EIR Economics

Russia's financial crisis threatens global system

by Richard Freeman

"Russia's problem has the potential to become . . . central Europe's and the world's," U.S. Deputy Treasury Secretary Lawrence Summers told an international monetary conference in Vienna on June 1, at the beginning of a week dominated by furious international crisis-management attempts to deal with the "Russian phase" in a financial crisis that is now almost universally recognized as global, and systemic. The previous day, President Bill Clinton issued a highly unusual Sunday statement, to express hopes for "strong IMF [International Monetary Fund] and World Bank engagement in support of reform" in Russia, cite the importance of stability for the Russian currency, and endorse "additional conditional financial support from the international financial institutions, as necessary, to promote stability, structural reforms, and growth in Russia."

The IMF has announced that it will release a delayed $670 million tranche of its Extended Fund Facility for Russia; but it was rumors of a multibillion-dollar rescue for Russian finances, that brought a temporary stabilization of the Russian stock market, after its 44% collapse from May 1 through June 1, and a return of Russian Treasury bill yields to the 45% range, from their highs of over 80%, the previous week. Travelling to France on June 3, Russian Prime Minister Sergei Kiriyenko asserted that the worst was over.

Kiriyenko risked becoming the latest in a series of Russian political figures to stumble, having made such claims that a financial fever has passed. Russia faces a rugged series of debt payment deadlines, including weekly Treasury bill (GKO) rollovers, in the weeks ahead. The rise in GKO interest payments has already blown the Russian government's spending calculations to smithereens, making it impossible to meet state-sector wage payments and other obligations, essential for the stability of the country.

On June 2, a City of London financial source told *EIR* that "the situation in Russia is critical." He continued, "After Monday's sharp fall in the Moscow stock market, reports are that brokers can't meet their obligations, *threatening chain-reaction defaults across the Russian banking world*. Russia at the moment is the most serious problem faced by the G-7, even more serious than the yen."

U.S. Treasury Secretary Robert Rubin expressed similar concern, in an interview with CNN: "There is also the risk once again of contagion if Russia really has substantial instability and difficulties that can spread to central Europe and that can then spread further."

A flurry of emergency meetings on Russia is under way, including of the Deputy Finance Ministers of the G-7 industrial nations, scheduled for the week of June 7. On June 3, the Japanese daily *Nihon Keizai Shimbun* reported that the G-7 nations are contemplating a $10 billion financial aid package.

The danger, cited by Summers and Rubin, that Russia's crisis will spill over into Central Europe and beyond, is compounded by the strategic dimension: Further economic breakdown in Russia could lead to social unrest, and even the breakup of the country. Russia possesses 20-30,000 nuclear warheads, and its political and economic disintegration could be a catastrophe.

Under IMF direction, Russia's factories and raw materials have been looted, its industrial production is only 45% of what it was in 1989, its population is declining, and its tax revenue base has been destroyed. Unless world leaders address the global, systemic nature of the world financial disintegration, and destroy the power of the IMF, any attempt to stabilize the Russian situation, even in the short term, is sure to fail.

Budget, banking crises

Russia's budget crisis has been driven to new intensity by the speculative pyramid scheme of state Treasury bills.

In early June, Russian Finance Minister Mikhail Zadornov outlined an IMF-dictated austerity budget that called for 12% budget cuts across the board. Hundreds of thousands of state employees are to be fired, the railroads will be "reorganized," i.e., rationalized and looted, and so forth. Under this proposed plan, 3-4 billion rubles will be saved in the third quarter, and another 7-10 billion in the fourth quarter of this year. In the budget, Russian debt service for 1998 was planned to be about 100 billion rubles, with the interest rates averaging 25% through the year. But GKO rates have been averaging 50%; were that to continue, it would add an extra 100 billion rubles interest cost to the budget, an amount larger than all the IMF planned budget cuts.

