

Asian financial earthquake sends tremors around the world

by William Engdahl

Just below the surface of what appear to be booming world financial markets, are fundamental stresses and fault lines which threaten at any second to erupt into a global financial contraction of unprecedented dimension. The existence of such fault lines became obvious when American Federal Reserve Chairman Alan Greenspan made an unannounced stop-over in Tokyo on May 15, following talks in Beijing.

What Greenspan discussed with the Bank of Japan and the Ministry of Finance was kept secret; unusually, not even a brief communiqué was issued. Less than a week later, the consequence of the Tokyo talks became clearer. On May 20, Greenspan convinced his skeptical colleagues at the Federal Open Market Committee, which determines the level of U.S. short-term interest rates, to violate all precedent, and not to raise interest rates again.

The trouble involved, for the financial “managers,” in the question of raising interest rates, is that the world’s financial bubble-system is so hyperinflated, that to raise interest rates on the bubble, will serve to blow out the bubble. Put another way, the risk of bankrupting the bubble-system is less than the risk of continuing to “manage” it. Years back, an economy-friendly interest rate policy would have placed high interest rates on counterproductive, high-risk, speculative financing—such as derivatives—and placed lower rates on lending for medium- to long-term investments in infrastructure and production. This was not done. The world’s finance system-bubble is now at the bursting point, which poses the dilemma for the “managers.”

“This was one of the most difficult decisions of the Federal Reserve in recent years,” remarked City of London economist S.J. Lewis.

“The Fed shocked financial markets in March,” he said, “by raising rates for the first time in almost two years. The argument used was the looming threat of inflation. But data revealed no ordinary signs of wage rises, price rises, or such. Where was the feared inflation forcing the Fed to raise rates in order to cool economic growth? The inflation was in financial assets, what Greenspan called ‘irrational exuberance’ already last December. The effect of the March 25 Fed rate increase of a mere ¼%, was enough to trigger near panic in the stock

market, sending the Dow Jones Industrial Index down almost 10% from record highs, and other markets with it.

“This time,” Lewis added, “data pointed to even worse signs of inflation, with first-quarter GDP growing almost 6%, and official employment below 5% for the first time in 20 years. Wall Street investors fully expected the Fed to make a second rate rise, to signal it was serious about preempting inflation. The Fed has almost never raised rates only once. Why hesitate now?”

Much of the answer lies in Greenspan’s talks in Tokyo a week earlier. It was Greenspan’s second visit to Japan since November, and, Lewis is convinced, far from his last.

The new Japanese financial bubble

The vulnerable center of the present global financial structure, threatening to bring all down with it, is the situation in Japan. Since the collapse of Japan’s stock and real estate speculation binge in 1990, Japanese banks have teetered on the verge of one or another chain-reaction bankruptcy crisis. For more than six years, the Japanese Ministry of Finance had hoped that recovery of the Tokyo real estate market would allow the banks to recoup bad debts worth an estimated \$1.2 trillion or more. The scale of the Japanese crisis pales anything in the United States or Europe.

It is worth noting that, in comparative terms, U.S. banks are, by many key measures, such as derivatives exposure, significantly worse off than Japan’s. However, our point stands, that there is the potential for the crisis in Japan to spread shockwaves worldwide.

To prevent such a chain-reaction bank collapse, the Japanese Ministry of Finance finally acted, together with the Bank of Japan, in April 1995, to take emergency measures. They were supported by a worried Clinton administration and the Federal Reserve, which feared that a Japanese collapse would bring down the entire U.S. financial system with it. Japan’s government and private banks and insurance firms hold over \$500 billion in U.S. Treasury securities. Were Japanese banks or the government forced to liquidate even a sizable part of that amount, it would precipitate a crisis globally, beyond anything seen in the 1930s.

In summer 1995, the Japanese Ministry of Finance acted to force Japanese banks and insurance companies to push the yen drastically lower. The yen had hit a postwar high of Y 79 to the dollar that April, threatening a collapse of Japanese exports, the lifeblood of the economy. At the same time, the Bank of Japan lowered its key interest rate for banks, to an incredibly low $\frac{1}{2}\%$. The intent was to stimulate the depressed Japanese economy, and with it, bank profits, partly by allowing banks to borrow funds from the Bank of Japan at $\frac{1}{2}\%$, in order to buy dollars or European currencies, where the funds could earn 7% or more, a huge, apparently risk-free way out of the crisis. And it would cost Japanese taxpayers nothing.

