

All eyes are still on Japan and the yen

by William Engdahl

“The U.S. decision on June 18 to support the yen bought some time for Clinton’s China trip, a very important factor in its timing,” noted a senior strategist with a major Swiss bank. “Now, the question is whether the intervention and the overall pressure of the situation will be sufficient to get the Japanese to finally act to clean up their banking mess. If they don’t do something quite decisive by the July 12 Upper House elections, we could see a major global deterioration.”

The size of the problem facing Japanese Prime Minister Ryutaro Hashimoto is daunting, to put it mildly. In March, the Japanese Diet (Parliament) passed a record 30 trillion yen bank rescue package, amid great fanfare that it would finally deal with the problem of bank bad loans from the collapse of the bubble era in the late 1980s. The funds went to the government’s Deposit Insurance Corp. (DIC), to guarantee depositors at failed banks, as well as to provide fresh bank capital to ease the vicious credit crunch.

The problem is that banks have been “embarrassed” to ask for the money, which would be seen as an admission of bad bank problems. As a result, so far only 1.8 trillion yen has been allocated, and to banks both strong and weak, so that no one would “lose face.”

Getting the troubled banks to take DIC money is the least of the problems, however.

Compounding the problem

Given the special Japanese tradition of honoring one’s debts at all costs, it is still considered bad form for banks to write off unpaid debts. One consequence has been that Japanese banks, instead of admitting the obvious when the

stock market and real estate speculative bubbles burst in the beginning of the 1990s, and writing off defaulted loans, hid the reality by forcing de facto insolvent borrowers to take new low-interest loans, merely to maintain the fiction that the company was still servicing its loans. Many Japanese mortgage holders were forced to engage in a similar deception by their banks. The result has been a geometric expansion in the size of de facto defaulted loans still carried on banks’ books.

For months, the behind-the-scenes fight in Japan has been over whether to end the loan charade. On June 23, the *Wall Street Journal* reported that a bitter fight has broken out between powerful forces in Japan’s Ministry of Finance and the newly independent Bank of Japan, which since April 1 has been made largely independent of the Finance Ministry. According to this account, Bank of Japan Governor Masaru Hayami is demanding that banks make full voluntary disclosure of bad loans, to give “clear prospects for reestablishing market confidence and revitalizing the financial system.” Taking the other side of the fight is Finance Minister Hikaru Matsunaga, who argues that Japanese banks already are required to disclose bad loans, just as the Securities and Exchange Commission requires in the United States.

What Matsunaga has not yet acknowledged publicly, however, is the full implications of those U.S.-style disclosure rules. As part of Japan’s long-term program to reform its economy and financial sector, its so-called “Big Bang,” Tokyo imposed new accounting standards on its banks modelled on U.S. accounting rules for declaring loans non-per-

forming. At the same time, as of the start of Japan's new fiscal year on April 1, Tokyo mandated that all banks doing international business must adhere to the Bank for International Settlements rules for minimum "core capital" of 8% against total loans outstanding, a kind of minimum emergency backstop.

There is a confidential International Monetary Fund study, conducted in cooperation with the Paris-based Organization for Economic Cooperation and Development, examining the possible impact of these two changes. According to Japanese bank reports published just prior to introduction of the Big Bang, the largest banks had written off or otherwise provided for 80% of their bad loans—not an ideal situation, but grounds to convince officials that the end of the years-long problems was in sight. The IMF, using the U.S. rules, however, calculated that instead of having taken care of 80% of the bad loans, banks have in fact only dealt with 17%.

Moreover, there is a heated debate over the actual sum of bad loans to be disclosed. The Finance Ministry recently published revised figures showing that banks hold some \$560 billion in bad loans, more than double earlier figures. In fact, however, informed private estimates calculate bad loans to be in excess of \$1 trillion. On June 21, Angela Koehler, the Tokyo correspondent for the *Berliner Zeitung*, reported, "There is a 'secret paper' circulating inside German bank circles in Tokyo, which states that for Japan's leading banks alone, non-performing loans total more than \$1.5 trillion."

