

Backroom brawls on financial crisis mark Davos meeting

by William Engdahl

At the annual World Economic Forum, on Jan. 29-Feb. 3 in Davos, Switzerland, leading spokesmen of international banking, central bankers, cabinet officials, and heads of government of the Group of Seven (G-7), as well as numerous senior officials from Asia and other (formerly) emerging economies from Brazil to Russia, all echoed one theme: "The worst of the Asia crisis is over."

In private, however, the real discussion was 180 degrees opposite. Leading officials and bankers revealed their conviction that, far from being over, global shock waves radiating out of the Asia events are only in their initial phase. Behind closed doors, there were battles over potential policy directions.

At the same time, the Asian financial crisis and the issue of International Monetary Fund (IMF) policies, were the hot topics in Washington, D.C., addressed in the newly reconvened Congress, at hearings on Jan. 30 and Feb. 3 in the House of Representatives Banking Committee. On Jan. 30, witnesses included Federal Reserve Chairman Alan Greenspan, Treasury Secretary Robert Rubin, and Deputy Treasury Secretary Lawrence Summers, who then shuttled off to Davos. On the surface, U.S. officials all spoke on behalf of U.S. funding for the IMF. However, unlike Greenspan, who repeated his view that Asian nations deserve to be punished for having brought crises on themselves, Secretary Rubin spoke of assisting Asian nations to provide "stability," until there can be a "new architecture" created for the world monetary system (see *Documentation*).

On Jan. 30, in Davos, this viewpoint (expressed by Rubin at a January speech at Washington's Georgetown University and on other occasions) became part of a top-level, backroom brawl. According to the Feb. 1 account in Italy's *Corriere della Sera*, by financial reporter Danilo Taino, debate raged over the question of reintroducing national capital-control

mechanisms to allay systemic financial breakdown. Taino reported, "The issue was posed at the highest level a few days ago by Robert Rubin. He said that to prevent the repetition of such crises as the current one in the Far East, we need a 'new architecture' for the international financial system. . . . The Friday meeting was chaired by the former GATT [General Agreement on Tariffs and Trade] secretary general, Peter Sutherland, . . . to discuss reforming international agencies, starting from the UN, and including the IMF and the World Bank." Among those opposing capital controls, reported Taino, were Howard Davies, chairman of the British financial control authority; the IMF's Stanley Fisher; and World Bank director Sven Sandstrom.

Part of the fury behind the opposition to any thought of "new architecture," is that a world meeting on the financial crisis is in the works, at the initiative of the United States. No agenda details are yet available, but according to a U.S. Treasury Department advisory of Feb. 4, the date will be sometime this spring (April is likely), and so far, 21 nations are committed to attend: Argentina, Australia, Brazil, Canada, China (including officials from Hong Kong), France, Germany, India, Indonesia, Italy, Korea, Japan, Malaysia, Mexico, Poland, Russia, Singapore, South Africa, Thailand, Great Britain, and the United States.

Davos chorus sings, 'All is well'

In public, while TV cameras from around the world, from Cable News Network to the British Broadcasting Corp., filmed in Davos, and the world's major media took notes, speaker after speaker reassured the assembly of some 2,500 businessmen and officials attending. The chairman of Germany's Commerzbank, Martin Kohlhaussen, told the meeting, "The governments and central banks of the G-7 are now in control of events." However, even he was forced to add, "Maybe not yet

enough in control, but in control. Now it is of prime importance to prevent Asia's becoming a global crisis." Kohlhaussen had good reason to try to encourage optimism: His own bank is one of the banks most exposed to the Asia collapse.

Officials of the Japanese government, whose problems are at the heart of the Asia crisis, made bold statements which amounted to so much, "I'm all right, Jack." Vice Finance Minister Eisuke Sakakibara, in a move clearly intended to draw attention away from Asia, told the meeting, "Ladies and gentlemen, Asia is not melting down." He then raised eyebrows, saying, "And it is not an 'Asia crisis.' It is rather a crisis of global capitalism."

Sakakibara tried to paint a rosy hue over the ongoing Japanese political paralysis in dealing with that country's eight-year-old banking crisis, where bad debts from the wild speculative real estate and stock binge of Japan's 1980s "bubble economy," may total as much as \$1 trillion. He insisted, "In the past, the problem with Japan's domestic financial sector and fiscal crisis was that we lacked the political will. We have the money and the ability to solve our problems. Japan is not like the rest of Asia. We are a net lender, not a net borrower. I can now say, however, categorically, that the will exists in Japan," to finally resolve the banking problems.

