

## The Sumitomo crisis: more than meets the eye

by William Engdahl

In Tokyo on June 14, the president of one of the world's largest industrial, trading, and banking groups, Sumitomo Corp., told the press that the company had uncovered staggering losses of \$1.8 billion, which he claimed had been accumulated since 1986, by a person he described as a lone, "rogue" Sumitomo head of commodity trading, Yasuo Hamanaka. The company then rushed to reassure all, that Sumitomo, which last year had a gross sales turnover of \$152 billion, would stand behind the losses, which it said had all been made in secret trading on the London Metal Exchange in copper and copper derivatives.

At this juncture, there are so many parts to the story which do not add up, that the most plausible conclusion is that the "Sumitomo affair" is being used by international banking and financial authorities to cover up a crisis far more devastating, and systemically threatening.

### A very bad trader?

"Consider the facts of this case," a strategist for one of Europe's largest commodity trading banks told *EIR*. "Hamanaka has been active trading commodities since 1970. He is no Nick Leeson, no young yuppie who is wet behind the ears. He was widely respected as one of the shrewdest traders in the business. Second, copper is a tiny, closed club of traders. It simply isn't possible to run up losses of \$1.8 billion, and go undetected, and that, over more than 10 years. Third, Japanese culture does not produce 'rogue' traders. That's culturally foreign to their hierarchical ways. There is a far, far larger scandal here which has yet to emerge."

What that might be, was suggested by Lyndon LaRouche in comments on the breaking situation on June 18. "The sum of indications is that this is not a Sumitomo derivatives scandal as such, but a more widespread disorder whose extensive

nature is being concealed by a tactic of 'over-revealing' the Sumitomo aspect," LaRouche said. "This is a reflection of a systemic cash crunch throughout the system."

Several developments point to the conclusion that the Sumitomo affair is the mere tip of a financial iceberg of global, system-threatening dimension.

Over the weekend of June 15-16, a coordinated emergency effort was put in place involving the Bank of England, the Bank of Japan, the U.S. Federal Reserve, and market regulatory authorities in at least those three major financial nations. Ostensibly, the purpose was to prevent a copper market collapse when trading on the London Metal Exchange (LME), the world's largest metals derivatives and cash exchange, opened on Monday, June 17. Commenting on the emergency "hot line" talks of the leading central bankers, the June 17 *London Financial Times*, in its page-one lead article, stated that the purpose of the emergency coordination over the weekend was to "prevent a potentially disastrous drop in the metal's price that would have financial repercussions around the world."

But a loss of \$1.8 billion by a trading company with net assets of well over \$50 billion, and annual sales over \$152 billion, hardly seems systemic on the face of it.

"At this point the Bank of England has stepped in to exercise day-by-day control of the LME and trading," a senior City of London financial source stressed, in comments to *EIR*. "The copper price collapse has halted for the moment, but only because the Bank has rung up the world's major buyers of copper and pleaded with them to help restore 'order' in the market by not selling." Indeed, June 17 was the final trading day for the current copper derivatives options contracts, and the price that day did fall another \$100 per ton before recovering by day's end to \$1,990 a ton, down from a high of near \$3,000 six months ago.

## Investigations launched

On June 18, it was revealed that the U.S. Attorney's Office in New York had convened a grand jury to examine the Sumitomo losses, as well as to look into the possible role of a number of banks and companies. Among them are Bankers Trust and J.P. Morgan and Co., as well as the large U.S. brokerage firm, Merrill Lynch. All three firms have been involved in major derivatives-related scandals and losses in recent months. Merrill Lynch was a major party in the Orange County, California collapse, and Bankers Trust recently was fined for misrepresenting the risk in its derivatives products. J.P. Morgan was implicated in a major financial scandal in 1994 involving Spain's collapsed Banesto Bank.

These three banks have lost an estimated \$230 million in the copper options market so far in June because of the huge price volatility triggered around Sumitomo's dumping of copper stocks, according to market reports.

In addition, at least two commodity trading firms are being subpoenaed in the Sumitomo case—Winchester Commodities of the U.K., which had been a major client of Sumitomo, and Global Minerals and Metals Co. of New York. And, apart from the U.S. Attorney's investigation, the U.S. Commodity Futures Trading Commission has attached "highest priority" to an investigation of the entire Sumitomo affair, and the British Serious Fraud Office has initiated a full investigation.

