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Why markets are losing confidence

Central banks that had pumped credit into the financial markets for the last five years, are now fearfully pulling back.

The world's stock markets are losing confidence. Over the past year, stock prices have soared, with investors anticipating that the collapse in energy costs would guarantee a prolonged period of industrial growth without inflation.

Now, this assumption is being questioned, and the "bull" market in stocks is itself being explained as a byproduct of the unsound credit policies pursued by the central banks of the major industrial countries in recent years.

The new mood of uncertainty has undermined the markets. The U.S. market suffered the sharpest one-week points fall ever in the Dow Jones Industrial Average, in the five-day period up to Oct. 9. European markets are well below the peaks they reached a few months ago.

Only in Japan are stock prices still bidding high. But, there, Japanese authorities are still inflating the market to ensure a good reception for the government's sales of its holdings in Nippon Telephone and Telegraph, the telecommunications corporation, and in Japan Airlines, both of which are slated before the end of this year.

Investors would, by now, probably have seen through the oil price euphoria, but there is another factor which is causing markets to tremble.

It is a factor which stirs unhappy memories of the 1920s.

It is that the central banks, having pumped funds into the financial sectors of their economies—very little of which, predictably, percolated through to finance industrial investment—now appear to be drawing back in trepidation from the overblown credit bubble which they have created.

It was in 1929 that, in similar circumstances of overheated stock markets, the Bank of England tightened its own credit policy and persuaded the United States Federal Reserve to do likewise. That was in May of that year; it was in October that Wall Street crashed.

The Bank of Japan, of all the major central banks, shows the clearest signs of wishing, if it could, to reverse its actions of the past five years. Its reckless policies have led, over that period, to a quadrupling of stock prices.

Even modest two-bedroom houses in Tokyo now sell at $1 million apiece.

The Japanese central bank cannot cut off the supply of credit to the financial sector without risking heavy repatriation of funds by Japanese banks and insurance companies to shore up values in the domestic financial markets.

This kind of capital flow would drive the yen higher, prompting further de-industrialization of Japan as Japanese companies relocate operations in low-cost areas abroad. It would devastate those financial markets, most notably in the United States, which have relied for support on regular infusions of Japanese funds.

If the Bank of Japan could persuade the United States Federal Reserve to tighten its credit policies simultaneously with the imposition of a more restrictive credit regime in Japan, the risks of this disaster scenario unfolding might be lessened.

United States dollar securities would remain relatively attractive to Japanese investors, and the Bank of Japan would have a better chance of cooling down its domestic financial markets in an orderly way.

The only casualties would be United States industry and the less developed countries, both of which would be saddled with higher real borrowing costs.

These arguments are likely to have been presented to the United States representatives by the finance ministers and central bankers of the Group of Seven leading industrial countries at their most recent meeting in September.

This meeting was billed as an important step on the road to restoring order to the world's chaotic foreign exchanges.

Those present, in fact, spent little time discussing this subject, possibly because they know that the situation is beyond remedy and that all they can do now is to seize individually what advantage they can from it.

Instead, the time of the meeting was largely devoted to financial market excesses and the need for higher interest rates. The United States representatives seem to have been persuaded that a hike in interest rates was a necessity, to judge by the subsequent tightening in the Federal Reserve's credit stance.

The stock market's apprehensions are a reliable leading indicator of the troubles that lie ahead for the productive sectors of the economy. A general move toward higher interest rates, when such huge credit imbalances feature in the world financial system, threatens the onset of an industrial depression.

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