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U.S. speculation hits European stock markets

by William Engdahl

All major European stock markets have experienced a bizarre explosion of speculative investment, in recent weeks. But far from being a vote of "confidence" in an emerging European economic recovery, the latest rise to historic, new highs in stock prices in Frankfurt, Paris, London, and other markets is a symptom of the unregulated speculative excesses which have grown to unprecedented dimensions in the past months.

According to informed European investment sources, the cash driving the latest stock bubble is not coming from knowledgeable European investors expressing renewed confidence in Europe's imminent economic upturn. Rather, they say, it is coming from American "hot money" speculators, primarily out of what are called mutual funds.

In Frankfurt in early September, the DAX has gone well over 1,940 to again hit the record highs of the months following the euphoric boom after German unification three years ago; France's CAC in recent days has exceeded its all-time record high. London's FTSE-100 stock index just broke a new record of 3,100. In all of these countries the real economy is in the throes of the deepest unemployment crisis and industrial depression since the 1930s. In this respect, autumn 1993 is potentially far more dangerous to world financial stability than was October 1987, when such mutual funds played a relatively insignificant role. Financial "derivatives," including currency swaps and stock index options, have opened the door to rampant expansion of mutual fund speculations globally.

The mutual funds phenomenon

The frenzied rush out of U.S. investments into European stocks and bonds by American mutual funds took on new intensity during August. During that month, the European Community ministers effectively ended the narrow Exchange Rate Mechanism (ERM) monetary cooperation, and U.S. mutual funds doubled the percentage of their funds targeted for foreign investment from 10% of total funds to 20%. The New York Investment Company Institute calculates that in July some $3 billion in mutual funds was placed in foreign stock markets. This would mean that during August, some $6 billion flowed into mostly European markets, a huge inflow of new funds. This has been the trigger for the new market highs.

Mutual funds in the United States have been sucking in record levels of savings as Americans urgently seek new income to replace the lost revenues from bank deposits and other investments under the recent record low U.S. interest rate levels. The funds gain new money as they advertise double-digit gains to customers. Currently, an estimated $30 billion each month is flowing out of bank savings in the United States into such mutual funds. Wall Street estimates that since 1990, when U.S. interest rates began their three-year decline, some $450 billion has gone into various mutual funds, giving them a total value of a staggering $1.8 trillion, more than half the size of the entire U.S. banking system assets. But unlike U.S. bank deposits, mutual fund deposits are not government insured, and are often invested in high-risk areas. Government audits of such funds often only take place once every 4-5 years.

Mutual funds were expanded in the United States during the 1960s in order to attract the small savings of the ordinary citizen into large "pools," which then could buy or sell huge blocks of stocks. The argument for these funds is that by pooling thousands of small investors into special funds, managed by full-time professional investment advisers and strategists, the average person could earn far more on his savings by earning a share of the fund's broad overall investment return in many companies, than if he alone bought or sold stock in a single company. American mutual funds managers are known in financial markets as "hot money" players, who buy or sell on a minute's notice in order to maximize quarterly profits for the fund. They do not patiently hold onto investments for decades, as do, for example, pension funds.

But the presence of U.S. mutual funds in European stock markets is a new phenomenon, and an alarming one. Financial deregulation of the past decade has opened the door to huge international capital speculation inflows (and outflows). The U.S. mutual funds, such as Magellan Fund and Fidelity, have thus made the combined stock markets of most of Europe susceptible to a totally unexpected new danger. Because the funds are notorious for selling on short notice if they sense a market shift, the huge cash inflows into Europe could turn into a record selloff within minutes of the least bit of "bad" news. European bourses have become hostage to the most dangerous speculative investment, largely because of the foolish trend of the past decade, led by former Prime Minister Margaret Thatcher's Britain, to liberalize international capital flow controls and deregulate financial markets.

Alarm bells ring

This is the background to an unprecedented series of warnings appearing in the pages of some of Europe's leading

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financial dailies in recent days. Most notable has been the conservative Zurich, Switzerland bankers' daily *Neue Zürcher Zeitung.* For more than three weeks, the paper has run article after article with alarmist titles, such as "Warning of a Fall in the Stock Markets!" or other articles about phenomenal U.S. mutual fund growth, referring to the fund strategy as being, typically, "short-term and high-risk."