## The BIS re-assurances

Ironically, or perhaps not so, one week before the eruption of the Sumitomo scandal, the Basel-based Bank for International Settlements (BIS), the leading international body of major central bankers, issued its annual report, in which it documented a staggering growth of over-the-counter trade in financial derivatives globally, but insisted that the risks of such obligations was not alarming. "It is now widely recognized that derivatives are making an important contribution to overall economic efficiency," the BIS stated in its report, a dramatic reversal from the very critical stand which that same institution took toward derivatives risk to the financial system only 12 months ago.

Then, in the next breath, the BIS revealingly stated, "The fact that the system continued to function well in the face of a number of shocks (Barings, Mexico crisis, Daiwa Bank, and Japanese financial crises) should provide no grounds for complacency. Banking systems are, or will be, under pressure almost everywhere, in spite of recent improvements in profitability. Financial markets continue to be subject to large unpredictable price swings."

The volumes of outstanding derivatives contracts in the world financial system have exploded. The BIS estimates today a total of \$47 trillion in nominal derivatives contracts, some \$40 trillion of which is off-balance-sheet, or so-called over-the-counter trades between two private parties, mostly between banks. Such trades are largely outside of any regulatory control at present. In the first quarter of this year, the

derivatives business of American banks alone reached a record high of \$18 trillion. One week after the BIS report, the \$1.8 billion trading fraud involving derivatives speculation on the London Metal Exchange by Sumitomo Corp. was made public.

## Other signs of systemic stress

In a little-noticed development, only two days before the Sumitomo revelations were made public in Tokyo, the Japanese Ministry of Finance changed the technical means by which it buys Japanese government bonds on behalf of the state's giant Postal Savings Bank, which the ministry oversees. As of June 12, the ministry announced it will buy all Japanese government bonds directly on the secondary market from private banks and bond brokers, this, for the first time since the practice was suspended in 1993.

This step marks a major acceleration of Japanese official monetary reflation, or "printing money" to liquefy the financial system. Reflation had been under way, in fits and starts, since last August, by the Bank of Japan. The addition of the huge reserves of the state Postal Savings Bank, are clearly designed to allow Japanese banks and financial institutions to lessen the danger of collapse of Japan's huge banking system while they work out of their staggering bad debts of an estimated \$1.2 trillion from real estate and other speculation during the 1980s.

The timing of the decision by the Ministry of Finance to join forces with the Bank of Japan in reflation, coming just hours before the Sumitomo affair was revealed, seems to be no coincidence. It also underscores the fragility of the present financial structure, despite recent pronouncements of improvement. The recent failure of the Shin Kyoto Shinpan credit institution, with debts of almost \$4 billion, signals that the massive bad debt problems at smaller regional banks are only now emerging.

These banking difficulties are compounded by the problems of paying off the \$234 billion in debts of the Japanese National Railways (JNR). The persistence of depressed real estate prices across Japan to date has prevented the government from selling huge prime real estate holdings of JNR. By statute, land sales, whose proceeds are to offset the debt of JNR, must be completed by end March 1998. At that point, remaining debt will automatically pass to the debt burden of taxpayers, in the form of state debt. But significant sales of the state railway lands would itself trigger a new round of collapse in Japanese real estate prices, which would derail the fragile efforts of the Bank of Japan to recapitalize banks through its ultra-low 0.5% interest rate.

## Buying time

Against this background, it is more than plausible that the Sumitomo scandal is deliberately being used to take attention away from one or several system-threatening financial crises, while the Japanese and other Group of Seven governments

urgently try to patch together some time-buying arrangement behind the scenes.

Indeed, bond traders document that since approximately early March, the Bank of Japan and private Japanese buyers of U.S. Treasury securities have not been seen in the New York bond markets. In 1995, the Bank of Japan was the largest single buyer of U.S. Treasury securities as they tried aggressively to push the inflated yen down from its postwar high of 79 yen to the dollar. By the March 31 end of Japan's fiscal year, those U.S. Treasury purchases had brought the yen to its present range of 107-109 yen to the dollar, a decline of 38% to a level where Japan's industrial exports again were competitive on the world market, at which point the Japanese ceased buying.

