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Mexico shock waves hit European currencies

by William Engdahl

Following on the heels of the collapse of the Mexican peso in the first days of January, shock waves from the Mexico crisis crashed over what had been almost eight months of currency stability in Europe. Immediately, the three most debt-laden countries of the 15-nation European Union became the targets of a massive foreign selloff, plunging the Spanish peseta, the Italian lira, and the Swedish kroner to new lows against the strong German mark.

In Spain, concern over political stability coupled with growing nervousness from international fund managers after the 40% collapse of the Mexican peso early in January, brought the Spanish peseta to within a hair of its allowable limit under the rules of the European Rate Mechanism (ERM), the mutual support pact among 12 of the 15 European Union (EU) countries to support one another's currencies should they fall below or rise above 15% of the current median. It marks the most severe test of the ERM since August 1993 when the EU central bank governors and finance ministers voted to widen the bands to 15% from earlier tight levels of 2.5%, and thereby took away the speculative target from hot money funds such as George Soros's Quantum Fund.

Italy's lira nearly went into a free-fall in the first days of January, fueling the political chaos which forced the government of Silvio Berlusconi to resign on Dec. 22, 1994, leaving the political future of the country in doubt. The lira has fallen 6% against the deutschemark since mid-December when the government was forced to resign. Since the first major crisis of the lira in August 1992, shortly before Italy was forced to leave the ERM, the lira has fallen by 44%. While this makes exports of Italian machine tools and autos extremely competitive across Europe, it has had devastating effects on foreign investment needed to finance Italy's out-of-control public debt.

The Swedish kroner started a new round of collapse on Jan. 10, as the incoming Social Democrat government of Ingvar Carlsson presented its austerity budget; the proposed budget had a far less aggressive budget deficit reduction approach than that demanded by international financial investors. Sweden's government is heavily dependent on foreign borrowing to finance its huge deficit. The U.S. credit-rating agency Moody's announced that it was downgrading Swedish public debt, which sent the kroner falling and Swedish interest rates rising as international investors rushed to liquidate their Swedish bonds to forestall further losses.

Prospect of state default

The sudden shift to pessimism over the economic prospects of these European countries, whose currencies have been termed by one London currency trader as "basket case currencies," is directly tied to the shock effect on the world financial climate since the Mexican crisis erupted on Dec. 20. "Overnight, fund managers in London, New York, and other centers reversed their attitude. Last year and before, they were so eager to get high interest rate returns that they flooded the world looking only at interest rate levels, ignoring country risk," noted Andrew Smith, a strategist with a leading London bank. "Since the peso crisis, suddenly 'high-yield' has been changed into the words 'high-risk' for these bank and fund managers. The watchword is caution, retreat into quality, safe havens like the German mark, the Japanese yen, or the U.S. dollar."

In 1994 alone, according to data compiled by the Washington Institute for International Finance, fully $170 billion of capital flowed out of the industrial countries, mainly the United States, and into so-called "emerging markets" or places with high yields such as Sweden, Italy, and Spain. As that money is being pulled out, made possible by the global financial deregulation of the past decade which forbids nations from defending their currency by imposing controls on exchange, the currencies are falling in the wake.

The 'debt-trap'

But an entirely new focus of concern is beginning to emerge about the situation in major industrial countries like Sweden. Those countries, as is the case of Canada in North America, had allowed their national debt to build to staggering levels during the oil and interest rate shocks of the 1970s and up to the present. The consequence is a level of national expenditure merely for interest rate servicing of the public debt which is larger than any other budget item.

Calculations are being made frantically in banks and investment firms in New York, London, and elsewhere to evaluate each country and its debt risk. For Italy and a handful of industrial countries, the ratio of public debt to overall economic output has grown so large that almost all national savings are consumed for debt, leaving little room for investment in the real economy. Economists refer to the situation as a "debt-trap," that is, when a nation's ratio of debt to Gross Domestic Product is so high that non-debt-related government spending cannot be cut enough to cover rising costs of interest on that debt.

Italy today has a level of public debt equal to 112% of its annual GDP, a total of $1.2 trillion, far the largest in all Europe and approaching the $4.4 trillion level of U.S. debt.

