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Foreign Exchange by William Engdahl

Wall Street plays with fire in Japan

U.S. speculators hope that the crisis on the Nikkei stock exchange will force Japan to keep financing U.S. deficits.

When U.S. Treasury Secretary Nicholas Brady told his Japanese counterpart, Finance Minister Ryutaro Hashimoto, during their March 24 consultations in California, that the United States regarded the current Japanese monetary and financial crisis as a Japanese "domestic problem," he may well have detonated the financial equivalent of Pearl Harbor.

On Dec. 29, 1989, Tokyo's Nikkei Dow stock index hit its all-time high of 38,916 yen. It had soared 12% since mid-November alone. But certain people in Wall Street were preparing for the fall even then. According to banking sources in London and Paris, Salomon Brothers helped the last burst of the Nikkei late in 1989. It had introduced an exotic Wall Street innovation into the Japanese financial markets: "index arbitrage" or "computer program trading." The practice was implemented by Goldman Sachs, Salomon, Morgan Stanley, and other big Wall Street players in the weeks leading up to the spectacular Oct. 19, 1987 Wall Street crash.

A few months ago, Salomon and Morgan Stanley and friends brought their new toy to Tokyo to play with, and helped trigger the worst prolonged stock market crisis in postwar Japanese history.

Beginning last May, the Bank of Japan, like its counterparts in Europe, began to become alarmed about inflation, especially the prices of Japanese real estate, the highest in the world. They began to raise interest rates to dampen speculative frenzy. This did little. Then, on Dec. 26, the Bank of Japan raised the discount rate 1% to 4.25%, still the lowest of any industrial country in the world.

At this point, Salomon Brothers went to work.

Index arbitrage is speculation in which the trader buys a basket of stocks of the few companies which make up the Dow Jones Industrials or the Nikkei Dow. Then he sets up a "futures" contract where, for a tiny margin of the cost of the actual stock, a player can gamble on the future price of the stock. If the spread between the futures price (usually a three-month contract) and the actual stock rises above, say, the three-month differential in cost of borrowed money plus some formula constant, a computer "arbitrage" goes into play. Huge players like Salomon or Goldman Sachs can whipsaw between the two prices and manipulate the market in short-term moves.

What it did in Tokyo, is to turn a controlled deflation by the authorities into a financial avalanche. As of March 29, the Nikkei had lost 23% of its value since Jan. 1. For the first time since April 1987, the value of all shares traded on Tokyo's Stock Exchange fell below those of Wall Street, Tokyo being pegged at some $1.7 trillion, compared with New York's $1.8 trillion.

"Salomon triggered a deliberate panic sell-off in what was to have been a controlled deflation process," said one French banker with intimate knowledge of the Tokyo market. "They're playing with fire. They helped push the Nikkei up to its highs at the end of last year. Then, beginning in February, when they knew the large Japanese stock brokerages traditionally wind down their trading to realize profits before closing their fiscal year-end books March 31, they triggered the panic through their control of the index arbitrage." Some 80% of Tokyo "index arbitrage" is run by U.S. houses.

No doubt the aggressive traders at Salomon, et al. turned a profit on the trade, but there are hints it wasn't only Wall Street greed involved. It's rumored in London to have been done in concert with Mr. Brady's friends in Washington. Why? As one central bank source said, "They clearly thought this could 'soften up' Tokyo to finance the next phase of American deficits." If so, it may be the miscalculation of the century.

Unlike any other major stock market, Tokyo's market is inseparable from its banks. Banks raise huge sums of low-cost capital on the stock market by floating new issues. Japanese banks, the world's biggest in asset size since about 1985, accounting for 13 of the world's largest 25 banks and all of the top 10, are allowed to count as "current income" a portion of the appreciation of the market value of stocks they own in the year, even if they never plan to sell that stock.

As a result of the collapse of Tokyo stock prices, Japan's 13 largest city banks have lost nearly $100 billion in value. In addition, they have tens of billions in bond trading losses yet to be calculated. Japanese financial houses have been selling gold in order to cut losses, and the Eurodollar markets in London are dead as only a first result.

Ironically, this may mean that Japanese capital to finance U.S. budget deficits and real estate will come to an abrupt contraction, once lending strategies are evident in the second quarter of this year.

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