Swiss banks warn of 'worst financial crash in history'

by David Goldman and William Engdahl

The spokesman for the bank which led the creation of the unregulated offshore $1.8 trillion Eurobond market told the Swiss Bank Association on March 18, "We face a global crash like never before in history," because bankers have no idea of the liabilities they are incurring in deregulated world financial markets. The statement by Crédit Suisse director Hans-Joerg Rudloff came as

1) The U.S. Federal Deposit Insurance Corporation announced that it had lost money in 1986 for the first time in a quarter of a century (it sold assets to fake a small profit);

2) The FDIC revealed that one out of five American banks lost money in 1986, and that 1,400 of them were on the danger list;

3) Citibank, America's largest, announced that it may put Brazilian loans into non-accruing status;

4) Japanese banks announced that they would begin to put Ibero-American loans into the "garbage can," namely a separate company based in the Cayman Islands;

5) Negotiations for an emergency bailout of the bankrupt Federal Savings and Loan Insurance Corporation collapsed over Texan opposition to the FSLIC's "Gestapo" policy of shutting down community banks throughout the oil belt; and

6) Franz Heinrich Ulrich, the ex-chairman of Germany's largest bank, Deutsche Bank, committed suicide, following revelations about Europe's largest-ever fraud, the $225 million Volkswagen currency loss.

How the crash of 1987 will happen

The London *Financial Times* reports that the remarks of Hans-Joerg Rudloff, manager of Crédit Suisse and vice chairman of the world's largest Eurobond dealer, Crédit Suisse First Boston of London, have angered bankers who say he should not have "blown the whistle so loudly." Rudloff said that deregulated financial markets had gone beyond the control of any national regulatory authorities, citing such recent scandals as the Volkswagen currency fraud, the Stockholm city pension fund financial fraud, and the collapse of the commercial banks' floating-rate notes on the international market, as danger signals.

EIR reported in December 1986 that a mini-run against bankers' own obligations was emerging on the London-centered Eurobond market, reflecting a collapse of confidence in the banking system. During the week of March 16, London Eurobond traders reported that the Japanese were dumping the Perpetual Floating Rate Notes issued by British commercial banks. Japanese banks hold an estimated 60-80% of the total $50 billion market of Perpetual Floating Rate Note paper, of which $17 billion was issued by commercial banks. Last Dec. 4, trading was virtually suspended on almost $17 billion of floating-rate notes (FRNs) in London, when the Japanese pulled out of the market. One among many forms of "creative securities" that have proliferated during the past several years, perpetual FRNs, are a device through which the major banks have borrowed to meet capital requirements set by regulators.

Faced with a trillion dollars of bad Third World debt, and hundreds of billions of dollars of bad loans for oil, commodities, shipping, real estate, and related purposes, the major banks issued capital notes whose interest rate changes with the market, but whose capital will never be repaid—hence, "perpetual" notes.

By the middle of March, the entire $160 billion market for "conventional" floating-rate notes, i.e., notes which pay back principal as well as interest, disintegrated. Dumping was triggered by U.S. banks, "forced to sell their paper because of the Brazil and related debt problems. But because the Japanese were absent, there was no major buyer for their paper," one Eurobond trader explained. "Everyone is holding their breath and hoping the paper soon becomes tradeable."

"The professionals are so nervous about holding inventory that they will sell at any price," one U.S. bank official was quoted by Reuters on March 14. The recent trading, described as "panic trading," was concentrated in dollar-denominated notes in the banking sector, called "conventional FRNs." This market is some 10 times larger, an estimated $160 billion, than the "perpetual FRN" market which has been in deep crisis since late last year. Traders say the latest panic selling is related to increased worries over bank exposure to Ibero-American debt. The two-day rout was reportedly triggered by "aggressive selling by a few leading U.S. investment banks of paper they did not actually own."