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But even more dangerous, like Mexico in recent months, the Italian government has been forced more and more to resort to short-term debt to finance its huge annual deficits. In January alone, Italy must refinance some $60 billion in such short-term debt. With the value of the lira falling amid political instability, the danger is that any added Banca d'Italia (central bank) interest rate rises to stabilize the lira would send the costs of interest on the debt spiralling out of control. Already, the government must budget $100 billion annually for debt service.

Not surprisingly, international financial firms such as Barclays and S.G. Warburg in London, and Salomon Brothers in the United States, are demanding that Italy's government impose draconian budget reduction and radically reduce its annual $50 billion deficit in public pension funding, as a precondition for any more foreign investment into Italian government bonds. The new government of Lamberto Dini, assuming it even gets approved by parliament, faces demands to impose an added $42 billion in budget cuts within the next several months, or face what some financial analysts warn could be a state default, à la Mexico in August 1982.

Risks outweigh the rewards

In Sweden, where since 1990 the economy has been deep in the worst depression since the 1930s, the budget deficit has ballooned under the combined costs of state bailout of the bankrupt banking system and the soaring state costs of unemployment insurance. Fully 13% of the workforce is unemployed, up from only 2% in 1988. This year the total Swedish state debt will exceed 90% of GDP, some $175 billion, and the estimated budget deficit will be SKr 189 billion ($29 billion). With such an exploding debt burden, the government has been forced to pay 11% or more to sell its bonds to international investors, further adding to the soaring budget deficit.

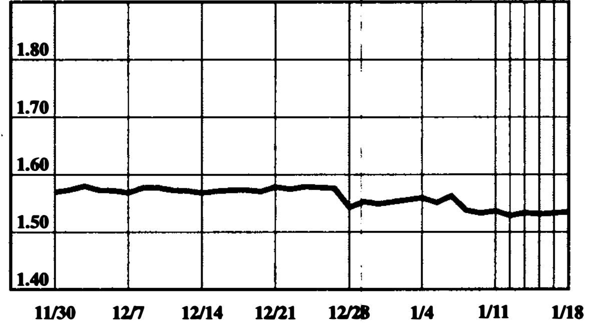
Last August, just days before national elections, Skandia, the country's largest insurance company and a major buyer of bonds, announced it would buy no more Swedish bonds until it was convinced that any new government was going to take draconian steps to cut the deficit. Since the 1970s, Sweden's traditional industrial economy has shrunk, while unemployment was absorbed into a huge public service sector. Today Sweden's public sector is 70% of GDP.

Spain is only slightly less grim in fundamentals, but there is a political crisis in the 12-year reign of Socialist Prime Minister Felipe González. Spain today has a public debt equal to 42% of GDP, but after the Mexico crisis, foreign investors began to liquidate their Spanish bonds, forcing interest rates up to 12%, a rise of 4% since January 1994. Reports from European bankers are that, amid a wave of political scandals which could topple the González government, nervous U.S. and British fund managers have decided that the risks of investing in Spanish debt outweigh the rewards.

Currency Rates

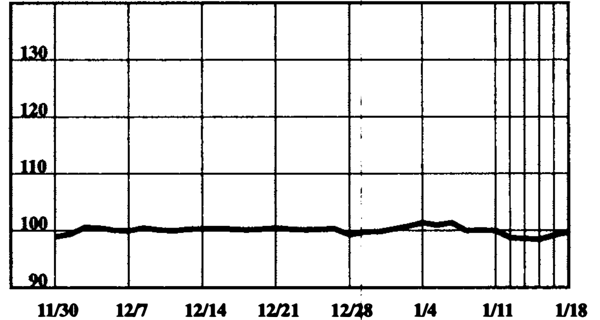
The dollar in deutschemarks

New York late afternoon fixing



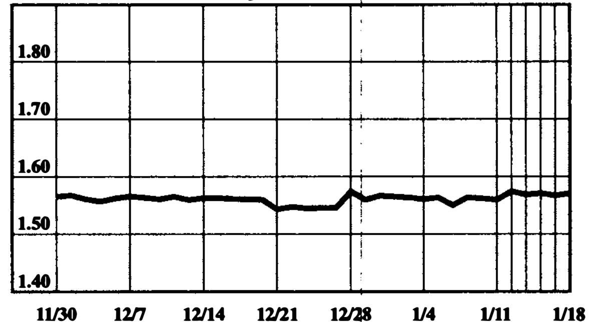
The dollar in yen

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