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Nervousness in Financial Markets

Since the fiscal crisis in Greece became headline news, financial markets – bonds (particularly of southern and central/east European countries), equities, currencies, commodities, etc. -- have been nervous and volatile. Amongst the major traded currencies, the biggest change has been in the dollar: euro exchange rate, which has slipped below $ 1.20. The nervousness also comes from worries about the quality of assets of European banks outside Greece, Portugal and Spain, since they hold private and sovereign obligations of the order of € 2 trillion, of borrowers in these three countries. One recent manifestation of market nervousness was the turmoil caused by some off-the-cough remarks by a Hungarian official. It led to a sharp fall of the exchange rate and worries about mortgage lenders: as much as 60% of Hungary's house mortgages are in low interest currencies like the Swiss franc and Japanese yen, with the borrowers attracted by low interest rates.

Nervousness also arises from the fact that the latest U.S. jobs data are disappointing. These, coupled with the fact that the growth in the core consumer price index over the last 12 months has been just 0.9% -- its lowest rate since 1966, -- are creating worries that the U.S. economy may also be slowing down, at a time when outlook for much of EU is weak despite the fillip given by the far more competitive euro. No wonder the euro dropped early last week, despite the poor jobs data in the U.S. (To be sure, the rate seemed to have stabilised later in the week.)

Another sign of market nervousness is the thousand points drop in the Dow Jones Index of stock prices on the New York Stock Exchange, followed by a six hundred point recovery, ***within a span of 10 minutes on May 6, 2010!*** This seems to be the result of ultra-fast, high frequency, algorithmic trading. Such trading is now estimated to account for as much as 70% of the equity trades in the United States, and uses high speed computers to identify and execute trades in milliseconds (thousandth of a second). (To describe such trades as having been made by “investors” is a travesty.) And, given the ultra fast execution needed for such trades, it seems that locating the computers physically close to the stock exchange, also gives a comparative advantage! The regulators are considering measures to curb such volatility, by imposing circuit breakers. Meanwhile, such trading seems to be catching the fancy of the Indian market as well. Obviously, we have become a “developed” economy!

Meanwhile, Germany has unilaterally acted to curb speculative trades in the eurozone sovereign bond markets – it has banned “naked” short selling of such bonds and of 10 stocks of the largest financial firms. “Naked” in this context means that not only does the seller sell a stock or bond without owning it, but also without borrowing it from somebody else for delivery. (Instead of calming market participants, it seems that their first reaction was “does the German government know about the eurozone sovereign bond markets something that we do not? Is some other country in trouble?”) Germany has also taken steps to ban the use of credit default swaps for speculating on price changes in sovereign bonds. France and Germany have called on the European Commission to follow suit on an EU–wide basis. The German chancellor made her unhappiness with the functioning of financial markets clear while addressing a high level conference on market regulation. She said, “We need the financial industry to be honest with us … If we don’t get honesty, then we might not do the right thing technically, but we will do the right thing politically.” The German Finance Minister made the same point by claiming, “The financial market is only concerned with itself, instead of fulfilling its purpose and financing sensible, sustainable economic growth … We have to change that.”

The bigger issue is that financial markets, driven by a market fundamentalist ideology, have grown much, much faster than global trade or global GDP. One McKinsey study recently estimated that financial assets have grown from $ 12 trillion in 1980 to as much as $ 200 trillion by 2008! The result is that, as Jeffrey E. Garten, professor of international trade and finance at the Yale School of Management wrote recently (Newsweek May 17, 2010), “the financial markets still cast the deciding votes about how things work – in the form of currency movements, bond prices, equity values, and the cost of credit default swaps – ***even more so than the votes of millions of citizens at the ballot box***.” Prof. Garten obviously seems to see this as a positive development. Should the rest of us also? Is this good when measured against the yardstick of “the greatest good of the greatest number”?

The fact is that the growth in financial markets is the result of a very sharp increase in speculative trading. What value does it add to “market efficiency”, let alone to the real economy? -- a point I will come back to next week.

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