Yet, the problem faced by the Hashimoto government and the banks is made even more complicated by the adoption of the BIS capital requirements. Well before April 1, Japanese banks, unable to raise funds to increase their equity capital because of the collapse in Tokyo stock market prices, had been forced to call in loans to healthy customers and to contract credit, to reduce the total size of loans outstanding.

"Japanese banks have a major currency mismatch which aggravates their problem," said one European banker familiar with Japan. "They must calculate their core capital in yen for the BIS rules, but most of their loans abroad are all in dollars. As the yen value falls against the dollar, Japanese banks have little option but to savagely cut total loans to meet the BIS 8% target. The yen is down some 20% since January, so the impact is huge. This is a major added source of the so-called credit crunch. Rather than lend to stimulate economic expansion, either in Asia or in Japan itself, Japanese banks have been aggressively calling back existing loans, and forcing record-high bankruptcies in the process, as companies cannot cope."

A bridge too late?

Debate now is centered on various options being leaked

almost daily by the ruling Liberal Democratic Party and government figures regarding creation of a special state "Bridge Bank," which could guarantee depositors or borrowers if a bank failed. Some LDP leaders, such as Taku Yamasaki, have proposed using 17 trillion yen of the 30 trillion yen DIC package for such a new bank, which would provide loans to sound clients of the failed bank to enable the economy to begin to recover.

In recent days, rumors have spread that the Long-Term Credit Bank of Japan (LTCB) is suffering severe liquidity problems because of bad loans and high capital costs. Stock shares have collapsed, and reports in Tokyo are that the bank may have to be taken over by the government, much like what occurred in Sweden in the early 1990s. If so, the LTCB case could be a test of Japanese resolve to deal with the mountain of worthless debt on bank books.

To underscore how seriously Clinton administration officials regard the Japanese bank situation, U.S. Deputy Treasury Secretary Lawrence Summers, acting as President Clinton's personal emissary, flew to Tokyo on June 17 to meet with top government officials and LDP party leaders. Little-noted, is that accompanying Summers was a high-level U.S. bank team, including New York Federal Reserve President William McDonough, Washington Federal Reserve Board Director Roger Ferguson, and a specially named Clinton emissary, William Seidman. In the late 1980s, as chairman of the U.S. Federal Deposit Insurance Corp., Seidman played a pivotal role in dealing with the savings and loan crisis, and in the creation and operation of the Resolution Trust Corp., the government agency charged with cleaning up the S&L mess.

It is clear what Washington keenly desires from Japan at this point. It is also clear that China, as well, is putting extraordinary pressure on Japan to act decisively. On June 25, China's Foreign Ministry spokesman Tang Guoqi told reporters in Beijing, "Japan, as a major economic power, should assume greater responsibility at a time of Asian economic difficulties. The yen should play a role of stabilizing Asian economies and not become a destabilizing factor." He added, "We hope . . . the Japanese government will adopt effective measures to stabilize the yen."

To date, large foreign investors who speculate in yen are not at all convinced that Japan will adopt effective measures. After the surprise U.S.-Japan joint intervention brought the yen from a low of 147 to the dollar up to 133, in a matter of hours on June 18, lack of decisive action by the Hashimoto government on the bank problems has led to renewed selling of yen by foreign banks. As of June 25, the yen had again fallen to 141 to the dollar. One French banker with intimate knowledge of the Japanese situation told *EIR*, "Japan now needs to strike a blow to reverse the negative sentiment. If this credit crunch continues, all the world will simply collapse."

America is not immune

Roger Altman, “Beware America, the World Financial Crisis Is Serious,” *International Herald Tribune*, June 24 (appeared first in the *Los Angeles Times*). Altman served in the Treasury Department in the Carter administration, and was Clinton’s First Deputy Treasury Secretary.

