EIR Economics

Currency crises lead march to October global crash

by William Engdahl

For more than two months, a series of currency crises and fears of worse to come, have devastated the stock markets and foreign exchange reserves of a growing number of Asian countries, led by Thailand and the Philippines. Are these shocks, tiny as they are in comparison with the scale of financial and currency markets in the United States or Europe, the precursor of a global financial earthquake?

"Right now we have a Southeast Asia crisis," S.J. Lewis, a City of London economist, commented to *EIR*. "But, as that begins to combine with what I see as the maturing potential for a full-scale Brazil financial crisis, then we are looking at something far more serious." Lewis added, "Combine this with the financial costs of the ongoing floods in Poland and the Czech Republic, which is spreading financial unrest there. Then, sometime in October, we can also expect to see a full-fledged crisis in the European Monetary Union [EMU], with currency crises probable in Europe as well."

The potential is great, that the Thai baht crisis, what is now a relatively small perturbation on the global financial markets, could thus detonate a chain reaction of ever-larger crises which, given the bloated stock markets across Europe and the United States, could converge with a global stock market crash. Stock and currency collapses simultaneously in more than one part of the world financial system, according to Swiss bank sources, would be "uncontainable."

The Asia turmoil

The immediate trigger for financial market uncertainty has been Thailand (see *EIR,* March 21 and June 6). On July 2, following a more than month-long effort to counter massive speculative attacks, reportedly led by Quantum Fund's George Soros and other offshore hedge funds to force devaluation of the baht, Thailand's government let the baht float. Since then, the baht has fallen more than 25% against the dollar, with no bottom yet in sight. The problem is that the Thai economy is in the midst of an intense banking crisis which has yet to fully implode. When it does, it promises to unleash a new wave of currency crises which are likely to spread across so-called Emerging Market countries from Asia to Ibero-America. Moreover, Thai corporations have borrowed huge sums abroad, some $60 billion. As the baht falls against the dollar or yen, companies' debt service soars. A wave of Thai bankruptcies is at this point all but preprogrammed, which will put Thai banks under stress.

On July 28, following feverish negotiations with the Japanese government (Japanese banks are the major Thai lenders, with $37 billion in loans outstanding), and with the International Monetary Fund (IMF), the Thai government is scheduled to announce whether it will accept harsh IMF austerity conditionalities. This IMF agreement is the minimum precondition reportedly demanded by the Japanese government for granting an estimated $20 billion emergency bailout assist in stabilizing the Thai situation.

According to Japanese financial sources, Japan's Ministry of Finance is trying to organize a Mexico-style international rescue package to prevent a collapse of the Thai banking system. Such a crisis would threaten severe problems for embattled Japanese banks. "The economic dilemma facing Thailand's banking system is far worse than the one Mexico faced," claims Goldman Sachs' Roy Ramos. "Thailand is far more leveraged, with loans outstanding equal to more than 140% of GDP, compared with Mexico's 45% in 1994 before the peso crisis."

The Thai currency crisis has spread to attacks on other fragile emerging countries. On July 21, the IMF announced that it had rushed through an extraordinary $1 billion loan to help the

Bank of Philippines stabilize the peso, the first such IMF action since the 1994 Mexico crisis. On July 22, the Indonesian rupiah lost more than 7%. That same day, Malaysian Prime Minister Mahathir Mohamad denounced unnamed speculators, in a clear reference to Soros, for politically motivated attacks on Malaysia's and other Asian currencies. "Are we sovereign nations?" Mahathir asked. "If we are sovereign nations, shouldn't we be able to protect what belongs to us? Instead we are told we should allow such speculative activities. But they are teaming up to impoverish the poor countries."

UBS, one of Europe's largest banks, has just issued a study of the banking problems in Asia. It calls Thai bank problems, because of large bad real estate loans, low risk provisions, and wild speculation, "truly stratospheric." But UBS places the Philippines, and South Korean banks, in the same league. UBS describes the Philippines financial system as "more vulnerable now to a meltdown than at any point in the past two decades. No other Asian country has a banking system that is in as much trouble."

In South Korea, where banks just bailed out the failing automaker KIA, and where exports have stagnated for months, UBS warns its clients, "While bank runs and failures are rare in Korea, banking 'crises' are reflected in their share prices, which have fallen 40% since mid-1996. Stay away from the Korean market." On July 23, Standard & Poors, the U.S. credit-rating agency, placed five Korean banks onto its "credit watch" list for their combined $1.9 billion exposure to KIA, to reflect what it called "heightened industrial risks faced by Korean banks as defaults continue to emerge among Korea's highly leveraged conglomerates." Hanbo and Sammi Steel collapsed earlier this year, and since then, Korean banks have agreed to rescue industrial companies. "This could lead to higher non-performing loans" for many Korean banks, S&P warned.

Floods in Europe

The problems are not restricted to Asia, as some have tried to argue. For several weeks, the central European regions of Poland and the Czech Republic bordering Germany have been hit by the worst floods in the century. With a severe deficit of economic infrastructure investment, especially in Poland (see p. 6), the floods have caused billions of dollars in damage to the vital Silesia coal and industrial region. In the Czech Republic, just barely out of an earlier currency crisis in June, the floods will force the government to spend unplanned billions there to repair damage, threatening a new collapse of the Czech Stock Exchange and the koruna, making urgently needed foreign investment that much less likely.

