Market Drop Fueled by a Crisis, Anxiety and an Error

MARKET, STOCK MARKET, SELL OFF, DOW, TRADE, STOCK MARKET
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Combine one part nervous traders, one part Greek crisis and one part trader error. Stir in one part central bank complacency. Bring to boil. Panic.

That combination produced one of the wildest days ever in financial markets, with the Dow Jones industrial average, at one point, down almost 1,000 points while the euro sank to its lowest level in more than a year. There were substantial declines in emerging markets, whose economies had seemed to be booming, and in developed markets fearful of renewed recessions.

Even though a substantial part of the worst plunge appeared to be linked to a trader error — one $40 stock fell for a time to one penny — prices had fallen around the world even before such mistakes began to happen.

It appears that investors are again growing more hesitant to own assets like stocks and bonds, particularly since many now cost far more than they did only a few months ago.

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Another sharp retrenchment by investors, consumers and businesses could threaten the current global recovery by choking off financing and new orders for companies.

For much of the last 14 months, the prices of risky assets around the world have been rising rapidly. That recovery, from lows reached in March 2009 amid talk of a new Great Depression, both reflected and encouraged a revival in economic activity. Manufacturers in most countries this week reported rapidly growing order books.

The most recent recession was made in the United States, and to a large extent it was unmade here as well. If it was the subprime mortgage market and other credit excesses that sent markets reeling, it was also a willingness of the American government, including the Federal Reserve Board, to plow in money when fears were at their highest that helped to bring those markets and economic activity back.

For the last several months, worries have been alternately rising and receding that the next crisis would be made in Europe, where Greece has faced the possibility of default. Europe and the International Monetary Fund have announced plans for a bailout, but there have also been riots in Greece amid anger over the steep budget cuts being forced on the country.

On Thursday, Jean-Claude Trichet, the president of the European Central Bank, said at a news conference that the bank’s governing council had not even discussed the possibility of buying government bonds. That was taken as a disappointment by some traders, who had hoped the central bank would follow the Fed’s lead in spreading liquidity around if conditions grew worse.

Instead, fears are growing that Europe, which is worried that the crisis in Greece could be followed ones in Portugal and Spain, will follow the pattern laid down by the United States government in 2007, when officials offered frequent reassurances that the subprime mortgage problem was “contained” but delayed taking the bold action that finally did stop the panic.

The height of panic on Thursday was reached shortly after lunchtime in the United States. First some currencies began to fall rapidly, with the euro suffering especially against the Japanese yen.

That could have been an indication that some large traders were unwinding positions. It has been popular to borrow yen at low interest rates and then use the money to speculate in higher yielding assets denominated in other currencies. Anyone unwinding such a trade would buy yen to repay the loan.

Then, within a few minutes, the United States stock market appeared to be collapsing. Some of the decline was real, but another part of it was simply trading gone awry.

Temporary plunges in the price of **Procter & Gamble** and **3M** , the former Minnesota Mining, cost the Dow about 300 points, and appeared to be the result of errors, not intentional sell orders. Similarly, Accenture, a large consulting firm, fell from more than $40 a share to one penny.

By the close of the day, the Dow was down 347.80 points, or 3.2 percent, to 10,520.32.

There were also substantial declines in most major European and Asian indexes. In Greece, however, the stock market put on a small rebound after falling to a 13-month low on Wednesday.

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Europe faces many obstacles in trying to deal with the growing crisis there. The European Central Bank, which handles monetary policy for the 16 countries in the euro zone, has fewer powers than the Fed does, and there is no Europe-wide government with powers to act quickly. Even now, after months of talking, the Greek bailout has not been approved by all whose approval is needed. The German parliament is expected to approve it on Friday.

Moreover, the American crisis developed before budget deficits spiraled upward. Coming up with cash now would be harder, a fact Mr. Trichet pointed to when he called on European governments to cut their budget deficits.

Spending large amounts of cash to bail out European governments is unlikely to be popular with voters in countries that are not in trouble, but a failure to do so could threaten many financial institutions around the continent.

A traditional way to reduce debt is to devalue currencies, which leaves the outstanding debt worth less. Countries in the euro zone cannot do that, which is one reason Greece is in such difficulty.

But some investors seem to expect that eventually worldwide inflation will form a significant part of the solution, enabling governments and other debtors to pay back loans with currencies worth less than when the loans were made. In the last three days, while the Standard & Poor's 500-stock index has lost 6 percent of its value, the price of 30-year inflation-indexed Treasury security has risen by almost 4 percent.

There is no way to know whether this week's jitters will be put aside as more good economic news is released, or whether Europe's woes will create a repeat of the growing panic that engulfed American markets not that long ago.

In the second case, this could be another one of those times when markets move from one extreme to the other. In the fall of 2008, the collapse of Lehman Brothers sent investors fleeing. The following spring, hopes that the bailouts and stimulus plans were working helped to begin a strong bull market in nearly every asset category.

If this is another turning point, some of the winners will be those who, by luck or vision, managed to sell securities while the selling was easy. On Tuesday, Beazer Homes, a builder that was almost given up for dead in 2009 — when its shares traded for less than 25 cents — managed to raise $350 million selling new shares and new bonds. The money will go to refinance debt that otherwise could have forced the company into bankruptcy.

By the close on Thursday, investors who bought shares at that offering, paying $5.81, had lost almost 10 percent of their money as the stock closed at $5.25.

All this is taking place as the Senate debates financial reform amid considerable public hostility to banks. That no doubt will lead some on Wall Street to say the markets are warning against making regulation too harsh, but the gyrations also serve as a reminder that the efficient markets hypothesis is not a very good model of what actually happens.

Markets turn out to be very bad at assessing values under some circumstances. They were far too optimistic in 2006, and ridiculously pessimistic in early 2009.

That is not a reason to get rid of markets, if only because any alternative, like letting judges and government officials set values, would likely be worse. But it does serve as a counterpoint to the infatuation with markets that led to the creation of a virtually unregulated shadow financial system. Those who believe in regulation will point to that, and say that if this wild ride continues, it will provide further evidence that markets need adult supervision.

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