# Business Briefs

*Derivatives*

## Buffett Warns of 'Mega-Catastrophe'

In his annual letter to shareholders, excerpts of which have appeared on the *Fortune* website on March 3, Warren Buffett says that he and Berkshire Hathaway partner Charlie Munger "are of one mind in how we feel about derivatives and the trading activities that go with them: We view them as time-bombs, both for the parties that deal in them and the economic system." He added that "the range of derivatives contracts is limited only by the imagination of man (or sometimes, so it seems, madmen."

Buffett said that "the macro picture is dangerous and getting more so. Large amounts of risk, particularly credit risk, have become concentrated in the hands of relatively few derivatives dealers, who in addition trade extensively with one another. The troubles of one could quickly infect the others. On top of that, these dealers are owed huge amounts by non-dealer counterparties. Some of these counterparties, as I've mentioned, are linked in ways that could cause them to contemporaneously run into a problem because of a single event (such as the implosion of the telecom industry or the precipitous decline in the value of merchant power projects). Linkage, when it suddenly surfaces, can trigger serious systemic problems.

"The derivatives genie is now well out of the bottle, and these instruments will almost certainly multiply in variety and number until some event makes their toxicity clear. Knowledge of how dangerous they are has already permeated the electricity and gas businesses, in which the eruption of major troubles caused the use of derivatives to diminish dramatically. Elsewhere, however, the derivatives business continues to expand unchecked. Central banks and governments have so far found no effective way to control, or even monitor, the risks posed by these contracts. . . .

"Charlie and I . . . try to be alert to any sort of mega-catastrophe risk," Buffett wrote, and that posture may make us unduly apprehensive about the burgeoning quantities of long-term derivatives contracts and the massive amount of uncollateralized receivables that are growing alongside. In our view, however, derivatives are financial weapons of mass destruction, carrying dangers that, while now latent, are potentially lethal."

Buffett's warning provoked "rage in the industry," said the London *Financial Times* on March 5. "Buffett's warning on derivatives is a wake-up call," the newspaper's lead editorial noted, but has infuriated derivatives banks and traders though it "differs little from a string of regulators who have raised concerns about" credit derivatives. "So far, there has been no explosion, but the risks of this fast-growing market remain real," the *Financial Times* said, adding that "the concentration of risk in a few institutions and the involvement of organizations not experienced in the credit market could still trigger systemic problems. As so often in the past, Mr. Buffett sounded a timely warning."

*Aerospace*

## Employment at 50-Year Low

Not since 1953 has employment in the U.S. aerospace sector been as low as it was at the end of 2002, at 689,000, according to Aerospace Industries Association head Jon Douglass on March 4. Employment in the industry—which includes military and commercial aircraft, missiles, and commercial and government space—has fallen 13% since Sept. 11, 2001, and by nearly half since the fall of the Soviet Union in 1989. The dramatic collapse in employment by 106,000 jobs just since 9/11, was due to the crisis in civil aviation, the decline in commercial space activity due to the decline in telecommunications, and industry mergers and acquisitions.

*Israel*

## Another Record Government Deficit

Israel racked up another record state deficit in February, as foreigners continued to withdraw funds at an unprecedented rate, according to Israel's major daily *Ha'aretz* on March 4. The state deficit hit 2.752 billion shekels for the month. This follows a similar amount for January, which give a total deficit for the first two months of 2003 of 5.43 billion shekels, or over $1 billion. This is already one-third of the deficit the government had projected for all of 2003; this rate of deficit exceeds 6% of Gross Domestic Product. There is an ongoing collapse of tax revenues, which for February were 11% lower than the year before. If this trend continues, the credit-rating companies will cut Israel's state credit rating, making it even harder to borrow overseas. Durable goods purchases collapsed another 22% compared to the year before.

Benjamin Netanyahu, now Finance Minister, will be implementing a drastic budget-cutting program that will include massive layoffs in the public sector.

Foreign residents continue to pull their foreign currency holdings out of Israel. In January alone, they withdrew $174 million from Israeli banks. In addition to this, $74 million was sent out of the country by Israeli citizens.

*Turkey*

## $30 Billion Loans To Avoid Default

Turkey needs $30 billion in U.S. loans to avoid a foreign-debt default, according to international bankers who say International Monetary Fund loans and IMF-backed austerity plans would not be enough to meet all Turkey's debt obligations this year, Bloomberg reported March 4. Interest payments on Turkey's national debt currently use up two-thirds of its fiscal revenue. Turkey would use the U.S. loans to "swap" about one-third of its domestic debt, reducing debt payments and lengthening the repayment schedule. The government borrows in its own currency, at a cost that has risen to 30% above inflation, to make debt payments—and reportedly will have to tap its cash reserves on March 5.

"Financially, there's no way out for Turkey if there's no U.S. money," said a Deutsche Bank economist.