

World financial hurricane makes land-fall in Brazil

by Dennis Small

A new, qualitatively more severe phase of the rolling disintegration of the world financial system was ushered in the week of Sept. 21, as three distinct areas of the global speculative bubble exploded simultaneously. Each of the three is making the others worse, and in combination they are threatening to detonate the chain-reaction meltdown of the entire global system, about which Lyndon LaRouche and this magazine have repeatedly warned.

- *Hedge funds.* The Long Term Capital Management (LTCM) fund, described by some as the largest hedge fund in the world, went bankrupt, and had to be bailed out to the tune of a reported \$3.75 billion—for starters. According to press accounts, a desperate U.S. Federal Reserve Chairman Alan Greenspan pressured 15 or so of LTCM's creditor banks to cough up the money, in exchange for a promise to lower U.S. interest rates in order to inject liquidity into the system. It is widely believed that the LTCM mess is only the tip of the iceberg, and that other hedge-fund bankruptcies may have to be announced shortly. The hedge funds, with their tens of trillions of dollars of side-bets on derivatives, are the most volatile potential trigger of a global financial crash.

- *Banks.* Europe's largest bank, Union Bank of Switzerland (UBS), announced at a press conference more than \$700 million in losses for the third quarter of 1998—although there is still a week remaining in that quarter—in part due to its involvement in the LTCM fiasco. The value of UBS's stock shares plunged by 7% in one day, bringing their total decline over the last two months to 42%. There are insistent rumors that a major European bank is about to go belly-up, although it is not known if UBS is the bank in question. Meanwhile, the entire Japanese banking system is suffocating under an estimated \$2 trillion in non-performing loans, and any number of banks in that country could be pronounced insolvent momentarily.

- *Nations.* The largest debtor nation among the so-called "emerging market" economies, Brazil, with \$481 billion in real foreign debt, is teetering at the brink of national bankruptcy. Hysterical scrambling by the International Monetary Fund (IMF), commercial creditor banks, and various Group of Seven (G-7) governments have reportedly cobbled together a \$30 billion package of financial *promises*—not to be confused with actual money—to try to prevent Brazil from going over the edge in the next week or two. With Presidential elections

scheduled for Oct. 4, and capital fleeing Brazil at the rate of between \$500 million and \$1 billion *per day*, the world financial community is holding its breath to see if the country will even make it to election day in one piece.

'Nightmare scenario'

It is widely acknowledged that a default by Brazil—whose economy is by far the largest in Ibero-America, and twice the size of Russia's—would quickly bring down the rest of Ibero-America with it. "And the result would almost certainly be a new downward spiral in Asian markets," the *Washington Post* explained nervously on Sept. 20. The *Post* quoted John Boorman, director of the IMF's Policy Development and Review Department: "Such a nightmare scenario 'is on people's minds. It has to be.'"

One man's nightmare is another man's poetry. Citicorp vice chairman William Rhodes chose to describe his plight metaphorically: "The Rubicon is basically Brazil, and if Brazil holds, so do the emerging markets." Rhodes's classical allusions may have been prompted by the fact that, as of the end of June, his Citibank had \$4.4 billion in direct loan exposure in Brazil—more than any other U.S. bank. U.S. banks as a whole have \$29 billion in direct loan exposure in Brazil, and another \$10 billion in domestic bonds and other holdings, for a grand total of \$39 billion (as of March of this year). This is more than they have at risk in any other emerging market: for example, it is more than five times the \$7.7 billion exposure that they have in Russia.

The Brazilian government is currently scrambling to do the impossible: roll over \$97.5 billion in public debt which comes due between now and Dec. 1, at a time when no one is buying government paper.

Of that, \$24 billion comes due in the last half of September, \$48 billion in the month of October, and another \$21 billion in November. The debt service on this is staggering, as some 60% of those debts are "post-fixed" notes, which means the government must pay the bondholder the interest rate prevailing when they come due, not when they were purchased. As of now, that is approximately 50%. In addition, 30% of the domestic public debt is denominated in dollars, which means they have to be paid in dollars when they come due.

But Brazil is quickly running out of dollars. The country

entered August with about \$70 billion in foreign reserves; \$12 billion fled over the course of August; and at least another \$16 billion have left so far in September, despite the fact that the government has announced new budget cuts, and jacked up domestic interest rates to nearly 50%. Today, Brazil has an estimated \$42 billion in reserves, a 40% drop in less than two months. With every billion that leaves, the likelihood of a further speculative assault by the global hedge funds increases.

