include hard-to-sell securities backed by mortgages, according to media reports. There will be no limit to the amount that can be borrowed, which is a major departure from previous Fed fund injections.

Third, the Fed also lowered the rate for borrowing from its so-called discount window by one-quarter percentage point, to 3.25 percent.

"The moves amounted to a sweeping and apparently unprece-dented attempt by the Federal Reserve to rescue the nation's financial markets from what officials feared could be a chain reaction of defaults," according to an *International Herald Tribune* article.

The speed of Bear Stearn's collapse and takeover was astoni-shing. The bank faced two problems–it had to write off billions of dollars of losses in mortgage-related investments, and then investors withdrew their funds–forcing it to seek the bail out.

On 11 March, the Chairman of Bear's executive committee Ace Greenberg dismissed speculation that the bank had liquidity problems as "totally ridiculous." Just a few days later (14 March), it was revealed that the bank had become insolvent and had to be bailed out. And on Sunday (16 March), the buy-out to J P Morgan was announced.

Dramatic as it was, the sudden demise of Bear Stearn was only one of many major developments in recent days indicating that the crisis is spiralling in many areas.

First, data was released on 7 March showing that the US lost 63,000 jobs in February, following a fall of 22,000 in January. A few days later came data showing a decline in retail sales. This has prompted many economists to conclude that the US is in a recession.

And not just a shallow, short-term dip. It will be "a deep recession that could be the most serious since World War II", according to Martin Feldstein, president of the National Bureau of Economic Research.

"The situation is bad, it's getting worse, and the risks are that the situation could be very bad," said Feldstein, adding that the chief causes are falling housing prices, job losses, and turmoil in the financial markets.

Second, the US dollar fell sharply to a record low on 13 March, going below Yen 100 to the dollar (Y99.77) for the first time since 1995, and to a record low of $1.56 to the euro on the same day.

On 17 March, the dollar fell further in Asian trading, plunging to as low as 95.72 yen, while the euro jumped to a new record high $1.5903. In Japan, officials called for calm in the currency markets.

More gyrations in currency markets are expected. Such a sharp decline in the US currency affects the competitiveness of exporters in many sectors in other countries, as they will receive less in local currency for the sale of their exports that are denominated in the dollar.

Third, on 13 March, the spot price of gold for the first time broke through the $1,000 level, indicating a further fall of investor confidence in liquid assets and a shift to safety.

Fourth, in the midst of the financial crisis has come a jump in oil prices, which will increase costs and inflate the import bill of net oil importers.

The price of West Texas crude oil reached US$111 a barrel on 13 March. On 17 March, in Asian trading, the oil price hit a new record high of $111.80 (light, sweet crude for April delivery) in electronic trading on the New York Mercantile Exchange.

Fifth, there is mounting evidence that the crisis has spread to hedge funds, which are facing pressures from their creditors and investors. Expect adverse repercussions as these funds "unwind" their positions in the markets in forced sales to meet these demands.

The banks that lend to the highly leveraged hedge funds are making margin calls. To meet these demands for more collateral, the funds have to sell their securities. Nervous investors are also redeeming their shares, thus adding to the pressures on the hedge funds to sell, and in a falling market. Their losses are thus climbing.

A dramatic sign of this was the collapse last week of Carlyle Capital Corporation (CCC), a $22 billion hedge fund that is part of the Carlyle Group, one of the world's largest equity fund groups.

CCC had unwisely invested in mortgage-backed securities. It revealed that up to 12 March it had defaulted on $16.6 billion of its indebtedness, and the remaining indebtedness is expected soon to go into default. It added that its banks are likely to take possession of its remaining assets and liquidate them, after it ran out of cash to meet margin calls.

A front-page article in *Financial Times* (14 March) said the markets are "grappling with mounting signs of forced sales by hedge funds driven to reduce their portfolios by lenders trying to reduce their own risk exposures."

Chief US economist at Merrill Lynch, David Rosenberg was quoted as saying that "the credit crunch has now reached the hedge fund industry." Co-chief executive of Pimco Mohammed El Erian said there were signs of "a growing number of hedge funds having to go into survival mode."

Sixth, the cost of protection against credit default is also mounting, and this may soon trigger forced sales of structured credit instruments. The cost of protection from credit risk is measured by two indices - in the US, the CDX index for investment grade companies; and in Europe, the iTraxx index of investment grade corporate debt.

On 10 March, the CDX index jumped 15 basis points (bp) to a record 193 bp (a year ago, the index was only 30-40 bp). The iTraxx index was trading on 10 March at a record 157 bp, up from 146 bp on 7 March.

According to *Financial Times* (11 March): "Structured trades based on the value of the CDX and the iTraxx are close to reaching a major inflection point. Many complex structures including so-called constant proportion debt obligations (CPDOs) have triggers that are released when spreads widen to a certain level. This could cause such complex vehicles to begin selling into the market and push credit spreads wider still."

The CDX and iTraxx are very close to triggering a wave of such forced sales. Further ratings downgrades could also cause the sale of other structured credit instru-ments and weigh further on CDX and iTraxx, according to traders.

And seventh, is the news that the two big companies, Fannie Mae and Freddie Mac, which hold or guarantee most housing loans in the US, are also facing a crisis and that Fannie may require a government bail-out as well. Credit Suisse has estimated that Fannie and Freddie might have to write down $5 billion on portfolio of sub-prime mortgage bonds.

They have already reported large losses in the fourth quarter of 2007 –$2.5 billion for Freddie and $3.6 billion for Fannie.

All the above are signs of a most serious crisis causing the crumbling of significant parts of the US financial structure. The impact on the real economy of production, jobs, and income will be serious, not only for the US but also the rest of the world.□

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