

Panic in the world's bond markets could pop the speculative bubble

by William Engdahl

During the last ten days of February, the world's major bond markets have been in what traders describe as "near panic selloff," in the sharpest decline since the bond market collapse of February-March 1994. According to informed financial market sources, the speculative bubble in world bonds, which had grown to staggering size in recent months, was a result of the effort of the Bank of Japan and the Japanese government to prevent a systemic collapse of the Japanese banking system, by injecting almost cost-free credit, in nearly unlimited sums, into the Japanese financial system since last summer. The Official Discount Rate of the Bank of Japan, the rate at which banks can borrow, went to an historic low of 0.5%. With the Bank of Japan printing yen at a record pace since September 1995, the classic ingredients for a new financial molotov cocktail were at hand.

"What has been driving the record levels of speculation in U.S. and European stock and bond markets since last autumn," observed Stephen Lewis, a leading London bond analyst, "has been the easy credit policy in Japan. Especially speculative hedge funds, like George Soros's Quantum Fund, have gone into Japan and made huge loans at 0.5% or so in yen, sold the yen for dollars or marks, and invested in bonds or stocks that pay many times that interest rate."

The risk was that the concerted Japanese effort to push the overvalued yen down against the dollar, and thus boost Japanese exports, would begin to fail, and the yen would again rise. "Two weeks ago it began to unwind," Lewis noted. "The yen suddenly rose from Y 107 to Y 104, despite Bank of Japan intervention to keep it down."

Losses for the high rollers

That yen reverse apparently triggered a financial debacle for the highly leveraged speculators like Soros. To avoid losses should the yen rise even more, they were forced to sell dollars and buy yen. That, in turn, increased the pressure. Then, on Feb. 15, Japanese Finance Minister Wataru Kubo made a statement which created panic in the world bond markets. He said that the record low interest rates in Japan were "affecting the lives of elderly people living on pensions. It is important that we take them into consideration in making monetary policy." Speculators had bet that Japanese interest

rates would remain so low at least until 1997.

Despite Kubo's immediate denial that Japan was about to raise interest rates, financial markets went into panic. Large holders of U.S. and European bonds, who had bought the securities on cheap money borrowed in yen, began selling.

According to reports in the Feb. 25 London *Sunday Telegraph*, the world's largest hedge fund speculator, George Soros of Quantum Fund, who claimed to have won \$1 billion in September 1992 speculating against the British pound, had recently gambled on falling U.S. interest rates and a rise in U.S. bond prices, as well as a further rise in the dollar against the yen. When just the reverse took place, Soros reportedly took a loss of \$1.6 billion.

The confirmation for many of a global bond market panic was sounded in the Feb. 22 *International Herald Tribune*, which interviewed William Gross, manager of the world's largest bond market mutual fund, the \$65 billion Pacific Investment Management Co. (PIMCO) of California. Gross declared that bond investors now feared that their bond investment would be devalued by the concerted push by major governments, from Japan to the United States to the European Union, to inflate their way out of the present economic crisis by printing huge sums of money. In these circumstances, Gross commented, "it is time to bail out."

The comments by Gross, one of the most optimistic investors in bonds in recent years, reportedly triggered an avalanche of selling, which, because much of the bond market speculation was made in borrowed money, itself triggered more panic selling to cover growing losses.

'Unprecedented scale' of speculation

Commenting on these developments, on Feb. 25, the London *Financial Times's* financial commentator, Barry Riley, asked, "Would the shake-out prove to be just a dress-rehearsal for the next global financial crisis, or would it turn out to be the real thing?"

Noting that indications were that the worst might be over for the moment, Riley cautioned, "Such speculation [in global bonds, stocks, gold] . . . is not in any way new. But its scale

is unprecedented. Funds running into trillions of dollars are now dedicated to short-term position-taking in markets around the globe. The key gamblers include the notorious hedge funds, the proprietary trading desks of banks and global bond and currency funds.”

Riley, like Lewis and other analysts, identified the reflation policy of the Bank of Japan as at the heart of this latest manifestation of the global financial bubble. “Since September,” Riley noted, “the Bank of Japan has been holding the U.S. dollar above Y 100 through massive intervention on foreign exchange markets, and by printing money fast enough to hold Japanese interest rates at 0.5%.”