At the beginning of September, when Brazil still had \$58 billion in reserves, market analysts were warning that a \$50 billion level was the “trigger” for a total crisis. That level has come and gone. Now, Morgan Stanley Dean Witter’s Latin American economist, Ernest Brown, is among many who say that “\$40 billion is the critical minimum level. Below that, prudent investors would have to consider that the chances of there being a maxidevaluation of the *real* in the coming quarter are very high”—meaning that “prudent investors” should get their money out of Brazil, while the getting is good.

A further problem was noted by a foreign diplomat in Brazil, as quoted in the Sept. 24 *Washington Times*: “If \$40 billion is the line, they should be able to tough it out until the elections at this rate, but that’s assuming the elections will prove a watershed. What happens if the money keeps flowing out after?”

During her mid-August visit to Brazil, Helga Zepp-LaRouche repeatedly warned her audiences of the likelihood of precisely such a speculative attack, as we document in the coverage below (see the text of Mrs. LaRouche’s speech before the São Paulo City Council, along with that of Brazilian Presidential candidate Dr. Enéas Carneiro).

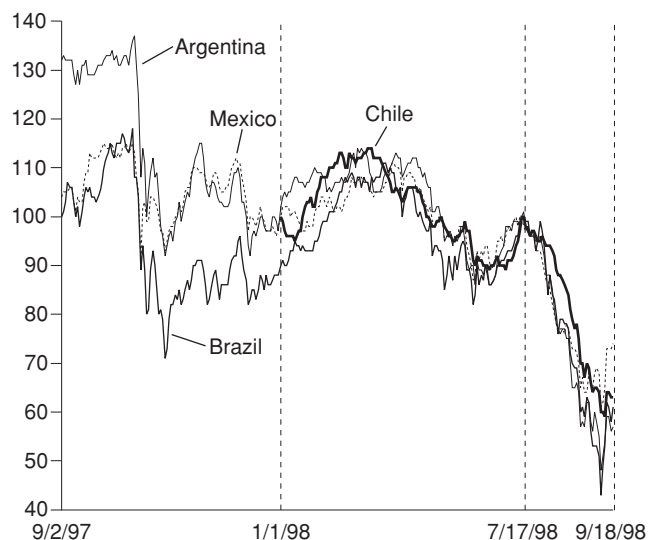
Credit asphyxiation

Brazil, like the rest of Ibero-America, has been subjected to a near-total capital cut-off since the middle of July of this year, when the first stages of the Russian financial crisis unleashed a wave of panic across the global markets. For a region which had become addicted to such flows of foreign speculative capital, the effect in Ibero-America has been like pulling the oxygen tubes from a respirator patient: the monetary and banking systems in country after country are grinding to a halt.

The three major sources of earlier foreign capital flows have all dried up.

First, *government bonds* have seen their interest rate spreads (the differential between these bonds and equivalent U.S. Treasury notes) nearly triple, from 6% to 16%, between July and September. These have become the interest rates at which such bonds are *not* being sold—since country after country has cancelled their bond auctions, as they are unable to pay such usurious rates. This has meant that previous bond issues reaching maturity cannot be rolled over, but have to be redeemed: thus the drop in foreign reserves all across the continent.

FIGURE 1
Ibero-American stock markets crash
(index: July 17, 1998 = 100)



Second, *stock markets*, which had attracted foreign capital in 1997 and even through mid-1998, went into free fall precisely on July 17 (see **Figure 1**)—the day the Russian crisis swept the world markets. For the year prior to July 17, the major Ibero-American stock markets had more or less held their own. But in the two months since July 17, they have plummeted: -43% in Argentina, -39% in Brazil, -37% in Chile, and -26% in Mexico.

Third, *commercial bank lending* is no longer available to any of the governments of Ibero-America: They have been red-lined. Some governments, such as Brazil’s, have tried to cheat their way around this blacklist, by having private sector companies, including banks, go borrow abroad and then turn around and lend that money (at higher interest rates) to the government (by purchasing government bonds). Such desperation tactics only go so far, and they end up aggravating the underlying problem.

With foreign funds being cut off, and with domestic interest rates rising to the stratosphere, national banking systems are entering rigor mortis. In Peru, all credit card transactions were temporarily suspended during the week of Sept. 21. Local banks wouldn’t issue credit to *any* clients for *anything*. In Mexico, the banks stopped issuing any mortgages or car loans in September. Only a few are being issued in Argentina; almost none in Venezuela. In Brazil, car producers are shutting down plants, because no one can get auto loans. Unemployment has reached a record 20% in the state of São Paulo, the heart of Brazil’s industrial capacity, and, at these interest rates, businessmen forecast layoffs to triple by December.