

New Junk-Bond Crisis Radiates Globally

by William Engdahl

Amid the proclamations from financial traders, such as Goldman Sachs market guru Abby Joseph Cohen, that the “market correction” is over, the underlying reality is anything but tranquil. While the Dow “industrial” stocks may climb a bit higher, in what market pros cynically call a “suckers’ rally,” a credit crunch in the global market for high-risk corporate bonds is radiating out of the debt-choked U.S. and European telecoms and Internet companies, across the world. With Argentina and the Philippines the focus, the world is right now on the brink of a new debt crisis in the emerging markets.

Ironically, the latest international bond market crisis is erupting just as the “Group of 20” central bankers and finance ministers met on Oct. 24-25 in Montreal to discuss “how to reduce vulnerabilities in financial crises.” Little news came out of those talks.

Many of the economies which were worst hit during the global crisis of 1997-98, are once more about to explode into new, far more dangerous debt crises. This time, the artificially soaring dollar is likely to be the trigger, as dollar-short, oil-importing developing economies are driven to the brink.

Simultaneously, the euro, the single currency of 11 members of the European Union, continues to fall to daily new lows, now down 29% against the dollar since its January 1999 launch. The euro’s troubles are bringing a political and monetary crisis closer, in the world’s second-largest economic domain, further adding to institutional instability.

Junk-Bond Gridlock

The epicenter of this deepening global financial crisis is located in the corporate bond market—more specifically, the market for high-risk bonds issued by companies. Over the past five years or so, especially in the United States, many new high-tech startup companies have gone to the high-yield corporate bond market to raise capital for various Internet and related ventures which otherwise would have had trouble getting capital. The Internet revolution in the United States is built upon this mountain of high-yield bonds. In the bond market, these high-interest bonds are referred to as “junk bonds,” as they turn into worthless junk for the holder, in the not-too-unlikely event of the corporation’s bankruptcy.

Over the past two months, interest rates in junk bonds have risen to 8% on average above that for comparable U.S. Treasury bonds, a jump of 1.5%. Many firms have to pay interest of 14% or more on such bonds, or face bankruptcy.

With a slowing economy and several highly public bankruptcies in telecom companies in recent weeks, banks have all but cut credit to such high-risk firms.

The situation is becoming alarming enough that Moody’s credit rating agency chief economist John Lonski warned on Oct. 18: “The third quarter of 2000 was the tenth straight quarter in which U.S. corporate credit quality weakened, with downgrades outnumbering upgrades by two to one.” Speaking of junk-bond issuers, he said, “Speculative-grade-rated [i.e., junk-bond-rated] companies contributed the bulk of the quarter’s downgrades. A slowing of domestic expenditures; higher costs for credit, energy, and labor; the lagging performances by the economies of Japan and Europe; and a strong dollar all create additional challenges to credit quality for U.S. firms.” Lonski also pointed out that “not since 1989 have speculative-grade credit-rating revisions incurred so worrisome a deterioration. 1989 coincided with the approach of the credit crunch and recession of 1989-92.” Ironically, that recession is widely credited with having cost George Bush re-election in 1992.

The corporate U.S. bond market has ballooned over the past decade amid declining government deficits, to the point that the \$4.5 trillion of total U.S. corporate bonds outstanding now exceeds the \$3.5 trillion total of U.S. Federal debt traded in public. Much of the growth has arisen from the dubious practice by corporate treasurers of issuing bonds to raise money to buy their own stock back, which gave a major boost to share prices in the late 1990s. The problem is, it has left companies with extremely dangerous debt levels.

Of this \$4.5 trillion in corporate U.S. bonds outstanding, some \$800 billion, according to informed estimates, is low-grade, high-risk speculative “junk.” In another study of the “Refunding Risk for Speculative Grade Borrowers: 2000-2002,” Moody’s points out that many companies which have issued junk bonds “may have difficulties rolling over” those bonds as they come due. They point out that, while “both speculative-grade bond and bank debt should be manageable in 2000,” an “increase in total maturities and the large percentage of unsecured bank debt maturing in 2001 and 2002 increases refunding risk.”

In short, the crisis in the junk-bond market is just beginning. William Gross, the head of PIMCO, a California-based investment company which is now part of the German Allianz insurance group, and the world’s largest bond fund, warned investors on Oct. 17, that they should avoid corporate bonds “at any cost.” He said that the junk bond portion of the bond market is “in for some grim reappings in the next month, and in the next few quarters,” and recommended the safety of government Treasury bonds or government-guaranteed bonds such as Ginnie Mae—of course, some months after he himself had moved his money there.