But in their effort to prevent full collapse of the fragile Japanese financial markets, the Japanese authorities inadvertently destabilized financial markets in the rest of the world, from South Africa to Germany, and above all in the United States, where interest rates on 30-year bonds rose at an alarming rate from 6.01% in mid-February, to 6.48% by Feb. 28—a huge increase.

The broader impact

But, as large as these bond markets are, the danger is not limited to them alone. Rising interest rates are the consequence of having more bond sellers than buyers on a given date. If those rates continue to climb, in Europe as well as the United States, the falling levels of real economic production will turn, in the coming months, into a full-scale depression, as the 30-year process of financial deregulation and speculative buildup, at the expense of real economic investment, can no longer be sustained. The recent collapse of Europe’s largest shipbuilder, Bremer Vulkan, is merely a hint of what would follow.

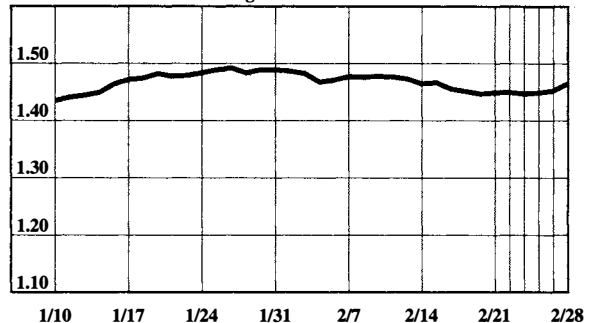
Given the heavy Japanese investment in the United States’ bond and stock markets, by far Japan’s largest foreign investment markets, the potential consequences of a major crisis in the yen at this point would immediately threaten a chain-reaction collapse of not only the \$3.5 trillion of bonds traded in the U.S. secondary market, but, under rising interest rates and a worsening economy overall, the hyperinflated Dow Jones and other major stock market levels would likely collapse in chain-reaction. The total market value today of all stocks traded on the New York Stock Exchange is a staggering \$6 trillion.

A simultaneous collapse of both U.S. bonds and stocks would, in turn, most certainly lead to wholesale liquidation of some \$1 trillion of American stocks and bonds held by foreign central banks and investors, which, in turn would trigger what is being called in Europe the ultimate “financial Chernobyl” scenario on global financial markets. Little wonder that financial investors have been more than nervous in recent days. As Riley cynically concludes: “The world’s financial centers are full of worried gamblers weighing their options. How long have they got before the real crisis hits? No problem: Each one will hit that panic button first.”

Currency Rates

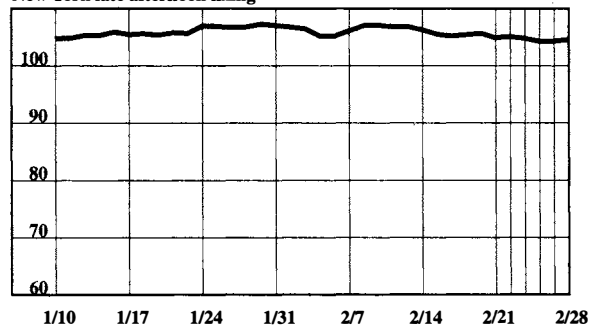
The dollar in deutschemarks

New York late afternoon fixing



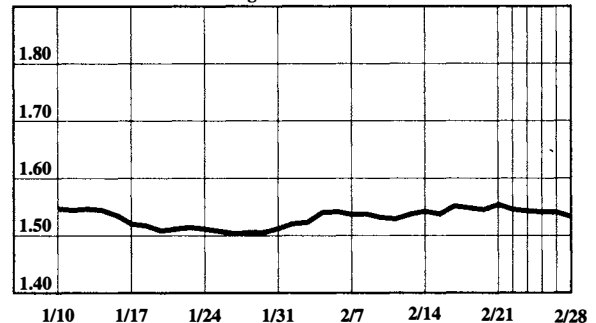
The dollar in yen

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