On June 3, the Russian government raised another 5.83 billion rubles ($950 million) by issuing GKOs. The 343-day GKOs sold with "only" a 54% interest rate. But, as a measure of the government's desperation, for the first time in its history, it issued seven-day GKOs, meaning that the Russian government is financing itself on a week-to-week basis. The initial annual yield on the seven-day bills was 39.9%. According to one report, after the seven-day bills were issued, their price fell, and the yield shot up to 50.8%. The government could only find one-fifth the buyers it needed to sop up the $200 million it issued in seven-day bills.

The weekly Wednesday panic is projected to continue through the summer, since 100 billion rubles ($16 billion) in Treasury notes come due before the end of August.

The most serious element is the potential meltdown of the Russian banking system, warned the City of London source. Indeed, the Toko Bank failed this year, and the Sberbank, which represents Russia's national savings system (and which is the largest holder of GKOs), has seen its share price hammered down each day in trading on the Russian stock exchange. The danger is that the interbank market—in which banks trade money for 24- to 96-hour periods, and which keeps the Russian banking system liquefied—will become illiquid.

A banking crisis would make it impossible for the stock or the GKO markets to function. It could also force Russia to default on its $145 billion foreign debt. Russians, as well as foreign investors, would incur tens of billions of dollars of losses on investments in Russia.

Another Achilles' heel: Ibero-America

The troubled world financial system might be compared to a centipede with not one or two, but many "Achilles' heels." One, is Ibero-America. The May 29 *New York Times* commented, "Just when it began to look as if Latin America had dodged the bullet of Asia's financial and economic woes, stock markets from Mexico to Chile began to tumble. The decline, which began in earnest three weeks ago, accelerated earlier this week, ushering in a period of increased volatily."

Since May 1, the Mexican IPC stock market has fallen 12.6%, to a six-month low; the Argentine MerVal has fallen 14.4%; and the Brazilian Bovespa has plummeted 15.6%. U.S. mutual funds that specialize in investing in Ibero-American stocks have reported a net outflow, that is, disinvestment, for 20 of the last 21 weeks.

But there are fundamental problems in each of these countries. In Brazil, just from January to March of this year, total foreign debt rose by $18.7 billion, to $212.4 billion, making Brazil the world's largest debtor. In part, this is due to the Asian phase of the world crisis. For example, last year, once the crisis in Asia became more severe, the interest rates charged on the foreign debt rose not just for Asian nations, but also nations in Ibero-America, increasing debt service costs.

Moreover, fundamental weaknesses threaten both to unravel the economy and put Brazil in the target sights of hedge-fund speculators. On May 28, the Brazilian Central Bank's director of International Affairs, Demosthenes Madureira Neto, nervously announced that the government is prepared to spend $15-16 billion in reserves to defend the value of Brazil's currency, the real, against attack.

Asian crisis enters second phase

Finally, there is no let up in the virulence of the "Asian" crisis, which entered a second phase in March-April. Since May 1, Asian stock markets, which during the first quarter of this year only partially recovered the ground lost since June 1997, have been hammered once again. Since May 1, Hong Kong's Hang Sheng stock index has fallen 16.1%, Thailand's SET index has fallen 22.5%, Malaysia's Composite has fallen 17.2%, South Korea's Composite has fallen 21.1%, and Singapore's Straits Times index has fallen 20.5%.

In South Korea, during the first quarter, investment in machinery and equipment fell 40.7%, from a year earlier; output in the construction industry fell 39%, compared to the previous quarter; and household consumption, which accounts for half of Gross Domestic Product, fell 10.5%, the worst decline since the Central Bank began compiling figures in 1953.

Meanwhile, private capital flows are leaving Asia. The June 1 *Business Week* reported that in the last ten days of April, Japanese investors bought a record $21 billion in foreign bonds and foreign equities, a sign of flight capital. This would undermine the Japanese government's attempt to defend and strengthen the yen; during April and May, Japan's central bank reportedly spent more than $20 billion trying to defend the yen.

Such capital flight undermines Japan, a nation with roughly $770 billion in non-performing commercial bank loans. Japan is the economic pivot of northeast and southeast Asia, and the second-biggest economy in the world. Its financial failure could bring down the world financial system all by itself.