However, the troubles are not restricted to the U.S. corporate bond market. According to one estimate by Bridgewater Associates, a U.S. economics research firm, a global dollar

shortage is rapidly developing, aggravated by the soaring price of crude oil, which by Organization of Petroleum Exporting Countries rules must always be sold in dollars. According to this estimate, "The United States is now absorbing about 70% of the net savings of all surplus countries combined." This is in turn creating the kind of crisis which a soaring yen created in 1996-97 for the Asian currencies.

The shortage of cheap dollars means that oil-deficit developing economies, many just staggering out of the International Monetary Fund-induced depression of 1997-99, must pay exorbitantly high interest costs to borrow dollars to import oil. Countries such as South Korea, Taiwan, Peru, Thailand, Argentina, Malaysia, Bulgaria, the Philippines, and Turkey are all facing a new liquidity crisis. To date, it is not yet to the breaking point of 1998, but it is getting there, fast.

Worst hit are developing economies with high dollar debt compared to their Gross Domestic Product. Aside from the basket-case economy of dollarized Ecuador, among the worst are Chile, Bulgaria, Thailand, Argentina, Indonesia, the Philippines, Peru, and Brazil.

"Argentina is the country to watch," says Bridgewater Associates in a recent statement. "It is the bellwether; it could be the first to go. It has an exchange rate pegged to the dollar,

so its competitiveness is eroded by dollar strength." Written into Argentina's Constitution is a mandate to have a currency board which ensures a rigid peso-dollar link. Bridgewater continues, "It has a sizable amount of dollar-denominated debt, a slug coming due over the next year; interest on dollar debt is now over 3% of GDP, and principal payments coming due are large. The economy is stagnant and deflation exists. So, Argentina needs to come up with lots of dollars at a time that they are especially hard to come by. Classically, the next move is to devalue and stimulate monetary growth, but that is not an option. Deflate, contract, or default are the more viable alternatives."

The default of Russia on its sovereign bonds in August 1998 was the trigger which set off the worst crisis in global financial markets since the end of World War II. Today, an estimated \$1 trillion in dollar-denominated high-yield or high-risk bonded debt of emerging economies hangs over the global financial system. One or more defaults, or new debt crises at this point, could set off a chain-reaction collapse. Bonds, unlike stocks, are the securities at the heart of the global money mechanism. A full-blown bond-market crisis, notes City of London bond strategist S.J. Lewis, "for this reason strikes at the very heart of the global credit system."

Smithers: Asset Bubble Is Worse than 1929

British consultant Andrew Smithers, head of London's Smithers & Co. firm, told *EIR* on Oct. 20, that the U.S. equity market is now "probably three times" what it should be, and that this "is very frightening, much worse than the asset bubble of 1929." He stressed that "a good central banker would do anything possible to avoid an asset bubble," but U.S. Federal Reserve Chairman Alan Greenspan has done exactly the opposite, creating "the worst asset bubble in modern history."

Smithers concurred with *EIR's* assessment, that Greenspan has allowed an excessive expansion of the money supply, and seems anxious to keep the stock market from collapsing. He wishes, perhaps, to avoid going down in history as the man whose policies led to a major crash. But, paradoxically, he noted, "the more Greenspan postpones the crash, the worse the eventual crash will be, because of the massive build-up of debt."

Smithers recently co-authored a book, with Cambridge University economist Stephen Wright. In the Oct. 20 discussion, he stressed that "the asset bubble has driven down savings. The household sector is not saving, and the cash

deficit of the U.S. private sector is 6% of GDP. The growing deficit on current account, is financed by vast flows of debt. The debt is expanding, because the bubble is, necessarily, debt-financed." He noted that lenders are becoming "increasingly nervous," as seen in Europe, over the telecom sector, and the pressure by European banking regulators on banks, because of the increase of telecom debt. In the United States, Deputy Comptroller of the Currency Nancy Wentzler recently predicted that this year would show a 50% increase in banks' delinquent commercial loans.

Smithers noted, that in both the United States and Great Britain, the major buyers of shares are companies, which is why the debt is rising so rapidly. Respecting the U.K., he has recently co-authored a report, entitled "Britain: The World's Largest Hedge Fund," in which he shows how Britain has become an enormous beneficiary of the asset bubble. He said, "We are almost a mono-economy. As with the Saudis and oil, so it is with us and financial services. As the Americans would say, we have been living high on the hog, from the asset bubble. We are, actually, in far worse shape than is being acknowledged. The current account is being held up, despite a massive trade deficit, because of the very big income from abroad, which comes from financial services. Meanwhile, we have negative external assets. Such a situation cannot go on for long."

—Mark Burdman