Governments scramble, as panic hits Tokyo markets

by William Engdahl

Despite the 815-point recovery of stock prices on the Tokyo Nikkei Dow index on Jan. 13, there is still concern in international financial circles that the Japanese financial situation could serve as detonator to a global systemic financial and monetary crisis in coming weeks. A critical date is March 31, the end of the Japanese fiscal year.

With the Nikkei Dow index hovering precariously near the 18,000 level as of this writing, at least two large Japanese banks are reliably reported to be technically insolvent. But the government of Ryutaro Hashimoto, by all indications, is in a state of policy paralysis, amid what is now the seventh year of Japan's most severe financial and economic crisis of the postwar period.

Having recently unveiled a program calling for financial market deregulation in many areas by 2001, as a keystone of his policy, Hashimoto has committed himself to lift the famous Japanese "market supervision" mechanisms, which in the past always meant that the government would help private banks or financial markets in trouble. Indeed, as the Nikkei continued to fall, Finance Minister Mitsuzuka told press on Jan. 9, "There's nothing we can do about it." His comments prompted even worse panic selling the next day, driving the Nikkei to 17,300, the lowest since August 1995. But the situation has deteriorated so severely in recent days, that those promises of non-intervention have already been shoved into the background.

For the first time since the crisis days of April 1995, when Japan's entire financial and economic system threatened to implode in an uncontrollable deflation spiral, some analysts, including Mitsubishi Research's chief economist, Takahashi, are predicting that the Nikkei could again fall, to 14,000 or lower before March.

Japan's exception haunts banks

Why should the stock market have such influence on banks and the world financial system?

Japanese banks, today among the world's largest, enjoy what has become a perverse linkage to the fate of the Tokyo stock market. In the late 1980s, the central banks of the industrialized countries, through their chief lobby organization, the Bank for International Settlements (BIS), hammered out a set of rules, defining for the first time common standards of minimum bank capital and risks for different types of cross-border lending.

Growing concern over reckless bank lending, which was pouring funds into real estate speculation, junk bond investments, and such, prompted the central bankers of the BIS to agree to impose uniform strict capital requirements on BIS member-country banks doing business internationally. Since the BIS rules took effect in 1992, all such banks must show a "core capital," in terms of reserves, equal to 8% of its total loans. Japan alone managed to get an "exception" from the BIS rules, and was able to count bank holdings of stocks in other Japanese companies as part of their 8% "core capital" for BIS purposes. Their argument was that Japanese banks uniquely had large cross-holdings of stocks in related industrial companies, which were regarded as core or permanent bank assets. At the time, the Nikkei was rising.

Under the BIS rules, at the end of every Japanese fiscal year, March 31, the banks must declare the market value of their stock holdings on that day, their so-called hidden reserves.

The exception has now become an albatross hanging around the neck of the entire international financial system, notably that of the United States and a large part of the European Union. As one senior Swiss banker characterized it, "The Japanese situation has the real potential to provide the critical mass which could turn a Japanese problem into a full-scale systemic crisis of the international financial system."

Here is the nub of the present dilemma: The more the Nikkei falls in the run-up to March 31, the lower the book value of banks' reserves falls. To compensate, banks can only issue new stock (further depressing the Nikkei), or cut their loans (further depressing the economy), to hold the 8% rule. Both are already taking place, aggravating the crisis.

According to calculations by the London rating agency IBCA Ltd., at a level of Nikkei of 18,000, one major bank, Nippon Credit Bank, has a deficit in its hidden asset value, i.e., a negative worth. At 17,000, NCB is joined by three other of Japan's 20 biggest banks—Hokkaido Trust, Long-Term Credit Bank, and Yasuda Trust. And at 14,000, fully 16 of the top 20 banks have negative hidden asset value.

Compounding this problem is the overhang of bad loans from the late-1980s lending binge in Japan, in which banks flooded the market with dubious real estate loans and stock purchases. In late 1990, the Bank of Japan intervened to try to deflate the speculative bubble, as it reached, on paper at least, a total market value of stocks in Japan exceeding that of any other nation, the United States included. The Nikkei had hit its all-time high of 38,000 in December 1990, before the "correction."