The high point of optimism was sounded around the appearance of the Governor of South Korea's Cholla Province, You Jong Keun, an adviser to South Korea's President-elect Kim Dae-jung, and likely next Finance Minister after the government is inaugurated on Feb. 25. "First, I want to tell you participants here in Davos," Governor You stated, "I have just come from New York as part of the Korean team negotiating restructuring of the short-term debt. We have reached an agreement . . . with the committee of 13 creditor banks led by J.P. Morgan to restructure for up to five years some \$24 billion in debt due in the next weeks. This is extremely important for Korea's progress. I can also tell you that we had all agreed in New York that we would reach an agreement in time to announce it here at Davos."

Indeed, the Korean debt news, combined with the fact that most Asian financial markets were closed during the Chinese New Year celebrations, ironically to usher in what the Chinese call "The Year of the Tiger," allowed a mood of near-euphoria to develop over the following days, as reports beamed out to the world from Davos heralding "the end of the Asia crisis." By Feb. 3, stock markets from Frankfurt to London to New York were near or breaking new all-time highs; that, in the wake of resumed Asian trading which saw stock markets from Malaysia to Singapore to Hong Kong, and even in Bangkok and Jakarta, soar by double-digit sums daily. More sober observers dubbed the brief Asia stock rally a "dead Tiger bounce," a play on the age-old Wall Street term for a last gasp rally before a crash.

Reality leaks out

In private discussions in Davos, however, numerous high-level officials and bankers admitted that the crisis is not over.

U.S. Assistant Secretary of State for East Asia Stanley Roth, when asked his assessment of the situation, stated bluntly, "This crisis is far from over. In the short-term, Indonesia is a major worry; medium-term, it is Hong Kong and China where we have great concern."

Hong Kong and China are the only remaining Asian countries which have not yet been forced to abandon their peg to the U.S. dollar and allow a free-float. Were they to do so, it is feared that that would trigger an uncontrollable spread of the crisis, one which would be impossible to contain even if all the central bank printing presses of the world were to work at full speed.

Indeed, a trip by U.S. Deputy Treasury Secretary Larence Summers to Beijing in January was aimed at getting assurances from China that it would hold firm in the face of possible speculative pressures in coming months. China's Vice Premier Li Lanqing told the Davos audience, "China's renminbi is stable and it will remain so."

Ronnie Chan, chairman of one of Hong Kong's largest real estate groups, Hang Lung Development Co., told the Davos attendees, "For the next two years, the dollar peg of the renminbi will stay fixed until the currency is harder, despite economic pain. China won't devalue for at least 18 months."

Chan admitted, however, that "the Achilles' heel" of the Hong Kong dollar, despite a strong industrial economy and a developed bank regulatory system, "is the dollar peg." "Speculators see the peg as an easy target because we have only one weapon to defend it: raising interest rates," he said. "That allows the speculators to profit by going short on the Hang Seng stocks, as stock and real estate prices fall with high rates. In recent months, real estate prices have already dropped 35% in Hong Kong, partly as a result of high interest rates. That is a problem whose remedy is not clear."

Ominously, at the Davos conference, aggressive hedge fund speculator George Soros drew the spotlight to China's and Hong Kong's dollar peg. Soros's Quantum Fund has been accused by several Asian governments of triggering the Asian collapse last May, when he and two other offshore hedge funds, Julian Robertson's Tiger and Jaguar Funds, and Moore Capital Management, launched a concerted attack on the Thai baht and Thai stocks. In Davos, Soros called the crisis "far from over." Soros, who privately has boasted that the British royal family is among his secret investors, added, "The key will be if Hong Kong is able to hold the peg. If that goes, there will be a very negative spread of the entire crisis."

Soros is reported to be doing everything possible to force that break with the dollar and detonate far the worst dimension of the crisis yet. In an interview with the Hamburg weekly *Die Zeit* on Jan. 15, carried in Reuters and other financial wires used by currency traders worldwide to guide trades, Soros said, "The situation in Hong Kong and China is extremely precarious. The peg of the Hong Kong dollar to the U.S. dollar will only be maintained under enormous cost. And if the Chinese renminbi would be devalued, then the Hong Kong peg can't hold. The storms will then grow stronger."