Investors have taken to flight out of the Polish zloty and the Czech koruna. Some estimates put the actual damage, as opposed to what is insured, in both countries as high as $10 billion. Speculators have reacted. The zloty fell 4% in one day, despite central bank interest rate rises and intervention, and the koruna is again under pressure.

Investors have also begun to rethink the recent success story of Brazil, where draconian economic deflation measures in the "Real Plan" 18 months ago have controlled hyperinflation, but at the price of severe bankruptcy problems for mid-size companies unable to repay bank debt. Brazil has covered over the problem in recent months with a huge inflow of short-term borrowing from mainly U.S. banks, such as Chase and J.P. Morgan. Were confidence to collapse and the banks to call in their loans—an estimated several billion dollars—Brazil would plunge into a Mexico-style crisis as well. In mid-July, investors, fearing that the Thai crisis would spread, sold stock shares in the São Paulo exchange, triggering a 15% collapse in three days.

The Brazilians and their U.S. bank creditors are holding their breath. Lewis estimates, because the bad loans held by Brazil's banks will increase as long as the Bank of Brazil is forced to defend its currency with higher interest rates, that "sometime in September or early October we could see a full-scale Brazil crisis."

Is a euro crisis next?

In this context, little noticed outside foreign-exchange trading rooms has been the development on Europe's foreign exchange market in recent days. The German mark, traditionally the "anchor of stability" for the European Union, has fallen 23% against the dollar since summer 1995, when the Bundesbank began to ease interest rates in hopes of stimulating Germany's depressed economy. But today, the mark is in danger of free fall, as speculators calculate that the Bundesbank is powerless to stop a fall during the countdown to Europe's EMU. A rise in German rates to defend the mark would trigger a market panic across Europe, risking killing the EMU.

Traders say the late-July decline in the mark was triggered by growing belief that the resulting single supranational currency, the euro, due to be created on Jan. 1, 1999, will be a weak one. On July 21, French Finance and Economy Minister Dominique Strauss-Kahn revealed that an audit of government finances showed the deficit likely to hit 3.5-3.7% this year. The 1997 deficit for a country to be allowed to enter the EMU, should not be above 3.0%. When the French government revealed its far weaker economic results, and combined it with a restatement of French intent to be among the first EMU countries, along with Italy, financial markets reacted by selling francs and marks, and buying dollars.

In the complex political chess game now under way to determine who qualifies to join EMU, the issue of Italy has become pivotal. "If Italy manages to join on the first round," Lewis stated, "my view is that Germany would then be forced to announce delay of the entire EMU, something with unpredictable and perhaps fatal consequences."

Marcello de Cecco, an Italian economist, told *EIR,* "The German elites, especially the banks, want a hard, stable euro because they're prepared, and the other countries' banks and companies aren't. German banks are fixated on switching from their present tradition of industrial economy to a service economy where banking and finance dominate. This, they believe, will only be possible if the euro is strong from the start. Then they can buy up weaker French or other banks at a premium discount." On July 24, Deutsche Bank Chairman Rolf Breuer announced that Germany's largest bank, which just posted record after-tax profits of 27%, was planning to buy up French banks or financial institutions. "This is one of the biggest things we're looking at," Breuer said.

But, France, for political reasons, insists that weaker countries like Spain, but especially Italy, must also be allowed to join the EMU, partly as a defense against stronger German banking competition.

According to informed Brussels European Commission reports, this tension over Italy will come to a head around October, when the EC issues an official estimate of each country's expected budget deficit for 1997 and 1998. According to this report, the "estimate" will show Germany, France, and Italy in 1997 all with a 3.4-3.6% deficit. But, for 1998, Brussels reportedly will estimate both Germany and France below 3%, but Italy at 4.8%. "These estimates in any case are politically manipulated," stressed De Cecco. But such a report, with so negative a forecast for Italy, according to currency traders, would trigger a panic sell-off of the lira, and soaring Italian interest rates, which would devastate Italian chances of early entry to the EMU. For months, banks and investors have speculated that Italy will meet the criteria, and have invested billions into Italian bonds, which still pay a higher interest rate than French or German bonds.

"But an EMU crisis in October," Lewis concluded, "especially in the context of what by then I expect to be even larger banking crises in Asia and probably Latin America, would create the critical mass for a real global crisis. Add to these currency problems which are building across the world, the problem posed by historic new record high stock markets from New York to Frankfurt to Paris and Milan. The moment the Fed or German central bank raises interest rates, that bubble will also burst."

The present vulnerability of the global system to such a shock, was noted by a Boston fund manager in reference to Fed Chairman Alan Greenspan's July 22 Senate testimony. "If Greenspan says anything about 'irrational exuberance,' " he noted, "the market is going to panic." Obviously, this was just the reason Greenspan perplexed his listeners, by intoning a bizarre hymn to a "new paradigm" of inflation-free prosperity, suggesting no plans to raise interest rates. Had he raised rates even 0.25%, as he did on March 25, it would likely have triggered a chain-reaction collapse of world stock markets, and detonated an emerging market collapse which would drag down banks from New York to Tokyo to London.