According to reliable bond market sources, this absence of major Japanese support for the U.S. bond market is a crucial reason for the alarming collapse of the U.S. bond market since February. Interest rates on U.S. 30-year bonds have risen well over 7%, a huge rise of 1.3% since January. Rising bond interest rates reflect the lack of Japanese as well as other buyers in recent months.

In this precarious situation, reportedly, the Federal Reserve has been forced to step in covertly numerous times in recent weeks, to act, in the words of one bond broker, "as buyer of last resort," to prevent a further debacle in bond prices.

The aim has been, according to these accounts, to cap the rise in interest rates below the danger level. "If U.S. interest on 30-year bonds were to go above 7.5%," noted S.J. Lewis of London Bond Brokers Ltd. in a recent discussion with *EIR*, "that would be the trigger, all else being equal, for a substantial crash in the overvalued U.S. stock market. The Fed is concerned to prevent this at all costs."

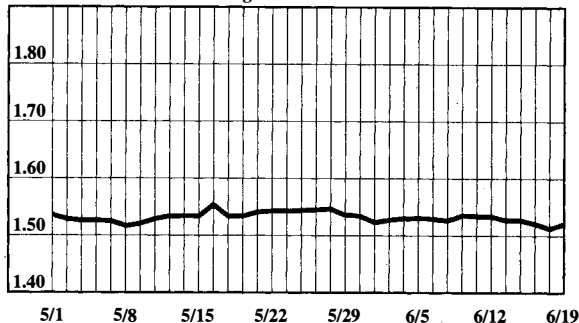
At the same time, the financial structures in the European Union, especially in France, are more fragile than ever before in the postwar period. France's largest bank, the state-owned *Crédit Lyonnais*, which only a year ago got a FF 135 billion (roughly \$27 billion) state bailout to avoid collapse, recently announced it was having problems servicing its debt, and is reportedly frantically trying to devise a new bailout scheme to keep afloat. France's huge, partly state-owned real estate mortgage bank, *Crédit Foncier*, just announced record losses, and France's large bank, *Paribas*, is in serious trouble, with a huge amount of defaulted real estate from the 1980s Paris real estate speculative boom which since collapsed.

"Taking the latest Japanese decision to accelerate deflation, the recent Federal Reserve deflation moves, even if so far disguised so as not to trigger panic, and given the fragility of the economic and banking problems in western Europe," Lewis concluded, "it is clearly the case that a main focus of discussion at the June 10 BIS central bankers closed-door meeting, was coordinated global deflation." This is a more appropriate context to consider the otherwise inexplicable Sumitomo affair.

## Currency Rates

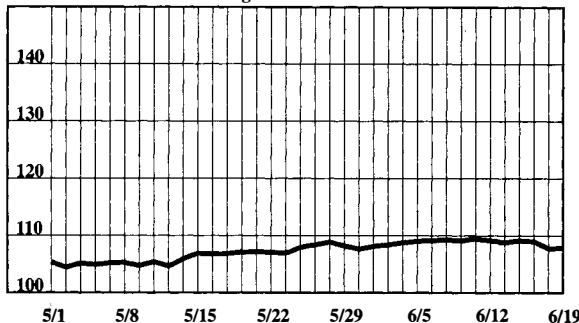
### The dollar in deutschemarks

New York late afternoon fixing



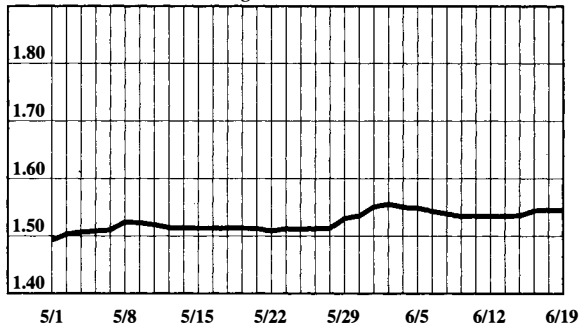
### The dollar in yen

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

