Global Credit Ocean Dries Up

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One by one, the eurozone, the Swedes, the Swiss and now even the Japanese, are turning off the tap of ultra-cheap credit that has flushed the global system for the past year, keeping the ageing asset boom alive.

The "carry trade" – as it is known – is a near limitless cash machine for banks and hedge funds. They can borrow at near zero interest rates in Japan, or 1pc in Switzerland, to re-lend anywhere in the world that offers higher yields, whether Argentine notes or US mortgage securities.

Arguably, it has prolonged asset bubbles everywhere, blunting the efforts of the US and other central banks to restrain over-heating in their own countries.

The Bank of International Settlements last year estimated the turnover in exchange and interest rates derivatives markets at $2,400bn a day.

"The carry trade has pervaded every single instrument imaginable, credit spreads, bond spreads: everything is poisoned," said David Bloom, currency analyst at HSBC. "It's going to come to an end later this year and it's going to be ugly, even if we haven't reached the shake-out just yet," he said.

"People have a Panglossian belief in the march of global capitalism but that will change as soon as attention switches back to US financial imbalances," he said.

There were early signs of panic this week when the Icelandic krone crashed 8pc in two days, setting off dominoes in high-yielding currencies of New Zealand, Australia, South Africa, Hungary and Brazil.

The debacle was triggered when the rating agency Fitch downgraded Iceland's sovereign debt, a move that would not normally rattle markets. The new skittishness comes against a backdrop of ever more hawkish moves by Japan and Europe.

"There are several hundred billion dollars of positions in the carry trade that will be unwound as soon as they become unprofitable," said Stephen Lewis, an economist at Monument Securities. "When the Bank of Japan starts tightening we may see some spectacular effects. The world has never been through this before, so there is a high risk of mistakes."

Toshihiko Fukui, the Japanese central bank governor, gave a fresh warning yesterday that this day is near, saying the country was pulling out of seven years of deflation. The economy grew at a 5.5pc rate in the fourth quarter of 2005. In his strongest words yet, he said the bank would act “immediately” to curtail its extra injections of liquidity, preparing the way for rate rises above zero in coming months.

“The moment of truth is approaching,” said Kenichiro Ikezawa of Daiwa SB. In Europe, Sweden raised rates to 2pc this week in the face of an overheated Stockholm property market, while Germany’s IFO business climate index soared yesterday to its highest level in 14 years.

The European Central Bank will almost certainly raise eurozone rates to 2.5pc in March, with likely moves to 3pc by the end of the year.

Most of the world is now tightening, with no sign of a fresh credit window opening to keep the game going. This is new. Japan has had the tap on continuously as the trade exploded over the past five years, while America itself became the source of funds after it slashed rates to 1pc at the end of the dotcom bubble, and held them there until June 2004.

The US Federal Reserve has since raised rates 14 times to 4.5pc in a belated effort to restore monetary discipline, with at least two more rises priced into the markets. It is an open question whether the yen, euro, Swiss franc and Swedish krona carry trades have occurred on such a scale that they have led to over-investment in Latin America and beyond, and compressed US yields, fuelling the American housing boom in 2005 despite Fed tightening.

There are other big forces at work: huge purchases of US Treasuries by Asian central banks, and petrodollar surpluses coming back to the US credit markets. Stephen Roach, chief economist at Morgan Stanley, warns that the carry trade is itself, in all its forms, a major cause of dangerous speculative excess. “The lure of the carry trade is so compelling, it creates artificial demand for ‘carryable’ assets that has the potential to turn normal asset price appreciation into bubble-like proportions,” he said.

“History tells us that carry trades end when central bank tightening cycles begin,” he said. Ominously, almost every bank other than the Bank of England is now tightening in unison.

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