EIR Economics

Collapse of Carry Trade Would Blow Out Financial System

by L. Wolfe

A panic is setting in among key financial circles—a panic that we are fast approaching the final disintegration of the financial casino known as the global monetary system.

An indication of that panic and of near-term breakout of a systemic credit crisis came in the form of an article in the Feb. 24 London *Daily Telegraph* titled, "Global Credit Ocean Dries Up," which identified as the trigger point for such financial disaster the collapse of the so-called "carry trade"—the ability to borrow large sums of money at low interest rates in Japan, Switzerland, and similar locations, and then use them in any sector that offers higher yields on interest rates. In particular, several analysts interviewed by the *Telegraph*'s Ambrose Evans-Pritchard warned that if Japan responds to higher interest rates in the U.S. by raising its rate (currently at zero!), and shuts down the so-called yen carry trade—or the Japanese-currency-dominated component of this global carry trade—the entire financial system, which has been fuelled by this speculative money machine, is immediately in jeopardy.

What gives credence to such reports is mootings from Bank of Japan officials that such a rate hike is under consideration. While there is little chance that Japan would hike its rates to the levels of the U.S., even a small movement in yen-based interest rates is enough to trigger a further panic in the volatile speculative markets which depend on the yen-carry trade for their monetary fuel.

While Evans-Pritchard and his quoted analysts fanned the panic, they still backed away from stating that a blowout was on the agenda. In greeting this report, and developments which last week collapsed the Icelandic markets (which had served as an ice-bound version of offshore money machines through its carry trade), Lyndon LaRouche was far more plain-spoken and blunt: "The yen carry trade is in big trouble. The mere fact that such questions as those reported in the *Daily Telegraph* are being raised means that the carry trade is about to bite the dust. Iceland and other countries are going to go bankrupt. But the multiplier effect of the blowout of the carry trade is going to mean that the crisis hits with a magnitude far beyond any individual nation or currency. This will bring down the whole post-Bretton Woods floating-exchange-rate system."

The Sound of Panic

As the *Telegraph* defined it, "The 'carry trade'—as it is known—is a near limitless cash machine for banks and hedge funds. They can borrow at near zero interest rates in Japan, or 1% in Switzerland, to re-lend anywhere in the world that offers higher yields, whether Argentine notes or U.S. mortgage securities."

The Iceland example shows how unstable this house of cards is. The crisis, which broke out on Feb. 21, appeared to be deliberately triggered for some reason when the bankers' own Fitch rating agency downgraded that small country's sovereign debt; its interest rates shot up to 10.75%, and the markets froze up. Its currency, the krone, suffered a 9.2% collapse against the dollar, bringing the Icelandic ICEX15 equity index down to a two-day loss of 5.2 per cent. The crash in Reykjavik set off shock waves in currency and bond markets in Brazil, Mexico, Australia, New Zealand, Indonesia, Turkey, South Africa and Eastern Europe.

But Iceland is a drop in the bucket compared to what would happen if Japan reversed its zero-interest-rate policy, which has provided a cash source to liquify speculative markets and the illiquid U.S. banking system.

David Bloom of Hongkong Shanghai Banking Corporation, a pillar of the Anglo-American financial establishment, was quoted in the *Telegraph:* "The carry trade has pervaded every single instrument imaginable, credit spreads, bond spreads; everything is poisoned. It's going to come to an end later this year and it's going to be ugly, even if we haven't reached the shake-out just yet. People have a Panglossian belief in the march of global capitalism but that will change as soon as attention switches back to U.S. financial imbalances."

Stephen Lewis economist from Monument Securities was quoted: "There are several hundred billion dollars of positions in the carry trade that will be unwound as soon as they become unprofitable. When the Bank of Japan starts tightening, we may see some spectacular effects. The world has never been through this before, so there is a high risk of mistakes."