Only in the past 15 months or so had Japanese banks even begun concerted efforts to write off their estimated $800 billion to $1.1 trillion in bad loans. Most of those loans are still counted on the books of Japanese financial institutions as "performing" loans, a dangerous accounting fiction that now threatens to come unravelled.

The few write-offs of bad loans that have taken place, perhaps 10-20% of the total, became possible only when the Bank of Japan and Ministry of Finance, beginning May 1995, realized that they were facing a total meltdown of Japan's banking system, as well as its economy, and that of much of the world with it.

At that point, with strong support from U.S. Treasury Secretary Robert Rubin and Federal Reserve Chairman Alan Greenspan, the Japanese government implemented the most dramatic bailout effort in the postwar period. Official interest rates were brought to the unheard-of low of 0.5%, where they remain today. Banks were able to borrow at this ludicrously low level, and were encouraged to use the funds to invest in risk-free state bonds abroad, especially in the U.S. Treasury market. They would earn huge profits on the higher interest in the United States, as well as profit from a currency gain. The capital outflow from yen into dollar bond investment by the banks, together with an agreed joint U.S.-Japanese central bank strategy to push the dangerously high yen down, gave the banks record profits over the past 20 months. Banks for the first time began cautious write-offs of bad debt.

Continuation of bad loan write-offs sufficient to wipe out some $1 trillion in bad loans, however, required something more. It needed a huge boost in the Nikkei, to give banks an inflated core capital against the required write-offs. A rise in the Nikkei to something like 25,000 to 28,000 would be required to stabilize the overall bad loan crisis, by informed estimates. Solving the problem only through low interest rates would take years, and would so damage the liquidity of pension funds and insurance companies dependent on interest income, that that alone would detonate a systemic crisis.

'Damned if we do, damned if we don't'

This was the deadly dilemma Japanese authorities and banks faced this past December, when foreign investors began to sell their stocks, seeing the weakening prospects for Japanese economic and banking recovery. Last June, the Nikkei had slowly climbed to 22,700 as confidence in rising exports, boosted by the 42% fall in the yen over one year, created the first hint of optimism among foreign fund managers. By Dec. 5, that optimism had evaporated, and foreign funds began to sell, to get out before the year's end. But, while they sold, no Japanese pension funds or large investors stepped up to buy. In fact, the banks, too, were selling their Nikkei stock.

Beginning early in January, that selling took on panic dimensions, coupled with aggressive derivatives options betting on the further drop of the Nikkei. By Jan. 10, the Nikkei had dropped 24% from last summer. At this point, Japanese authorities have reportedly been forced to secretly intervene to support the Nikkei, in a so-called "Price-Keeping Operation," buying from a large public pension fund, the source for the 815-point "recovery." Few are convinced, and more sharp falls, especially of bank stock, appear pre-programmed as March 31 nears.

The yen trap

Little-understood is the role which the Ministry of Finance has played, both in aggravating an already serious financial crisis, and now, in trying to contain it. The International Finance Bureau head of the Finance Ministry, Eisuke Sakakibara, who has been dubbed in Japan "Mr. Yen," has overseen a 43% drop in the currency against the dollar since the April 1995 record high of Y 79 to the dollar. Today it hovers around Y 116.

Left unsaid, however, is that the Ministry of Finance, with the Bank of Japan, deliberately pushed the yen dangerously high from 1992-95, as part of an ill-conceived strategy of forcing Japanese companies to relocate a large chunk of their manufacturing to low-cost Asian or other areas.

Major relocation indeed took place—and almost destroyed Japan. In addition to threatening the social fabric of "lifetime" employment security in Japanese companies, the high-yen tactic had a short-term devastating impact on export companies' profits, leading the Nikkei to a dangerous low of 14,500 by April 1995, and threatening a meltdown of the Japanese banking and financial system.

As *EIR* has detailed, that was the context for an emergency Group of Seven agreement, spearheaded by Rubin and Greenspan, to avert a systemic disaster by cooperation among major central banks to sell yen and buy dollars. In addition, to restore international confidence in the interbank lending market, the United States revealed that an extraordinary $500 billion potential line of dollar credit had been made available to any major Japanese bank in liquidity trouble. The line was never drawn on; its mere announcement served to calm bankers' fears. Japanese banks in October-November 1995 were being forced to pay up to 1% over normal to refinance their interbank credit lines. That Japan "risk premium" threatened to freeze the banks out of access to urgently needed liquidity.

