EIR Economic Feature

Swiss central banker warns of threat to 'whole system'

by William Engdahl

On Oct. 14, Prof. Bruno Gehrig, a member of the Switzerland National Bank directorate, became the first central banker to publicly warn that, if the speculative activities of the international foreign exchange markets continue in the present mode, a huge catastrophe is immediately ahead. In remarks to the Swiss Bankers Association which were publicized in the Swiss financial daily *Neue Zürcher Zeitung* on Oct. 15, Gehrig focussed on worldwide daily foreign exchange trading of some $1.2 trillion, and the danger of a breakdown in the global payments system from a collapse of one or more large banks, the so-called Herstatt Risk, named after a small German bank which went bust in 1974 and triggered a global crisis.

Gehrig bluntly stated, "The settlement risk behind this volume [over $1 trillion] has been long ignored in the market. The risk, however, could threaten the stability of the entire financial system and endanger the international financial markets." Gehrig concluded by castigating the private banks for tolerating "these no-longer-tolerable systemic risks."

This warning, which echoes what leading economist Lyndon LaRouche has been addressing for years, is not unique within the financial world, especially among high-level European bankers. But, its prominent coverage, which occurs within the context of the ongoing instability in the Asian markets and growing terror about the uncontrolled derivatives bubble, signals a phase shift in the financial crisis.

At the same time, leading financial commentators in London, including former London *Times* editor Lord William Rees-Mogg, and British fund manager Tony Dye, have again gone on record, saying that the unbridled speculative binge on the international markets means the *doom* of the international financial system. As LaRouche has continually stressed, no one can say *when* the system will collapse, but the process of buying time, which has been proceeding since 1994-95, actually worsens the crisis, and will make the inevitable crash even bigger.

A chain reaction

What Swiss banker Gehrig's speech highlighted was the danger of a "chain reaction" resulting from the inability of banks to handle the "settlement risks" of the huge volume of daily foreign exchange trading. He maintained the common position of international central bankers in favor of "self-regulation" to limit risks, but warned that "otherwise, regulatory steps by the authorities will have to follow."

Gehrig harkened to the 1974 collapse of the German Herstatt bank, which, due to its big foreign exchange positions, was causing a chain reaction of problems for its overseas counter-parties. These banks lost the full nominal value of their foreign exchange transactions, when Herstatt bank suddenly was shut down by German authorities on July 26, 1974, at 10:30 a.m. New York time.

Even though the Herstatt case was 20 years ago, Gehrig said, "the core of the problem is still the same," while the volumes have by far increased. The payments by the two parties in a foreign exchange transaction can have a time difference of many hours or even several days. Therefore, any foreign exchange transaction "definitely involves a credit risk for the bank amounting to the full value of its payments." While waiting for the payment of the counter-party, the bank has to look for an intermediate refinancing, adding "also a liquidity risk." Gehrig emphasizes, "These already worrisome risks, as seen from the perspective of a single bank, in

Federal Reserve Board Chairman Alan "Dracula" Greenspan, who is determined to protect the international speculative bubble—down to the last American. In Congressional testimony on Oct. 8, Greenspan called for privatizing and slashing Social Security, cutting Medicare, holding down wages, and allowing no new spending on infrastructure.

the meantime pose a systemic risk and therefore a danger for the functioning of the financial markets."

Gehrig also referenced the "severe clearing problems" which had been created by the collapse of Barings Brothers bank in 1995, and noted that many banks are blithely ignoring the dramatic risks. He said, "Many banks are completely unaware, that they are routinely being exposed to risks in foreign exchange trading, which are bigger in value than their transactions of several days. The amount of risk, even with respect to only one counter-party, can therefore surpass the stock capital of the bank." The efforts "to effectively contain the systemic risks are . . . not sufficient." And, as he notes, some banks are even sticking to "the erroneous belief" that they, or their counter-parties, are "too big to fail."

Liquidation of the system

Economist LaRouche, who correctly forecast the 1987 stock market collapse, the collapse of the Soviet Union, and several other crucial developments, has been warning, especially since 1994, that the global financial system would inevitably *disintegrate,* unless there were a "politically improbable decision by leading governments to put the relevant financial and monetary institutions into bankruptcy reorganization."

In a radio interview with "EIR Talks" on Oct. 14, LaRouche reiterated the warning. "There are over *one hundred trillion U.S. dollars equivalent* of financial short-term obligations sitting out there. The United States is carrying *thirty*—about one-third of them—thirty-odd trillion of these obligations, plus other obligations. This is *several times greater than the entire GNP of all the world's nations combined!* Therefore all banking systems, since their current obligations vastly exceed all possible assets—*they're all bankrupt!* And this thing is coming down. The ability to postpone it, gets shorter and shorter. In other words, every time you try a time-buying deal, the time that you can postpone it to the next time, gets shorter and shorter and shorter. It's a boundary layer. It's going to *go!*

"Now, it's gotten to the point, that even some of the dumbest people in the markets are beginning to catch on to this. People like Warren Buffett, for example—and there are people in England, and so forth, doing the same thing—have been taking their money, since the beginning of 1995, beginning to move their money o-u-t of these high-risk financial markets: Let the *suckers* come into the derivatives market. Let the *suckers* buy into the stock market. Let the *suckers* keep in the mutual funds market. They're all going to go bankrupt!

