New flight-capital wave 'stupendous'

The inside story on how portfolio managers profit from "arbitrage" between long- and short-term instruments.

The continuing European central bank "interventions" on foreign exchange markets are not serious attempts to stem the rise of the U.S. dollar at this time. The Swiss central bank, which is synonymous with the Nazi International-controlled Bank for International Settlements, was actually *buying* dollars this week, to drive the German mark downward in line with the collapse of other European currencies.

For the short term, the net effect of these central bank "pokes" in currency waters has probably been little more than to cheapen the cost of dollar purchases for the investment managers of the European private investment funds who are now running a large round of flight capital into the United States. The central banks are setting up Europe for a massive new round of devaluations and loss of purchasing power.

In the meantime, the managers of the powerful family fortunes (*fondi*) are raking in extraordinary earnings through a process of "arbitraging" transfers of old and new flight capital inflows into the United States, shaving off the difference between last year's long-term investments and this year's short-term investments.

How does this work?

In discussions with New York bankers who work with European investment managers, *EIR* has traced the step-by-step investment strategems the *fondi* managers have pursued since August 1982, the turning point in the Ibero-American and world-debt crisis in large part, what the *fondi* managers have done is to take advantage of the opportunities for arbitrage which have been created through the process of deregulation of U.S. financial markets since 1979. A not-so-visible effect of such deregulation—that is, of the creation of what is often called the financial supermarket—is the way deregulation "pools" the gross resources of the U.S. financial system.

For the European flight capital investment houses, this means that they are virtually guaranteed a buyer for any paper which was good last month but which may no longer be a premium investment. Thus, the "risk" to the foreign investor of playing with very large sums of money is greatly reduced—especially when the sheer profit earned on the rise of the U.S. dollar is calculated into the earnings evaluation.

When the Ibero-American debt crisis hit last year, some $10 billion plus in European flight capital came into the United States, "piggybacking" on the much larger flow from panicked Latin American investors. Under the pressures of this "flight to quality" and the shortage of U.S. dollars to finance debt payments worldwide, the dollar gradually appreciated, guaranteeing a higher return on those investments. However, U.S. interest rates were under 10 percent for most of that time.

Thus European investment houses concentrated their dollar investments in the longer-term bond market. According to an informed Wall Street source, however, these bond purchases were *not* made with intent to accrue earnings off the bond coupons. What the foreign investors were primarily interested in was the *short-term* resale potential of big-name U.S. corporate bond issues. "The name of the game," the source emphasized, is "portfolio management."

The same source indicated that in approximately early June, the managers of European flight capital transactions began to put out the word that until U.S. rates went up again, they would yank their money out of the United States. "A leading West German investment fund, which placed $1 billion in U.S. corporates in 1982, estimated that they had probably earned everything they possibly could, and that unless interest rates start rising, there is no reason to keep their money here."

Uncertainty over U.S. rates prevailed until late July, and in that period a certain amount of foreign investment was indeed pulled out of the United States. Swiss bankers say some of these funds ended up in Italy, where supporters of Italian Prime Minister Bettino Craxi have come to the conclusion that this is a great time to buy into the Italian stock market, in order to support the neo-Fascist reorganization of Italian industry.

However, once Paul Volcker was reconfirmed as Fed chairman, and U.S. rates took off, the outflow from the dollar ceased. A new round of funds, plus last year's cashed-in investments, is being placed, we are told, primarily in the stock market; flight capital will only start moving into money market instruments if money market rates go well over 10 percent.

What permits the "cash-in" of earlier investments and removes the risk on such transfers, is the immense rise in deployable, reserve-free liquidity in the U.S. financial system overall as a result of banking deregulation.