



Highly contagious

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Stockmarkets have plunged nearly everywhere, in seeming disregard of national economic prospects. Is there a new global virus in financial markets?

THE half-point cut in interest rates by America’s Federal Reserve on March 20th was the third such cut this year. By past standards that counts as pretty aggressive monetary easing, but it does not seem to have satisfied stockmarket investors, who had hoped for a bigger cut. After the Fed’s decision, Wall Street fell again, leaving the S&P 500 index down 27% from its peak last March. The Nasdaq has now lost more than 60% of its value. Moreover, the bears are out all over the world.

In the week before the Fed’s rate cut, no fewer than 38 of the 40 stockmarkets tracked by *The Economist* fell. This week, 32 of them slid again. It is understandable that America’s overvalued stockmarket should plunge once its economy started to slow. Likewise, the 35% fall in the Nikkei 225 over the past year reflects the sickly state of Japan’s economy. European economies, on the other hand, are meant to be in much better shape. Household savings are comfortably high, and private-sector debt is more modest than in America. Though business confidence is dented, notably in Germany, a recession in Europe is not expected. Yet many European stockmarkets have fallen further from their peak last year than American shares (see table). Why the hammering?

Some economists think a new form of financial contagion is spreading, via stockmarkets, in a way similar (if slower) to that in which Asia’s financial crisis in 1997-98 infected one economy after the other. If stockmarkets tumble in even healthy economies, then business and consumer confidence there can be hurt. Where American recessions used mainly to affect the rest of the world through trade, stockmarkets are now perhaps a more powerful channel.

There seem to be three main reasons for the plunge in European shares. One is that some European stockmarkets had climbed higher, and possibly become more overvalued, even than Wall Street. Between January 1995 and its peak last year, the S&P 500 rose by 233%; in local-currency terms, the markets in Germany and Sweden rose by 286% and 372%, respectively. (In dollar terms they rose somewhat less.) A year ago, the Nasdaq’s valuations did indeed look crazy. But the price-earnings (p/e) ratios of European high-tech shares looked crazier still.

Fallback Stockmarkets	% change Jan 1st 1995 to 2000 peak		% fall, 2000 peak to March 21st 2001
	Local currency	\$ terms	\$ terms
United States	233	233	-27
Japan	6	-1	-46
France	251	127	-27
Germany	286	162	-35
Italy	245	179	-30
Sweden	372	299	-50
Britain	126	133	-29
Canada	170	157	-37
Source: Thomson Financial Datastream			

In part, this was because the choice of “new economy” shares was more limited in Europe than in America, while the demand for those shares at home was strong. Peter Oppenheimer, a strategist at HSBC, a global bank, calculates that (at their peak) high-tech shares in Europe were discounting an average real profit growth over the next ten years of 19% a year. That compared with 14% real growth for American high-tech shares. So it is hardly surprising that European stockmarkets have since tumbled.

But though the gap has closed, high-tech shares still seem to be discounting slightly faster profit growth in Europe than in America. For the broader market, shares in Europe now look more attractive than those in America, with lower p/e ratios.

A second reason why European shares seem to have parted from their underlying economies is that many large, European companies are exposed to demand in America. In 1999, for instance, 21% of the sales of European firms went to the Americas (north and south), up from 16% in 1998. Last year, that share was no doubt higher still, given the buying spree that European firms have enjoyed in the United States. According to Morgan Stanley, sales of European companies’ American-based affiliates were four times as big as their exports in 1998 (the latest figures available). Now those sales are being squeezed. Figures from America’s Department of Commerce show that the income of European firms’ American affiliates fell by 20% in the year to the fourth quarter of 2000.

European firms’ profits are also exposed to swings in the exchange rate of the euro against the dollar. Until now, the dollar has been strong. But if America actually went into recession, the greenback might weaken. That, in turn, would reduce the dollar profits of European firms when converted into local currency. Europe’s multinationals are far from being immune to America’s slowdown.

The third factor in the fall in European share prices is the longer-term evidence that stockmarkets are becoming more correlated with one another (see [article](#)). Research by William Goetzmann, an economist at the International Centre for Finance at Yale University, shows that during the 1990s the correlation between American and European share prices rose to its highest this century—except for during the Great Depression.

Some increased correlation is the inevitable effect of greater cross-border movements of capital and technology. Yet in times of crisis, correlations tend to get closer. Current unease in financial markets has eroded investors’ appetite for risk, encouraging them everywhere, not just in America, to shift from equities into safer bonds. And in America, as share prices tumble, the risk models used by financial institutions also force them to sell overseas equities to reduce the overall riskiness of their portfolios. This also helps to explain the otherwise puzzling rise of the dollar of late.

Chain reactions

Not only do stockmarkets move more closely together these days; worldwide, stockmarket capitalisation counts for more, as a proportion of world GDP, than it used to. The \$10 trillion of paper wealth that has been destroyed worldwide over the past year accounts for about 30% of world GDP. Never has so much been lost in such a short time.

Still, stockmarkets are only one of several new forces of potential contagion in a more globalised era. Traditionally, standard economic models judged the likely impact of an American recession on the rest of the world by focusing mainly on trade links. Today these models should worry Mexico and Canada, whose exports to America account for one-quarter and one-third of their GDP respectively. But Europe is relatively immune, through trade links, to an American recession. The EU’s exports to America account for less than 3% of its GDP. However, as indicated above, this understates Europe’s true exposure to the American market.

Another new way in which conventional trade links may underestimate the worldwide impact of an American downturn is the world-girdling supply chain in information technology (IT). East Asian economies, which are big IT producers, may be particularly exposed. America’s boom in IT spending pulled in lots of imports from Asia, and helped the region to recover from its crisis in 1997-98. But as America’s boom turns to bust, IT imports are likely to collapse, hitting Asia harder than in past American downturns. Growth forecasts through the region are being chopped. South Korea’s GDP actually fell in the fourth quarter.

According to Andy Xie, at Morgan Stanley in Hong Kong, IT equipment accounts for well over half of Taiwan’s

and South Korea's exports to America and 80% of Malaysia's. The bank forecasts that growth in America's total imports will slow from 14% last year to only 1% this year. That would be the sharpest deceleration in import growth in almost two decades. The slump in America's imports of IT equipment will be even sharper. Recent Asian data suggests that the region's exports of IT equipment to the United States have already fallen by 15% over the past year. Japanese firms are also slashing their IT budgets. America and Japan together account for almost half of East Asia's total exports. It is through the complex of cross-border IT supply chains, and through more integrated financial markets, that a more virulent sort of global virus might travel.

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