Japan in the eye of the storm

The center of the storm raging across Asia at present, however, is not South Korea, and not even Indonesia, which a week before the Davos talks declared a unilateral “payments pause” on some \$64 billion in short-term foreign debt due this year. Nor is it Hong Kong or China. It remains Japan, the world’s second-largest industrial economy and the world’s largest net lender, the country too big for an IMF bailout.

Since the Bank of Japan dropped its official interest rates to 0.5% in May 1995 in a futile effort to try to help recapitalize the bankrupt Japanese financial system with cheap credit, Japanese banks have borrowed at near-zero rates of interest and re-lent in high-interest-rate markets. Not surprisingly, those high-interest-rate markets, which promised Japanese banks enormous profit, were also the highest-risk markets of East Asia.

Eisuke Sakakibara went out of his way at Davos to deliberately downplay the extent of Japan’s direct vulnerability in the unravelling Asia crisis.

For understandable reasons. Even before the Asia crisis began, according to Bank for International Settlements (BIS) data through the end of June 1997, Japanese banks had loaned a total of \$275 billion in Asia. While Japanese officials insist the sum is “only” 7% of total Japanese bank loans, the exposure is life-threatening to the global credit system for the following reasons.

First, Japan has yet to resolve its domestic bad loan crisis, which has dragged its entire financial system, stock market, and real estate market to the brink of a full-scale deflationary crisis. According to private estimates by UBS Research in Tokyo, the present true value of bad domestic debts of Japanese banks is nearly \$1 trillion, almost double the latest “corrected” Ministry of Finance estimate. The Hashimoto government has pledged to push for Feb. 20 final Diet (parliament) approval of its proposed 30 trillion yen (\$240 billion) bank Deposit Insurance Corp. (DIC) fund to address the bank bad loan mess. Even under ideal external conditions, that bailout plan would feed a growing trend to financial and monetary inflation, which imminently would pose the threat of a global, Weimar-style hyperinflation.

But conditions for the Japanese bank cleanup are far from ideal. No one in Tokyo has yet to take into account the added damage from Asia’s continuing crisis, a crisis already being labelled by the head of the Hong Kong Monetary Authority, David Carse, as “one of the worst financial crises to hit the world this century.”

Japan’s \$275 billion in loans in Asia represent 85% of all Japan bank loans abroad. Of the \$275 billion, 31%, or \$85 billion, have been loaned to the three IMF victims: Indonesia, South Korea, and Thailand. Given their extremely weak domestic position, Japanese banks, unlike banks in Germany, France, or Holland which have made large loans in Asia, are unable to write off any of these Asia loans. This pressure is making Japan into a draconian debt enforcer, in a desperate

bid to recover its exposed Asia loans.

Adding to the plight is the fact that months before the Asia crisis erupted, the Japanese government determined to impose a radical restructuring and deregulation of Japan’s protected financial markets, known in Japan as the “Big Bang.” As part of the Big Bang, as of April 1, the new Japanese fiscal year, all Japanese banks will be required by law to disclose full market value of a bank’s assets and liabilities and to set aside a defined percentage of the bank’s total loans as reserve against possible loan default, a self-imposed attempt to parallel BIS capital adequacy minimum rules. Japan’s motives are to force mergers and reorganization of Japan’s finance, to be competitive with the wave of financial mega-mergers in the United States and Europe in the emerging globalized banking world.

Japanese banks have only two options to meet the new minimum capital reserve rules after April. One, is to cut back their total volume of loans. The other, is to increase the total of bank equity by issuing new stock or somehow increasing core capital assets. This is why the Ministry of Finance in January proposed various accounting gimmicks, such as allowing banks to count their real estate at market value, not the original purchase price, a highly irregular practice in OECD countries. That will give a small boost to bank capital by April, but will be far from adequate.

Thus, to meet the capital reserve targets, banks in Japan have been savagely calling in their loans to especially small and medium-size businesses. This is causing a “credit crunch,” a devastating economic contraction in Japan’s fragile economy. In turn, the depressed economy is causing tax revenues to fall and bloating the public deficit. Japanese loans to Asia cannot be called in for risk of detonating a global meltdown of the world financial system. The Japanese government has, essentially, ordered its banks to roll over the \$275 billion in Asia loans.