The Swiss banking community, one of the more sophisticated internationally, knows quite well the nature of the new speculation danger which threatens Europe's markets. The Zurich paper on Sept. 3 warned that the entire edifice of international speculation from the U.S. mutual funds was predicated on the difference in international interest rates and profits tied to such interest rate levels. "A 1% increase in interest rate levels of the U.S. 30-year Treasury bond," wrote the *Neue Zürcher Zeitung,* "would translate into an estimated liquidation of some 12% of investments in mutual funds. This in turn would translate into a fall of 455 points in the Dow Jones Industrial Average."

Detonating a panic

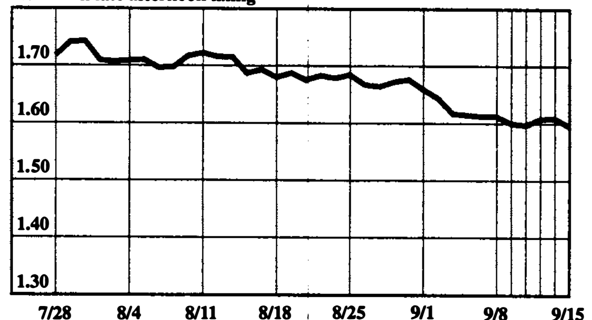
Today the Dow is at a high-water mark above 3,600, so the fall would be more than 12%. But this would not occur in isolation, and with the highly leveraged world of today's stock index futures and other derivatives, such a fall would detonate a panic selloff unlike even that of October 1987 when the Dow lost 30% in one day. Similar potential for a crash obviously now is building in the overheated European stock exchanges.

In this connection, a new study from the International Monetary Fund, "Monetary Policy, Financial Liberalization and Asset Price Inflation," is most remarkable, not the least because it comes from an institution whose policy for the past decade has been to promote the most destructive "free market" deregulation of national economies in the Third World and eastern Europe. The IMF study is sharply critical of the process of financial market deregulation of the past decade, asserting that governments, notably that of the United States, were "not fully prepared for the consequences of deregulation, and thus ignored until it was too late the fact that their deregulation of financial markets triggered an "asset price inflation" in Japan, North America, and much of Europe, including notably in real estate in the United Kingdom and in Scandinavia.

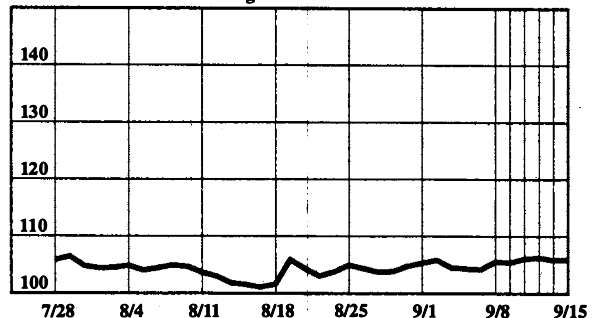
Central banks, says the IMF study, focused on traditional indicators of "inflation" which took no account of "asset price inflation," thus failing to halt the growth of the worst speculative bubble in history in real estate, stocks, and bonds. "The speed and scope of financial deregulation resulted in excessive risk-taking . . . [creating] systemic weaknesses arising from the insolvency of financial institutions." Certain sober European observers clearly worry that derivatives have brought the excesses of the U.S. financial system during the 1980s into Europe with a new vengeance.

Currency Rates

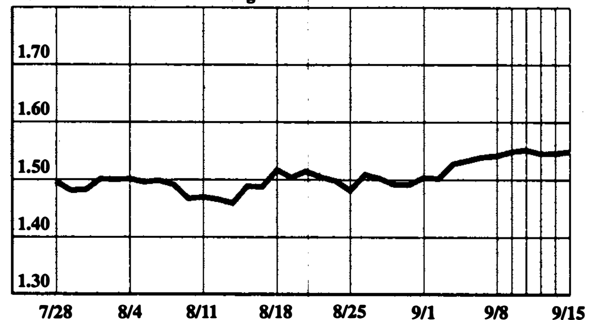
The dollar in deutschemarks
New York late afternoon fixing



The dollar in yen
New York late afternoon fixing



The British pound in dollars
New York late afternoon fixing



The dollar in Swiss francs
New York late afternoon fixing