“Despite last week’s tremors, an eerie calm hangs over U.S. financial markets, which reflects a seeming oblivion to the spreading international financial crisis. The stock market remains at stratospheric highs, interest rates have hit 30-year lows, and Wall Street sees the economy as impregnable. It is America as a financial island.

“But this isolation is increasingly untenable. A financial firestorm is spreading across East Asia, Russia, and parts of Latin America. Currencies have collapsed, capital has fled, and economies have sunk on an unprecedented scale. . . .

“All this constitutes the worst financial crisis since the birth of the international monetary system in 1944, and it seems to be accelerating. The U.S. Federal Reserve and Treasury are increasingly worried about a world market meltdown. . . .

“Apart from nuclear weapons, [the financial markets] are the most powerful force the world has experienced. In recent months the markets have obliterated governments overnight and imposed previously unthinkable changes on one nation after another. One day President Suharto of Indonesia is still omnipotent. Then, after the markets render their verdict, he is gone.

“Those who think that the mighty United States is immune to such forces are wrong. This is a dangerous moment.”

John Kenneth Galbraith, interview in *The Observer*, London, June 21.

Asked about the potential for a financial crash, economist Galbraith replied, “I, of course, don’t use the word crash; I repair to financial language and talk not about a major correction but a major adjustment. (I am considering retitling my book on the 1929 crash *The Major Adjustment*). . . .

“Greenspan has been doing admirably what the Federal Reserve has always done—which is nothing. . . . There should have been far more warning about the speculative splurge on Wall Street and the extent of citizen participation. That was the mistake that the Federal Reserve made in the ’20s, and the mistake that it has made again now. And the reason for it is simple: you cannot warn against a speculative splurge without taking responsibility for what happens thereafter; no head of the Federal Reserve wants to be held responsible for a dip in the stock market. . . .

“One thing is wonderfully clear—when trouble comes

on Wall Street, the blame will all be passed to Indonesia, Malaysia, and maybe Japan. Wall Street insanity—let me use a slightly milder expression, Wall Street ‘speculative error’—now has a perfect cover. . . .

“As is happening now in East Asia, the peculiar genius of the IMF is to bail out those most responsible, and extend the greatest hardship to the workers, who are not responsible, who are innocent participants.”

Interview: Arthur J. Rolnick

The case for fixed exchange rates

On June 20, the Minneapolis Star Tribune took up the debate on the need for a new world financial system, in an article entitled “Falling Yen Raises Questions About Floating Currency,” by columnist Mike Meyers. A section of that article was entitled, “A New Bretton Woods.” Meyers identified two economists from the Minneapolis Federal Reserve, Arthur J. Rolnick and Warren Webber, who, “for nearly a decade, . . . have made the case for a return to fixed international currency rates. . . . Rolnick and his allies at the Minneapolis Fed argue that today central bankers around the world accept the idea that stable domestic prices are a cornerstone of sustained economic growth. In effect, that removes one old argument against fixed international currency values.”

Rolnick, Senior Vice President and Director of Research of the Federal Reserve Bank of Minneapolis, was interviewed by Richard Freeman on June 22.

EIR: You are quoted in the *Minneapolis Star Tribune* of June 20 as advocating a fixed-exchange-rate system, which it said, you have been advocating for a decade.

Rolnick: A fixed-exchange-rate system should be reconsidered. I co-authored an essay on this subject that appeared in the 1989 *Annual Report* of the Federal Reserve Bank of Minneapolis, which was titled, “The Case for Fixed Exchange Rates.” I argued that within a few years after the world went to a floating-rate system (about 1973), it was clear that exchange-rate movements were not being driven by fundamentals. I think that this is an inherent problem with fiat monies.

My views are based on research by professors Neil Wallace and John Kereken. They argue that fiat monies are special, that unfettered markets cannot determine their rates of exchange, that there is a fundamental price indeterminacy. In other words, exchange rates can take any value. Consequently, you can end up with large fluctuations in exchange rates. And, it’s not because of inflation per se. Even if you