Global Financial Instability

by David C. Grabbe
Forerunner, "WorldWatch," June 2006

Forecasting the financial future is not unlike predicting the weather on any given day. While meteorologists are notorious for inaccurately predicting both sun and rain, some weather trends and generalities are still pretty safe bets. Likewise, while markets continue to vacillate, it is still possible to catch glimpses of when summer growth will occur, when a winter slowdown will happen, or even when cataclysm is bearing down on us. A flurry of recent financial headlines indicates a certain shakiness in the global system:

> » *The Telegraph* on May 15, 2006, reported, "Analysts said there were now clear signs that monetary tightening by the world's central banks was starting to crimp growth. Lombard Street Research warned the US was now heading into outright recession, with China also facing a hard landing. . . . It raised the risk of 'an impending financial crisis' caused by excess credit and leverage across the global economy." (Ambrose Evans-Pritchard, "Markets braced for the worst")
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> » *The Sunday Times* of London on May 21, 2006, noted, "Conditions in the financial markets are eerily similar to those that precipitated the 'Black Monday' stock market crash of October 1987. . . . A report by Barclays Capital says the run-up to the 1987 crash was [characterized] by a widening US current-account deficit, weak dollar, fears of rising inflation, a fading boom in American house prices, and the appointment of a new chairman of the Federal Reserve Board. All have been happening in recent months. . . ." (David Smith, "Markets 'are like 1987 crash'")
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> » In the one-month period from May 12 through June 12, 2006, the Dow Jones Industrial Average lost 588 points (5.2%). At the same time, the NASDAQ Composite lost 152 points (6.8%).
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> » According to the *Associated Press* on June 13, 2006, "worries over the outlook for U. S. interest rates sent global markets tumbling again on Tuesday, with the Japanese stock market plunging more than 4 percent, its biggest one-day loss in two years. In Bombay, Indian shares plummeted 4.5 percent to their lowest point this year." ("Global Markets Plunge on Fed Worries")

While these facts may mean little more than an unusually chilly day in late June, Stratfor's June 8, 2006, "Global Market Brief" highlights three areas where changes—corrections—seem imminent.

First, good news: Stratfor predicts oil prices will probably break. While both high demand and maximized productivity are unchanged, other factors are beginning to taper off. For example, a considerable amount of the price of oil is caused by "premiums"—fears of instability or insecurity that make traders nervous. Any time something untoward happens in a major oil-producing country, the oil price rises, even though production costs remain stable.

While certain premiums remain—the militant threat in Nigeria, the incendiary rhetoric of the Venezuelan president, the war on terror, and especially the war in Iraq—the premium of Iran's

nuclear ambitions may be at a breaking point. Stratfor has long argued that Iran's nuclear project is essentially only a lever in its back-channel negotiations with the U.S. over Iraq's future, and particularly its ability to threaten Iran. With the killing of Iraqi jihadist Abu Musab al-Zarqawi and the near-simultaneous ratification of the proposed Iraqi government, it appears that most of the interested parties there—including Iran—are on board, diminishing the need for hyped fear.

As tensions ebb, the various premiums will lose their potency, and the oil price should descend. As Stratfor puts it, "With refining capacity slim and with the beginning of hurricane season, the United States may not be able to look forward to a gasoline price crash, but a crude price reduction in some (large) form seems long overdue."

Second, as pointed out in "The Red Dragon: Rising or Falling?" (*Forerunner*, December 2005), the Chinese behemoth appears close to receiving a dose of fiscal reality. China's state-owned banking system has hundreds of billions of dollars in "non-performing loans"—loans given out for political or social reasons rather than economic ones, which will never by paid back. International financial institutions such as Fitch, Standard & Poor's, McKinsey Global Institute, and Ernst & Young all released analyses in May highlighting the enormous bad-loan bubble, and the markets are taking notice.

We should not let the conventional wisdom about China's economy fool us. Stratfor observes, "Size and growth are but two measures of an economy—or of a business. [But they] do not tell you how well it is doing." (Incidentally, this is also true of the U.S. economy.) China's vast, overheated economy is headed for a correction, and many nations will suffer from its contraction.

Finally, Stratfor calls Europe the "weirdest market of all." European markets have seen little or no growth for the past 16 years, and even their financial strongman—Germany—has underperformed over the last year. Inflation across the board is above the maximum level allowed by the EU's treaty. On top of this, an interest rate hike on June 8 will only slow the economy further. Amazingly, in spite of the data, European surveys show consumer and business confidence is on the rise, resulting in assertions that European economies are experiencing a boom. Stratfor views this "irrational exuberance" as a dead-giveaway that the global economy is in a nosedive.

Market reports and forecasts are a dime-a-dozen these days, and this analysis is no exception. While it is impossible to say exactly what the economy may do or when—globally or locally—what is apparent is economic volatility, and potentially, a multitude of economic woes in the near-term.