Commercial banks now hold untold trillions of various types of tradeable paper, such as the "floating-rate notes" whose value is now collapsing on the open market. If a few of them run into serious liquidity trouble, and must liquidate their paper, then the others must step in and pick up the paper—or the collective value of their assets will collapse. Now that the Japanese (whose foreign assets this year will exceed $500 billion), the biggest players, have given up on the game, that is precisely what has happened.

It is no surprise that Rudloff fears the greatest crash of all time; a 20% drop in the value of such paper would hurt the bankers more than the repudiation of all of Ibero-America's debt combined.

Central banks outgunned

Rudloff's warning makes nonsense of the common argument that the central banks will step in to bail out endangered institutions, thereby avoiding a 1930s-style crash. The entire purpose of "securitization," as the central banks complained loudly, was to put the market outside their grasp. Commercial banks' "off balance-sheet liabilities" (guarantees of various kinds) now exceed $3 trillion—10 times the combined reserves of all the world's central banks! After years of subverting normal central-banking standards of bank capitalization and solvency, the banks vastly outweigh their supposed "lender of last resort." If the central banks attempt to bail them out, they will go down as well.

Rudloff has acknowledged the point at which so-called securitization, i.e., the substitution of tradeable paper for book loans, has produced a generalized financial panic. Securitization took off in 1984, after the collapse of the $20 billion Continental Illinois Bank of Chicago. Like most major commercial banks, Conti turned over roughly 40% of its deposits on an average business day, and depended heavily on foreign deposits to fund its loan portfolio. The bank was doomed the moment large depositors, most of them from overseas, decided to pull their money out. The same banks which had "recycled" several hundred billion "petrodollars" during their 1970s heyday, discovered they were vulnerable to deposit runs that could drain them overnight.

While the Federal Reserve and the Federal Deposit Insurance Corporation found the means to contain the crisis at Continental Illinois, it was less clear that they could do so twice, let alone 5 or 10 times.

The bankers pulled in their horns, and major overseas depositors—drug dealers, OPEC countries, multinational corporations—subscribed to telex services monitoring the major banks, purporting to warn them the moment that their deposits might be in danger. Meanwhile, illegal capital flows increased at the expense of legitimate world trade. While world trade fell back to 1978 levels, the volume of the international drug traffic rose from about $200 billion then to over $500 billion today, not counting additional scores of billions of dollars deriving from flight capital, tax evasion, and other slightly less dirty money.

Over $200 billion a year in Eurobonds replaced what had been, before 1984, an equal volume of bank loans. The banks figured that if they had tradeable paper, they could always sell it on the market if money became tight. Loans on their books, by contrast, were not nearly so liquid. "Securitization" has a big disadvantage, however: Banks can effectively lie about the quality of loans on their books, hoping to collect on them at some future point. If the loans are tradeable securities, the mere anticipation of trouble can collapse their open-market value—and collapse the value of banks' assets, plunging them into instant insolvency.

Police-blotter economics

It is no accident that the shift from commercial banking to speculation in the market-value of traded paper, produced a wave of financial scandals. There is a thin line between "normal" speculation, in a market where $600 billion of futures and options, $400 billion of currencies, $120 billion of U.S. government securities, $800 billion in bank deposits, and so forth, change hands every day, and criminal fraud. When everyone is broke, bankruptcy takes the form of outright scandal.

Following the mass arrests of Wall Street "insider traders, the March financial scandals included, so far:

1) A $225 million foreign-currency loss at Volkswagen AG, West Germany's largest automaker. VW was allegedly swindled, with funds reportedly laundered through the Frankfurt branch of the National Bank of Hungary;

2) The collapse of the City of Stockholm pension fund, after a fund manager invested $80 million in sundry speculations. The entire loss was reportedly run up in only two months, before being detected by authorities.

3) Three top officials of the Berliner Bank, one of West Germany's largest, were fired after "gross irregularities" were discovered at the bank's Stuttgart branch. The firings came the same day that Stuttgart-based Daimler-Benz was forced to deny rumors that it has suffered major losses in foreign exchange dealings.