Or, so it was thought in 1995. What has happened, however, is that Japanese banks have re-loaned the cheap yen deposits they borrowed from the Bank of Japan, to anyone willing to borrow. Since the Japanese economy was in deep depression, and domestic interest rates were at all-time lows, that meant overseas lending, often through Japanese branch banks abroad.

The borrowers of these cheap yen included aggressive hedge fund speculators like George Soros or the Tiger Fund, as well as private banks, often in poorly regulated, so-called emerging economies such as Thailand, South Korea, or the Philippines. For almost two years, the Bank of Japan has provided the cheap money to prop up a colossal financial bubble across Asia.

So long as the yen was falling against the dollar, the risk was nil. It was a "sure bet," as one Luxembourg banker termed it. Thailand earned export dollars, dollars whose value appreciated steadily against the yen, thus enabling Thai banks to repay yen loans ever more cheaply in real terms. For example, a bank that borrowed \$100 million from a Japanese bank with the yen at 100 to the dollar in early 1996, would have had to repay only \$79 million in April 1997, when the yen hit 127 to the dollar, a nice 21% gain. As well, he would have earned another 10% or more on the higher interest rates abroad, giving double profits. Little wonder the yen borrowing business outside Japan boomed in the past two years.

From April 1995, when the yen hit the postwar high of 79 to the dollar, until this past April, the currency had fallen by 61% against the dollar. Japanese export profits were booming, and so was the flood of funds out of Japan. The money flowed into high-profit areas like Thailand, Indonesia, and even Philippines real estate lending.

In South Korea, foreign debt, private and public, rose from \$69 billion in January 1996, to what will likely top \$144 billion by end of this year, a jump of almost 110% in less than two years. Most of the borrowing has been for less than one year's duration, and most in yen. Similarly, in the Philippines, hailed as the "newest tiger economy" of Asia, private companies' and banks' foreign debt, which was \$13.5 billion in early 1996, is expected to top \$40 billion by year's

end, a 300% jump in two years. Thailand is similar. And the vast bulk of this Asian emerging country debt is in yen, while the currencies of the borrowing countries are pegged to the dollar. The result has been that exports to repay the yen debts have collapsed as the dollar rose since 1995. Thai or Korean exporters were priced out of markets by Japanese competitors with a cheap yen. This economic contraction set the stage for the present crisis, by depressing economic growth across the Asian economies. The only element lacking by this spring, was a detonator to explode the financial gunpowder.

Damned either way

The detonator came from the Japanese Ministry of Finance on April 21. On that day, the first life insurance company in Japanese postwar history, Nissan Mutual Life Co., declared bankruptcy, sending shockwaves throughout Asia. The principal reason was losses due to Japan's low interest rates, which, combined with a falling Nikkei stock market, had bankrupted the company. Its plight was shared, in one degree or another, by most other life insurers. Emergency measures were called for.

Japanese Deputy Finance Minister Eisuke Sakakibara began making public statements about the need to strengthen the yen. Behind the scenes, the ministry began encouraging Japanese life insurers and banks to begin bringing money back into Japan, to invest in the Tokyo stock market. To convince the Japanese investors of this risky ploy, the ministry took steps to revive the falling Tokyo stock market as well, by increasing the amount of Japanese stocks held by its state-owned Postal Savings Bank. With a staggering \$1.8 trillion of deposits the Postal Bank is the world's largest bank. The effect on the stock market was immediate, and the Nikkei climbed to well above 20,000 for the first time in over a year, a rise of almost 18% in less than two months. The ministry began dropping strong public hints that the days of almost free money from the Bank of Japan were about to end.

The Nikkei began to rise further, as money returned to Japan from abroad. The return of money began to strengthen the yen, and weaken the dollar. The yen began a dramatic reversal since the last week of April. By May 20, it had gone to Y 112, from Y 127 three weeks before, a jump of 12%. "Good" for Tokyo, catastrophic for Thailand, South Korea, the Philippines, and for banks and hedge funds that had borrowed the cheap yen, and changed it to dollars or other currencies.

As the yen continued to rise, according to informed financial market sources, hedge funds "went into panic" and began a rush to repay their yen loans before losing even more. "The effect of this panic, however," noted S.J. Lewis, "ironically, has aggravated the rise of the yen, forcing even more panic on the part of those around the world who have borrowed yen." Hedge funds' buying of yen in recent days, at any price, to cut their potential currency losses, aggravated

the very problem they were trying to avoid. No exact data on the amount of yen loans are available, but indications are that the total is staggering. Japan's banks are the world's largest.