A new system

But a step toward a solution to this crisis came from a national leader who has repeatedly denounced the "insanity of money-making" controlled by the financier oligarchy. Speaking at a Tokyo symposium on June 2, Malaysian Prime Minister Dr. Mahathir bin Mohamad called for establishing a "new international financial system" (see *Documentation*).

Mahathir's speech is in the direction of Lyndon LaRouche's call for a New Bretton Woods monetary system, based on fixed exchange rates, and pivoted around development of the Eurasian Land-Bridge. *EIR* will hold a seminar in Washington on this topic on June 18, titled "When Will the Leading Nations, Including the United States, Admit That the IMF Is a Complete Failure and Implement Lyndon LaRouche's New Bretton Woods System?" Such an approach is the starting point for world leaders anxious to solve the crisis in Russia—and the other "Achilles' heels."

Documentation

Mahathir urges reform of global financial system

On June 2, Malaysian Prime Minister Dr. Mahathir bin Mohamad addressed a symposium in Tokyo, entitled "Revitalization of the Japanese Economy and the Future of Asia," sponsored by the Institute for International Monetary Affairs:

Dr. Mahathir said financial experts should stop blaming Asian governments for the currency crisis and help reform the international financial system, in particular, to minimize exchange rate volatility and curb currency speculations.

"Our task is to focus on the remedies, the things which must be done if we are to revitalize ourselves, if we are to ensure the revitalization of Asia. . . .

"The present system, if there is a system at all, is messy, unreliable, and destructive. Can world trade depend on these shadowy market forces whose methods are not known to anyone except themselves?

"I believe the time has come to deal with the entire issue of reform of the international financial system to ensure currency stability and contain the activities of those who buy and sell money for no other purpose than to make profits."

Referring to the collapse in value of the Indonesian rupiah, Dr. Mahathir asked, "What indeed is the worth of a nation if suddenly someone can devalue and even bankrupt it? If currencies can be made useless so easily, what is the point in a country using its own money? . . .

"There was a lot of talk about market forces. But who constitutes market forces and how do market forces determine what value to give to each act of a government or an economy under attack? . . ."

Devaluation or revaluation of currencies is not the answer to the world's economic problems, he said. "Improvements in productivity are, and such improvements can be achieved through greater skills, better management and continuous technological improvements. . . ."

"Their [the world's great economists] habit of merely trying to explain the present turmoil as being due to bad practices by the governments concerned sounds too much like an apology and a defense of currency traders. . . .

"With regard to why we seem to be following the policies of the IMF, frankly we feel threatened. We are told if we don't do those things, then our currency would be depreciated further. . . .

"And so we try to follow the IMF, and it is very damaging to us. When you raise interest rates and squeeze credit and increase taxes, which is the standard formula for all countries having problems like that, the only result is that companies go bankrupt. And when companies go bankrupt, governments eventually will go bankrupt. . . .

"We think that those conditions would really bring our economy to a standstill. I think there is some basis for fearing the medicine that is being doled out by the IMF, because although the patient is very sick and needs medicine, some medicines do kill, and I am speaking as a doctor. . . ."

On June 4, Dr. Mahathir delivered his second speech in Tokyo, to a June 4-5 conference entitled "The Future of Asia," sponsored by the Japanese financial daily, Nihon Keizai Shimbun *(*Nikkei*). He warned of the risk of "a kind of guerrilla war" if foreign firms used the economic crisis to take control of national firms:*

"Sooner, rather than later, [Asians] will think of regaining control over their economies. They will regard this as a new war of liberation. . . .

"Even if they want to avoid violence, violence must come as the new capitalists disregard the signs.

"There will be no war of independence, of course. But there will be a kind of guerrilla war which will not be good for anyone.

"Maybe this will not be the future of Asia. Maybe Asia will extricate itself from the present situation intact."

But, he cautioned that "new capitalists" would be loath to miss the chance to "dominate the world and make lots of money in the process."

"Only if their own countries restrain them will the future of the world, of which Asia is a part, be peaceful and prosperous," he said.