Derivatives threaten shaky world financial system

by Richard Freeman

During the last week of November, the world financial system entered a convulsion, signaling its death agony.

In Japan, the nation's fourth-largest investment bank, the $31 billion-in-assets Yamaichi Securities, and one of the nation's 21 largest commercial banks, the $78 billion-in-assets Hokkaido Takushoku, filed for bankruptcy, forcing the Bank of Japan to pump in $21 billion in "liquidity support" to these two banks to provide sufficient funds for the banks' customers to withdraw their deposits. At Yamaichi's 116 branch offices, lines of worried customers, drawing out their deposits, wound round the block. Five of the remaining 21 largest commercial banks—Mitsui Trust and Banking Co., Yasuda Trust and Banking Co., Long-Term Credit Bank of Japan, Chuo Trust and Banking Co., and Nippon Credit Bank, with assets, respectively, of $320 billion, $270 billion, $224 billion, $160 billion, and $104 billion, for a total of $1.080 trillion—stand on the verge of bankruptcy, with their stocks being hammered on the Japanese stock exchange. The U.S. Federal Reserve Board of Governors and the U.S. Treasury Department, on the one side, and the Bank of the Japan, on the other, have been in furious discussions to activate a 1995 arrangement, whereby the Fed extends to Japanese banks collateralized loans, in order to prevent Japanese banks from dumping their sizable holdings of U.S. Treasury securities on the market as a means of raising cash. A dumping of such major proportions would send the U.S. dollar, the world's reserve currency, through the floor.

In South Korea, the banking and financial situation has turned from bad to highly dangerous. Despite the fact that South Korea has lined up $20 billion in borrowings from the International Monetary Fund—an amount that knowledgeable sources say will rise to $80 billion before the end of December—the Korean government and Korean corporations, including banks, have $122 billion in loan obligations to foreign creditors, 56% of which is short-term, and on which they have no means to pay. This threatens the world's settlements system.

In Russia, the market for GKOs, which are the short-term Treasury securities of the cash-short Russian government, has dried up, and the banking system, which has a shortage of liquidity, is imploding. In Brazil and Argentina, two of the three largest economies in Ibero-America, currency and stock market crises are acute. Two dozen other countries around the world are in the same boat.

Various major forces in the world, such as Federal Reserve Chairman Alan Greenspan, are attempting to treat this as a mere cyclical crisis, which can be crisis-managed—a dangerous flight into virtual reality. But this is emphatically not a cyclical crisis, but a systemic crisis, of global, historically unprecedented proportions. It is not based on a few mistakes, of whatever size, but stems from a 30-year policy of post-industrial society utopianism. This has destroyed the physical economy. At the heart of the crisis is the worldwide level of $125-150 trillion in derivatives. Each of the crises described above, such as in Japan and Korea—which are merely localized expressions of the systemic crisis—can burst this derivatives bubble, which, in turn, would immediately melt down the world's banking system, starting with the United States.

Japanese banks

Japan, the world's second-largest industrial economy, with the world's biggest banking system, is one of the focal points of the financial crisis. Though Japan possesses a still considerable industrial-manufacturing economy, it suffers from a "bubble economy" of bloated real estate, stock market, and, of late, derivatives speculation.

An economics researcher for the U.S. Congress, who has been following Japan's financial crisis for the last several years, reported on Nov. 21, that Japan's banks have $800 billion of non-performing loans, of which $400 billion are held by the 21 largest commercial banks alone. In addition, he said, the Japanese insurance companies are loaded with non-performing loans and investments to the real estate sector, which he estimates to be several hundred billion dollars. This brings the total non-performing financial paper in the Japanese financial system to over $1 trillion.

This does not factor in the $300 billion which Japanese banks have lent to the nations of Asia, of which $156 billion has been lent to Asian real estate outside Japan. A significant portion of that has gone bad.

The response of Japanese institutions has been mainly

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"administrative": The Bank of Japan lowered the interest rate at which it lends, through the discount window, to Japanese banks, to 0.5-0.75%. The Japanese banks borrowed at this lower rate, to invest in instruments in Japan and around the world, including U.S. and European nations' Treasury bonds, which yielded 4-7% rates of return. The banks pocketed the profits from the interest-rate spread. But, Japan, like other nations, avoided tackling fundamental underlying problems, leaving in place many of the rotting speculative structures.

In addition, in March of next year, Japan is scheduled to apply its version of the "Big Bang," which will deregulate and "liberalize" Japan's financial markets, and greatly add to the problem.