The crisis spreads

The effect of the panic has been, reportedly, that hedge funds and others began to liquidate their investments in Thailand and other Asian emerging economies, to get yen. The Thai baht, which is firmly pegged by the Thai central bank to the dollar, came under enormous selling pressure on May 14, as a result. To stabilize what some termed "a potential mini-Mexico crisis," the central monetary authority of Singapore, with its huge dollar reserves, announced, with Thailand, on May 15, a joint baht stabilization support against speculators. In the Philippines, banks began to get alarmed as the huge speculation boom in Manila's luxury real estate construction of the past two years came under threat. The Manila stock exchange index had plunged 19% since April, as foreign investors fled, eager to repay yen loans.

In South Korea, where heavy debt and the strong currency had devastated Korean exports, banks announced on May 20 an emergency rescue of a series of companies including Midopa Group, and Dainong textile company. The reason was to "prevent a chain-reaction bankruptcy crisis" in Korea. In January the famous Hanbo Steel Co. was forced to be bailed out by Korean banks, a victim of the collapse of exports, along with the interventions by the International Monetary Fund (IMF), the Organization for Cooperation and Development (OECD), and related London and New York financial interests, to "deregulate" and end the very labor and investment practices that built up the South Korean economy in the first place.

In Europe and the United States, hedge funds have been reported to be conducting massive selling of bond futures and bonds in German, British, and U.S. bonds, forcing interest rates higher as a result, potentially threatening a new international stock market crash. Unconfirmed market reports are that one large hedge fund may have lost upwards of \$1 billion over recent market shifts.

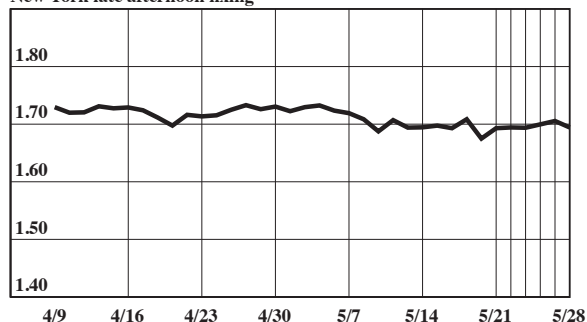
This is the non-Japanese side of the Japanese liquidity trap. To continue the low-interest, cheap-yen policy, will devastate Japanese insurance companies and weaken their banks, but will feed the global speculation bubble. But, ending the low-interest policy and raising the yen more, while it may help Japanese restructuring, will threaten a chain-reaction series of banking crises, which could bring down some of Japan's largest banks. Were that to occur, the U.S. financial system and that of Europe would follow.

That is the real reason for Greenspan's fear of raising U.S. interest rates even a mere 1/4% more — the dilemma of a global liquidity trap. It is also the grounds for U.S. Treasury Secretary Robert Rubin's latest call, on May 21, for a strong dollar. This problem, however, will require more than words and cautious inaction.

Currency Rates

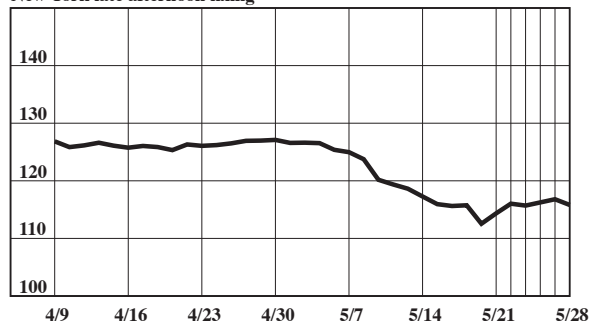
The dollar in deutschemarks

New York late afternoon fixing



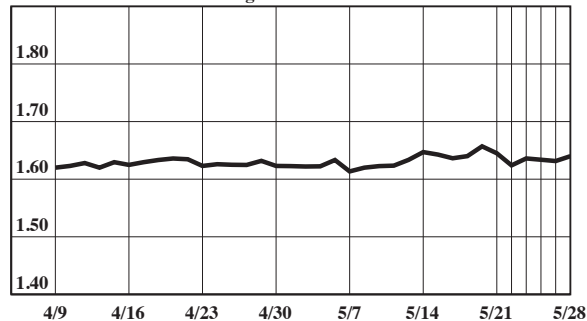
The dollar in yen

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