"These guys sneak out, invest in raw materials, control of raw materials, vital raw materials, or they buy gold, and hold it; they may take a loss on it, a financial loss, but that's not dumb, that's smart, if you can afford to do it. And they will buy U.S. Treasury bonds. Buffett bought zero-coupon bonds, that's bonds that have no-interest yield, but are sold at a discount, and you hold them—they're the most secure thing you can get, in terms of paper. And he's talking about the order of magnitude of $10 billion of personal assets going into zero-coupon bonds of this type. That's the smart thing to do, for people who have the money to do it with. And they're all doing it. They're saying: Get out! Get out! Get out! The party is over.

"Now, what the Brits, and what Rees-Mogg, and what these guys will do about it, is directly opposite to what I would do about it. But at least they recognize the problem, which the deluded, self-deluded optimist out there refuses to face, or the person too scared to face the truth."

LaRouche was parrotted on Oct. 13, by Rees-Mogg's commentary in the London *Times*. Rees-Mogg argues that conditions are ripe, in terms of standard measures of value, dividend yield, earnings yield, and ratio of the share price to the book value of the underlying assets, for a new crash. He then points his finger at the U.S. Baby-Boomer flood into mutual funds as creating conditions for a panic.

Rees-Mogg concludes that a Black Monday could occur at any time—today, next week, or next year. He says: "The likelihood is that stock markets will not have a soft landing; if the mutual fund investors of the U.S. stop buying, Wall Street will have to fall a long way, to get them started again. The risk of a stock market crash is a threat to world prosperity. . . . There is much more than the fortunes of speculators riding on Wall Street indices."

The derivatives time-bomb

It is widely recognized that the proportion of the speculative bubble made up of derivatives is among the most likely detonators of a blowout.

A feature article in the London *Sunday Times* of Oct. 12 stressed this point again. British fund manager Tony Dye, who had made screaming headlines several months ago warning of a "$55 trillion horror show" of derivatives, was once again quoted predicting a United Kingdom and U.S. market crash. Author Paul Durman put it this way:

"One reason the market has taken leave of its senses, Dye believes, is the growing use of derivatives. The market has become a commodity, driven by the purchase of options on the future level of the FTSE [London's Financial Times Stock Exchange index] whose movements are increasingly unrelated to the trading performance of its constituent companies." Dye says the total of such stock options and other derivatives runs into the trillions. "Yet the information is so sketchy it is impossible to tell where the exposure lies. The scale of derivatives trading hints at the extent of leverage in financial markets—large economic interests underpinned by only small down payments. When markets turn, many over-leveraged investors will have to raise cash quickly in order to meet their commitments. The wave of enforced selling that ensues is the classic way in which financial markets become unstable and crash."

The Asian currency crisis

The official line being spread by Western banks and governments to date, has been that the currency, financial market, banking, and now economic crisis sweeping Asian economies over the past five months has reached bottom, and that, as one Western corporate executive had been told by his government, "anyway, the rest of the world is fine, and this part of Asia, minus Japan, only accounts for 3% of global GDP."

Such official and private-sector nonchalance about Asian developments ignores the dynamic potential for the spreading East Asian crisis to interact with the Group of Seven (G-7) industrial nations' worst-case economy, Japan, as well as the United States and Europe, in a manner which would imminently bring down the entire global financial edifice. The Asian crisis is a *symptom* of the global crisis.

Far from calming, East Asian problems have continued to spread. On Oct. 14, Thailand unveiled its World Bank/International Monetary Fund-approved "financial restructuring" program, in hopes of getting the promised $17.2 billion loans promised in August. Part of the plan calls for government guarantee of all domestic creditors of still-operating banks and finance companies. In August, the government put 58 financial institutions, most with huge speculative real estate bad loans, into state receivership. Some 15 banks and 33 finance companies are still allowed to operate. All their credits will be guaranteed by the Thai taxpayer, essentially. As well, Thailand will create a Financial Restructuring Authority, similar to the U.S. Resolution Trust Corp., which dealt with the U.S. savings and loans crisis in the early 1990s, to liquidate the assets of the 58 defunct finance companies. And, in a desperate bid to attract foreign capital to stabilize the economy and currency, it will allow foreign takeover of domestic banks and finance companies for 10 years. But, as the London *Financial Times* noted on Oct. 15, "In the short term none of this is likely to help the baht" (the Thai currency).

Indonesia, which has been struck by raging forest fires and drought, and faces huge food import bills later this year, on top of a panic flight of foreign investors leading to collapse of the rupiah and the Jakarta Stock Exchange, the government has been forced to admit it has no accurate estimate of the size of bank bad loans. Reports of large foreign debt payments due in coming weeks lend a note of urgency to the situation and are fuelling foreign investor panic selling. With the rupiah down over 30% since June, and debts due in dollars or yen, the crunch is immense. One well-informed Jakarta source told *EIR*, "The government is in a panic, with not any idea how to deal with this shock."