By December 1995, as a result of impressive international efforts, the yen was falling sharply, Japanese exports were increasing significantly, bank profits began to recover, and the risk premium on banks all but vanished. The crisis seemed on the way to resolution.

These clever manipulations of the yen by the Japanese and U.S. authorities, however, created other problems, potentially as serious—if not more so. With the near-zero interest rates of the Bank of Japan, and the official Japanese policy to lower the yen, Japanese insurance companies and others, as well as banks, were encouraged by the Ministry of Finance to further weaken the yen, by taking money out of Japan to invest in low-risk government bonds, especially in the United States and Europe. The sums have reached reported record levels in recent months, with no sign of abating. The Ministry of Finance estimates total foreign investment by private Japanese firms today at some $100 billion.

But, as the yen continued to fall against the dollar, Japanese and foreign investors in Japan began to become alarmed about losing money on the currency. Over the past 12 months, the volume of capital flight out of Japan began to snowball to where, today, it has reached such alarming dimensions it threatens the Japanese economy. Already last November, Sakakibara tried verbally to stop the yen fall, but to no avail. Again on Jan. 6, Deputy Finance Minister Tadashi Ogawa tried, also with no effect.

This underscores the problem on the currency front. Japanese authorities are in a "damned if we do, damned if we don't" box. Each week longer with ultra-low interest rates in Japan, forces large funds or foreign investors to leave for foreign markets to earn more, forcing the yen lower still. Already, large Japanese pension funds have begun pulling their money out of life insurance companies, because interest rate earnings are too low. Yet, if Japan were to raise interest rates to try to reverse the capital flight, and push the yen back up, that rate rise could trigger a stock market collapse, and devastate bank earnings.

The systemic threat

Underscoring the global nature of the Japanese problem were the surprise remarks on Jan. 13 by U.S. Treasury Secretary Rubin. Despite growing protest by U.S. export companies over the high dollar, Rubin told the press that a "strong dollar is in America's interest," dashing hopes the yen's fall might end. "Rubin's comment tells volumes about the level of concern by international authorities, especially in America," said City of London investment strategist S.J. Lewis to *EIR*. "He fears that in the present unstable situation, were the dollar to unwind, the Japanese financial system could get out of control, leading to Japanese liquidation of U.S. Treasury securities in the process."

In addition to some $100 billion of private Japanese investment in U.S. and European markets, the Bank of Japan, in order to push down the yen, has intervened massively over the past two years to buy U.S. Treasury securities. As a result, Bank of Japan holdings of U.S. Treasury paper have climbed from $70 billion less than three years ago, to $212 billion by the end of last year. The Bank of Japan is the largest foreign holder of U.S. Treasuries today as a result.

Largely because of such Japanese buying of U.S. Treasury paper, interest rates in the critical U.S. bond market have fallen significantly. The falling interest rates, driven by the flood of cheap Japanese liquidity, in turn made it highly profitable for investors to borrow money to buy stocks. This has been a significant, if unspoken, factor in the wild rise of the U.S. stock market in the past two years, to a level where total stock market valuation, well over $7.8 trillion as of Dec. 31, exceeds the nominal size of the entire U.S. Gross Domestic Product, for the first time in history. This reportedly was behind the Dec. 5 remarks by Alan Greenspan about possible "irrational exhuberance" in the stock markets.

Were the Bank of Japan, or Japanese insurance firms and banks, to sell their U.S. Treasury securities, that would trigger a collapse in the U.S. bond markets, rising interest rates, and, very soon, a likely free fall in the U.S. stock market. Lewis estimates that the Dow could quickly "drop as much as 2,000 points" in such a case, or some 30%. If so, a systemic chain reaction in world financial markets could not be ruled out. Even a hint by a Wall Street analyst that Japanese buying might end, was enough to trigger a bond market mini-panic last December.

Ominously, in this regard, reliable reports out of the Tokyo financial sector in recent days are that, to stop the falling yen, the Ministry of Finance has privately encouraged Japanese insurance companies to begin selling foreign bonds and buying yen. These are some of the dynamics of the fragile world financial system as March 31 approaches.