A few weeks before the Nov. 17 failure of Hokkaido Takushoku bank, and the Nov. 24 failure of Yamaichi securities (a 100-year-old investment bank), Sanyo Securities, a second-tier investment bank, closed up shop. On Nov. 25, Tokuyo City Bank, a small regional bank, announced that it would cease operations, making four bank failures within a month.

The Bank of Japan pumped in a minimum of $21 billion of "liquidity support" into the banking system: $15 billion into Hokkaido Takushoku, and $6 billion into Yamaichi Securities. One financial analyst reported that this was to provide money "so that if you had $10,000 at Yamaichi, there will now be sufficient money there so you can draw your $10,000 out."

On Nov. 26, Moody Investor's Service placed under review for possible downgrade the credit rating of 5 of the top 20 banks of Japan. Moody's assigns a rating to each type of debt or credit that a bank has: senior debt, subordinated debt, commercial paper, etc. Moody's also assigns an overall rating of "financial strength" for each bank, starting with an A as the best rating and working its way down to the lowest rating, E.

Moody's has assigned either an "E" or "E+," which signifies "very weak intrinsic strength," to 5 of the top 20 banks in Japan (listed here, with their asset size as of Sept. 30, 1997):

- Mitsui Trust and Banking, $320 billion;
- Yasuda Trust and Banking, $272 billion;
- Long-Term Credit Bank of Japan, $224 billion;
- Chuo Trust and Banking, $160 billion;
- Nippon Credit Bank, $104 billion.

These five banks have combined assets of $1.080 trillion.

On Nov. 27, a Japanese Finance Ministry spokesman denounced Moody's rating announcement, indicating that it constituted interference into Japan's affairs.

On Nov. 26, a spokeswoman for Moody's said that the five banks "are very weak financially. We don't comment on whether they may go bankrupt, but Moody's believes that they don't have sufficient financial strength to stand alone. We think they will need a safety net to survive."

She stated that some of these banks will turn to groups that they are part of, for financial assistance. For example, she said that Yasuda Trust and Banking Co. is part of the Fuyo Group, which consists of Fuji Bank, Yasuda Trust and Banking Co., Yasuda Life Insurance, and Yasuda Fire and Marine. She said that Yasuda Trust and Banking Co. announced on Nov. 25 that it would issue either subordinated debt/debentures (which can be converted into equity), or equity directly, which the other members of the Fuyo group would buy up, to infuse liquidity into Yasuda Trust and Banking Co. However, it should be noted that Fuji Bank was also the largest creditor of Yamaichi Securities, and when asked to bail Yamaichi out during that investment bank's last days, it declined.

Moody's stated that, at the moment, the Bank of Japan will not be lending any money to the five banks with the E or E+ rating, "because the Bank of Japan only gives that liquidity support, once a bank has failed."

The Hokkaido Takushoku Bank had $78 billion in assets when it failed, and it required a $15 billion "liquidity support" operation from the Bank of Japan. Were the five Japanese banks with very low credit ratings to fail in the next few weeks, the Bank of Japan might end up having to pump in $150-175 billion in "liquidity support," an amount that would require extreme pump-priming and would likely, along with the bank failures, contribute to the blow-out of the Japanese financial and banking system, and the world credit system.

The Moody's spokeswoman was asked, "There has been discussion of off-balance-sheet liability derivatives exposure of Japanese banks which could create a problem. What is the situation with the derivatives exposure of these five banks?" She responded, "No comment."

During the two trading days of Nov. 26-27 on the Japanese stock market, the shares of Mitsui Bank fell 32%, those of Yasuda Trust closed down 38%, those of Fuji Bank closed down the limit; and those of Daiwa Bank closed down 50%. Yamaichi Securities stock fell heavily in the period prior to its ceasing operations. Further, as an indicator of difficulties, Japanese banks must pay a "risk premium" of three-quarters of a percentage point on the inter-bank borrowing market.

South Korea and beyond

In South Korea, five major banks—Cho Hung Bank, Commercial Bank of Korea, Korea First Bank, Hanil Bank, and Seoul Bank—are reportedly in serious trouble. Thirteen of the largest Korean banks are reported to have $30 billion in non-performing loans, representing 10% of all credit volume, although the actual figure could be much higher.

In mid-November, Korea approached the IMF for a $20 billion loan package. On Nov. 23, a Tokyo-based banking source reported, "This was an extreme liquidity crisis. It could

not have been allowed to go on even a few more days without an IMF loan," or else it "threatened the entire world's settlements system. . . . The G-7 central bankers and finance ministers have been in continuous meetings on Korea for over a week. The meetings were non-stop. They may deny this, but that's what is going on. The meetings started with the G-7 Finance Ministers in Frankfurt last Saturday [Nov. 15]. . . . Many more central bank meetings have occurred."