As well, the flight of capital and collapse of markets and currencies continues to savage the economies of the Philippines, South Korea, and most recently, Asia's largest financial market outside Tokyo, namely, Hongkong. The critical Hang-Seng stock index in Hongkong in mid-October fell well below the 13,500 level, and as of this writing continued to drop by 2-4% per day. Recent land auctions of the new government have reportedly been disastrous. Real estate is the prop for the entire economic and financial structure of Hongkong.

"The problem is that the banking systems and regulation in most of these countries is so lax or primitive that no one knows exactly what the size of the problem is in East Asia," noted a London-based senior economist of a conservative U.S. investment bank. "Best guess I have seen puts the present level of bad debt of the banks in these countries, minus Japan, at more than $660 billion. And it grows every day that the present crisis continues to force interest rates to remain so high."

'Tokyo gloom'

Yet, all this is small beer in comparison with the situation in Japan, where after seven gruelling years of economic depression, falling stock prices, and banking distress, the problems there appear to be on the verge of a new deflation crisis worse than that in 1995, which led to a joint U.S.-Japanese stabilization agreement. The bad debt of all Japanese banks is still well-hidden from public view by the banks, which are permitted to conceal much of their troubles by lax Ministry of Finance accounting rules. Private estimates place the scale of worthless non-performing loans on the books of Japanese banks after seven years of crisis at "well over $1 trillion." This despite several years of draconian bad loan write-offs by major banks.

But despite 0.5% interest rates by the Bank of Japan for two years, the domestic economy refuses to grow out of the crisis. The government just announced a catastrophic 11% drop in Gross Domestic Product from April to July. The problem is, banks are paralyzed from taking on new loan risks by the overhang of their bad debts. The government, as well, feels paralyzed to undertake the traditional kind of state "pump-priming" spending for public works, because, with state debt dangerously large and a current budget deficit an alarming 7% of GDP unofficially, Japan's Hashimoto government is committed to a de facto deflationary policy of fiscal austerity for the coming period, a Japanese repeat of Germany's catastrophic 1930-32 deflation policies, beginning with the government of Heinrich Brüning.

The result of the manifest political paralysis inside Japan has led in recent days to a full-scale foreign investor flight out of the Tokyo stock market. The Nikkei Index dropped briefly below the 17,000 level in mid-October. Only behind-the-scenes government buying managed to bring it above that. But, with domestic investors reportedly rushing for higher returns overseas in U.S. or European markets, some analysts predict the Nikkei could soon go below the April 1995 low of 14,485. At that point, many of Japan's largest banks would become technically insolvent, based on the market value of their core stock holdings in other companies.

The ultimate horror scenario is that under such pressures, desperate to raise cash, Japanese banks would be forced to liquidate their holdings of U.S. Treasury securities. While exact data are not made public, market estimates place Japanese bank holdings of U.S. Treasury paper at well above $200 billion. Were anywhere near that sum suddenly dumped on the market, the dollar would go into free fall and the U.S. financial system with it, to say nothing of the rest of the G-7.

The Fed defends global deregulation

Given this backdrop, it is more than ironic that the guardian of the world's most powerful monetary institution, Federal Reserve Board Chairman Alan Greenspan, in an Oct. 14 speech to the radical free-market Cato Institute in Washington, defended the recent globalization and deregulation of financial markets, only weeks after he had come out attacking a proposal to force banks to put derivatives exposures on their books.

"If we can resist protectionist pressures in our societies in the financial arena," Greenspan stated, "we can look forward to the benefits of the international division of labor on a much larger scale." The Fed chairman noted, "The recent financial turmoil in some Asian markets . . . confirm that in a world of increasing capital mobility there is a premium on governments maintaining sound macroeconomic policies. . . . The resort to capital controls to deal with financial market disturbances of the sort a number of emerging market economies have experienced would be a step backward from the trend toward financial market liberalization." The statements were a direct attack on recent proposals by the Malaysian government of Mahathir Mohamad, and those of LaRouche.

In fact, Greenspan's actions demonstrate that he is more than a bit alarmed at the potential, not only of an Asian crisis spreading, but also of the danger of a full-scale U.S. banking and financial crisis in the wake of a collapse of the bloated speculative stock market bubble of the past two years, largely fed by cheap credit from Japan. Greenspan appears to be jumping hoops in recent months to prevent any market panic from erupting into a systemic collapse of global dimension. The reason the Fed has hesitated to raise interest rates since March despite strong signs of inflation, according to informed market observers, is reportedly fear that such an action would trigger an out-of-control market collapse.

Notably, on Oct. 13, America's second-largest mutual fund, Vanguard Group, announced that it will no longer release data about cash inflows or outflows into any of its funds. The *Wall Street Journal* of Oct. 15 reported that Vanguard, "which specializes in so-called index funds that mirror the market, is bracing for a downturn in the U.S. stock market. In the event of a market plunge, these people said, Vanguard wouldn't want data showing big outflows causing a shareholder panic."