This leaves only the Nikkei stock market as an option to raise the bank capital. But, with the Tokyo Nikkei Dow stock prices hovering at 17,000, some 20% below the last accounting period on Sept. 30, bank hidden stock gains have all but disappeared. Issuing new stock is out of the question under such depressed market conditions. Hence, the Hashimoto proposal to inject 13 trillion yen into the banks by having the government’s DIC buy up to \$103 billion in special bank “preferred shares.” That, in turn, fuels the inflation engine globally. But, the sum would still be far below what’s called for.

Making a grim situation worse, because a large part of Japanese bank loans in Asia are to the three IMF “basket case” economies—Thailand, Indonesia, and South Korea—much of the debt service on that \$85 billion will not be paid on time, if at all, putting more bad loan pressure on Japanese banks. Unlike in Japan where a cozy relation between the Finance Ministry and the banks has allowed the true size of domestic bad loans to lie largely hidden from view, in Asia the strict IMF surveillance will force full disclosure of unpayable loans.

The net effect of this diabolical interaction between do-

mestic and Asian problems of Japan's banks has been to increase fears of international lender banks to lend to Japanese banks. In the past three weeks, the dreaded "Japan risk premium" has returned.

Today, in order for Japanese banks to borrow in the interbank market, they must pay between 0.85% and 1% above the London Inter Bank Offered Rate (LIBOR). This penalty, as the April 1 deadline nears, is expected to rise even more steeply, posing yet a new threat to the global credit mechanism. Indeed, the Davos façade of optimism, like the emperor's new suit of clothes in Hans-Christian Andersen's famous tale, is illusion. The bubble is about to burst on that illusion.

Documentation

Rubin: 'New architecture' needed for financial system

Here are excerpts of comments by Treasury Secretary Robert Rubin and Rep. John LaFalce (D-N.Y.), at a House Banking Committee hearing on Jan. 30. Emphasis is ours.

Secretary Rubin: The United States has critical economic and national security interests at stake in promoting restoration of financial stability in Asia. . . . The countries in Asia are our customers, our competitors, and our security partners. Financial instability, economic distress, and depreciating currencies all have direct effects on the pace of our exports to the region, the competitiveness of our goods, our agricultural products, and our services at home and abroad, the growth of our economy and, ultimately, the well-being of American workers and farmers. . . .

Financial assistance, while critical for a short period, is not the key. Only when nations pursue sound policies will confidence—and private capital—return. The central provider of this financial assistance is the International Monetary Fund . . . the right institution to be at the center of these support programs. The United States has worked forcefully to help the IMF meet the new challenges of the modern financial system. . . . This funding is absolutely necessary to enable the IMF to respond effectively if this financial instability were to spread and intensify—which we all want to avoid—and to deal with future crises that could similarly affect the interests of the American people. Moreover, failure to provide funding could reduce our leverage in the IMF, and could shake confidence in American leadership in the global economy at a time when confidence and American leadership are so important in reestablishing stability in Asia.

As to investors and lenders, the problem is more compli-

cated. *The right principle is that investors and creditors should bear the full consequences of their decisions. I would not spend one nickel for the purpose of protecting investors or banks. . . .*

It is critically important that we work toward changing the global financial architecture so that creditors and investors can bear the consequences of their decisions as fully as possible. But devising such architectural changes is difficult and complex. We cannot wait until that work is complete to take the steps necessary to deal with the crisis at hand that so powerfully affects our interests, or to provide funding that will equip the IMF to deal with a substantial spread of the present financial instability—which we are all working to prevent—a future crisis.

Rep. John LaFalce (D-N.Y.), expressed "concerns that the IMF not impose severe austerity programs that can do untold harm to Asian citizens and potentially to our own. . . . The IMF may not be a perfect tool, but right now it's the only tool we have. . . . The United States can only use its voice and vote to reform the IMF if we do not walk away from it in the midst of a crisis. . . . Ultimately, I agree with Secretary Rubin, and others, that we need a new architecture for the international financial system to manage, and more importantly, help avert crises like this in the future. But before we perform this surgery, we must stop the bleeding."

DO YOU
KNOW

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- that Washington and Franklin championed Big Government?
- that the Founding Fathers promoted partnership between private industry and central government?

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