He stated that the problem is that Korean corporations, including banks, owe $122 billion to international financial institutions. Were the creditors of Korea to either refuse to roll over their loans, most of which are short term, or try to collect on past loans, this would cause grid-lock in the Korean banking system, forcing Korea not to make payment on many more loans, and, in turn, "could close down the world's settlement system."

The IMF loan package of $20 billion will not be enough, and a second package is already being negotiated, which will bring the total IMF-organized loan agreement to Korea, to $80 billion, this source predicted.

The IMF package will have harsh conditionalities, and will include extreme forms of globalization, the source said. Korea will be forced to open its stock market, its financial sector, its bond market, and get rid of its closed system. As well, many industries will be forced to cut back or shut down, and workers will be fired.

With regard to the Korean bond market, according to this source, until now, only Koreans could own Korean bonds, which actually allowed Korea to internally manage its credit.

After a $40 billion financial loan package to Indonesia, a $17 billion package to Thailand, some $70-80 billion expected to go to Korea, the IMF is running out of money.

South Korea had been attempting to develop a "full set" industrial economy. For instance, its ship-building industry still builds 40% of the world's ships.

But many of the other southeast Asian economies had not proceeded much along the path of a "full set" industrial economy. To a significant extent, they relied on cheap-labor exports. These are the pussycat "Asian Tigers," such as Thailand, Indonesia, and Malaysia. This made them vulnerable to the rounds of London oligarchical financier-directed currency and stock market attacks. Thus far this year, their stock markets have all fallen 40-60%.

As the Southeast Asian economies contract, this adversely affects world trade, especially for America.

In Russia, an extreme internal liquidity crunch has left the financial system wobbly. The Russian government's attempt to hold a fire sale involving valuable state-owned oil and other properties, will make matters worse.

The derivatives bubble

The European press has at least covered some of these developments, however piece-meal. But in America, there has been a denial of reality. However, beyond the headlines, is the reality that this is a deeper phase of the systemic process of blow-out of the world financial system, with the principal trigger being the world's derivatives market. The IMF bailouts, with attached conditionalities, and the various liquidity injections that various nations are making on a "crisis-management" basis, according to "administrative rules," will solve nothing. The new liquidity will fuel the danger of hyperinflation, but will not correct the underlying bloated speculative structure. The IMF conditionalities will merely cut further the already ravaged world physical economy.

The danger that threatens to turn the current crisis into a death knell for the world financial system, is the derivatives bubble. The Bank for International Settlements reports that in 1996, derivatives for a select number of industrial countries were $82.6 trillion, up from $69.3 trillion in 1995, and $62.6 trillion in 1994. But the BIS survey covered just 79 institutions in 11 countries, leaving out many derivatives' holders. *EIR* has estimated, for 1997, total world derivatives holdings to be $125-150 trillion.

In the United States, total derivatives holdings are $38 trillion, as of mid-1997, nearly a fourfold increase from $10 trillion in 1990. Of the 1997 amount, the leading eight U.S. commercial banks hold $22.6 trillion of derivatives. These eight banks have combined equity capital of $93 billion, which is just 0.2% of their derivatives exposure. The equity capital is supposed to provide a cushion in emergencies. During an emergency, these eight banks—Chase Manhattan, J.P. Morgan, Citicorp, Bankers Trust New York, BankAmerica, NationsBank, First Chicago NBD, and Republic New York—could cover 0.2% of their exposure; *any bigger derivatives failure would melt down the U.S. banking system.*

The $125-150 trillion world derivatives bubble is interlinked across countries and markets—bonds, stocks, currencies, commodities, etc. A failure in one part of the market *can trigger the disintegration of the entire world system.* Reverse leverage will make this process happen with lightning speed.

Thus the Japanese and South Korean crises, which are very real and very devastating in their own right, could become the detonators which could ignite the global derivatives explosion.

On Nov. 20, Union Bank of Switzerland (UBS), one of Switzerland's "Big Three" banks, fired most of its derivatives trading department personnel in both London and New York. The *South China Morning Post* covered the story under the headline, "Trading Losses Force UBS Shake-Up." UBS deliberately withheld loss figures, but private sources report that the derivatives loss is large.

On Nov. 25, the economics editor of a major British newspaper told *EIR,* "There are rumors of huge derivatives losses at one of the big banks in London. I can't tell you which one, of course."