Stephen Roach, chief economist at Morgan Stanley, was even more blunt: "The lure of the carry trade is so compelling, it creates artificial demand for 'carryable' assets that has the potential to turn normal asset price appreciation into bubble-like proportions. History tells us that carry trades end when a central bank tightening cycle begins."

It's the Banks, Stupid!

While the carry trade has been the fuel for speculation of all kinds, it has also been one way of keeping the U.S. banking sector from collapsing. Not stated in the *Telegraph* article is that major players in the carry trade are the major commercial and investment banking houses, and more recently, the hedge funds; if the spread in interest rates collapses, if the carry trade in Tokyo, especially, dries up, then major U.S. and European banks will go down.

The Bizarre 'New Bank'

Meanwhile, there are signs that even before the carry trade shuts down, the banking system may be set for some significant shocks. How else explain the utterly bizarre announcement that the bond industry, with the support of the Treasury and the Federal Reserve System, is setting up an emergency back-up bank that will step into the breach if one of the two clearinghouse banks for U.S. Treasury sales, Bank of New York or Morgan Chase, should collapse or be unable to operate?

This new bank will be called just that, "NewBank," and will exist only on paper—no physical location. It will move in to take over operation of banks which can't clear their overnight positions, operating from their physical headquarters and using their employees. While the Feb. 28 *New York Times* article reporting this tries to claim that it is merely a precaution in case of a terror attack or similar catastrophe, it nonetheless indicates that such takeovers could be triggered by "sudden legal problems" or a "credit downgrade"!

Rumors are already circulating among Wall Street insiders that such a banking crisis is imminent, perhaps triggered by a new collapse of Morgan Chase, an investment bank such as Goldman Sachs, or a major hedge fund. Add to this the threat of a shutoff of the yen carry trade, and it's "white knuckle" time.

Then There Are Derivatives

In the midst of the tremors about the yen carry trade, Timothy Geithner, President of the New York Federal Reserve Bank, gave the featured speech Feb. 28 to the Global Association of Risk Professionals, in New York City. Geithner first praised the non-existent benefits of "the rapid growth in instruments for risk transfer," and then focused on derivatives, especially credit derivatives. He said, "They have not eliminated risk. They have not ended the tendency of markets to occasional periods of mania and panic. They have not eliminated the possibility of failure of a major financial intermediary. And they cannot fully insulate the broader financial system from the effects of such a failure."

He stated that, "The scale of the over-the-counter derivatives markets is very large. . . now approaching $300 trillion." He emphasized that were one derivatives counter-party to fail, and have to leave its contract, "the process of closing out those positions and replacing them, could add stress to markets and possibly intensify the direct damage caused."

Geithner pointed out that credit derivatives are "written on a much smaller base of underlying debt issuance," that is, for each $1 in a corporation's debt, banks could write up to $10 in credit derivatives, to supposedly "insure" the debt. Geithner underscored that "in the event of a default, [credit derivatives would] magnify. . . the risk of adverse market dynamics."

Geithner's remarks are all the more important since he has been assigned, essentially, to be the Federal Reserve's case officer to attempt to get credit derivatives under control, on which matter he has been unsuccessfully working with the 14 leading credit derivative banks.

It would not be lost on Geithner's audience that the Bank for International Settlements had recently emitted similar warnings. In an address to the European Financial Services Roundtable in Zürich, Switzerland, on Feb. 7, Bank for International Settlements (BIS) general manager Malcolm D. Knight pointed to a dangerous "disconnect" between "major macroeconomic risks present in the global economy" and the financial markets' "perception" of a benign risk environment, as indicated by paramaters such as risk premiums or volatility indices. The speech cited the U.S. budget deficit, the collapsing housing market, and credit derivatives as vulnerabilities.

LaRouche: Let It Happen

Lyndon LaRouche is not worried by these developments. "Let it happen," he said in response to the *Telegraph* reports. "The system is doomed under any circumstances, and we know what must be done to create a new, stable financial system, based on the principles of Franklin Roosevelt's original Bretton Woods System. I am ready with a recipe for precisely how to solve this crisis. Are you?"