Implosion of the Global 'Carry Trade'

by Lothar Komp

It is standard procedure of leading central banks these days to fight any symptom of global financial disintegration by further gearing up money-printing machines. Hedge funds and other investors could borrow the fresh liquidity at near-zero interest rates, and then channel it into any kind of high-risk, high-yield assets, from emerging market stocks, to junk bonds, or mortgage-backed securities. However, interest rates in the United States and Europe have started to rise, and even in Japan, the days of zero-interest rates are numbered. Already the expectation of reduced liquidity in the near term has caused a partial implosion of some of the "carry trade" bubbles. The first wave was marked by the Iceland crash in mid-February. In early March, another wave suddenly hit stocks, bonds, and currencies all over Ibero-America and Africa, as well as Russia and Turkey. Since mid-March, Arab asset bubbles have been the center of attention. The latest victims include the commodity-related currencies of Australia and New Zealand.

Referring to recent off-the-record discussions that *EIR* has had with senior financial analysts in Europe, Lyndon LaRouche noted on March 14 "that the accumulation of international financial storms associated with the 'Iceland crisis' of the world's so-called carry trade, must be seen as a collapse of the Greenspan bubble, and thus viewed as a consequence of policies introduced in 1987 by now-retired U.S. Federal Reserve System Chairman Alan Greenspan." It should be seen as a sign of the times that senior banking sources have come around to converge with LaRouche's assessment of Greenspan's role, which he had publicized widely during the recent decade.

Systemic Banking Crisis in Iceland

In the last few years, Iceland has been transformed into a Caribbean-style "hot money" and "carry trade" financial center. The country's three large banks—Kaupthing, Landsbanki Islands, and Islandsbanki—played a central role in such schemes. Investors were borrowing at ultra-low interest rates, in particular from the Euro-zone, and then investing the money into bonds in Iceland, such as those issued by the three banks, at rates above 10%. In so doing, the three banks piled up external debt of $18 billion—about 150% of the country's Gross Domestic Product—which is coming due within the next two years. Stock and property markets were pushed to the stratosphere by the foreign capital inflows. Stock prices increased by almost 300% since Summer 2003, and house prices in Reykjavik doubled in the same time period. Credit to the private sector doubled within three years. Meanwhile, Iceland's current account deficit expanded to 15% of GDP in 2005.

In the end, it required just one negative report by the British rating agency Fitch, pointing to the country's "unsustainable current account deficit and soaring net external indebtedness," for the whole thing to crash. On Feb. 21-22, Iceland's currency, the krone, suffered a sudden 9% collapse against the dollar. 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. London's *Financial Times* on Feb. 23 wrote: "A financial crash in Iceland snowballed yesterday, setting off a series of tremors as far afield as Brazil and South Africa. . . . The crash sparked a sell-off among hitherto strong performing emerging-market currencies across the globe." All profits from the Iceland carry trade over the last two years were eliminated within just two days. Foreign capital flows are reversing, putting the three large banks into an impossible situation.

The widespread fears of a systemic banking crisis in Iceland, have prompted Kaupthing to issue a statement, detailing its obligations and cash position, in an effort to convince investors that it's not about to go bankrupt. Islandsbanki on March 17 decided to cut the term "Island" from its name, hoping such a measure would calm investors. It's now called "Glitnir." As the bank explained in its press release, Glitnir is the home of the Nordic god of Justice, and "according to the legend, all those who go there leave reconciled and at peace." It's rather questionable whether the renaming will help to calm down international investors. The Danish newspaper *Jyllands-Posten* on March 13 warned of a blow-out of the Icelandic banking system that would be too big for any kind of public bailout. The banking crisis could have "incalculable consequences," read a statement by Nykredit, and the amount borrowed by the banks is so large "that they hardly can be saved by the Icelandic state alone, and since a major part of the investments are abroad, the state's obligation to provide a safety net under the banks is not the same as it used to be."

A devastating report on Iceland, headlined "Geyser Crisis," was issued on March 21 by Danske Bank, the second-largest Danish bank. It notes that in terms of parameters like the current account deficit, the Icelandic economy is the most extreme case in the entire OECD area. Therefore, "we think the economy is heading for a recession in 2006-07" in which GDP "could probably dip 5-10% in the next two years." While this picture already looks grim, the situation is actually much worse due to the pyramid of debt. In the recent few years, there has been "a stunning expansion of debt, leveraging, and risk-taking that is almost without precedent anywhere in the world. External debt is now nearly 300% of GDP, while short-term external debt is just short of 55% of GDP. This is 133% of annual Icelandic export revenues." "Since 1990," the report continued, "total debt as a percentage of annual GDP has more than doubled, to 350%. This development has primarily been driven by the corporate and household sectors, which have tripled and doubled debt as a percentage of GDP, respectively." External debt now accounts "for more than 80% of total debt," which in turn is "almost entirely denominated in foreign currency." "Consequently, the Icelandic economy has become increasingly dependent on foreign capital" and "the willingness-to-lend of global financial markets. This raises the question of whether the economy is facing not just a recession—but also a severe financial crisis. . . . Previous similar crises in other countries have sparked very large market reactions. In Thailand (1997) and Turkey (2001) the currencies weakened by 50-60%. . . . We conclude that Iceland looks worse on almost all measures than Thailand did before its crisis in 1997, and only moderately more healthy than Turkey before its 2001 crisis."

A Stock Market 'Desert Storm'

Iceland is just one example of numerous carry-trade bubbles all over the globe, that are now ready to burst, in particular as interest rates in the U.S.A., Europe, and Japan are rising. Another example is the Persian Gulf region. On top of the liquidity pumped in by international "carry traders," petrodollars resulting from the record high oil prices played an important role as well. During 2005, the Dubai stock market index rose by 125%, that of Saudi Arabia by 97%, and that of Egypt by 162%. The total market capitalization of the seven Gulf stock exchanges increased almost tenfold from $119 billion in 2000 to $1.14 trillion at the end of 2005, rising further to $1.3 trillion in mid-February.

By mid-March, panic sales had reached the Gulf region. On March 14, the Dubai stock market plunged by 12%, its biggest one-day decline in history. In total, the Dubai Financial Market Index has lost 40% since the start of the year. In Egypt, the CASE-30 stock market index had fallen by 11% in early trading on March 14. Then the government stepped in. Trading was suspended for an hour, and the Egyptian Capital Market Authority announced that it was buying up Egyptian stocks in order to prevent the market from crashing further. In Kuwait, the government-run Investment Authority was instructed to buy up stocks, after the Kuwait Stock Index Change Index fell by 4%. Saudi Arabia has by far the largest stock market in the region. On March 14 and 15, the Tadawul All Share Index fell by a combined 10%, following sharp losses on the previous three trading days. Saudi Prince Alwaleed bin Talal announced that he would buy $3 billion worth of Saudi stocks. After reaching an all-time high in mid-February, the total market capitalization among all Gulf region stock markets has imploded by an estimated $250 billion.

Nervous Central Bankers

More is certainly to come. In its latest quarterly report, the Bank for International Settlements (BIS), the central bank of central banks, highlighted the overheated situation of emerging market assets. The fate of such bubbles is closely related to the global hedge fund sector, and the big banks standing behind them. The BIS noted: "Asset prices in emerging markets rallied to record highs early in the new year. Foreign investors snapped up emerging market bonds and equities, pushing indicators of valuations towards, and in some cases beyond, the upper end of their historical range. . . . Almost all emerging equity markets had recorded double digit increases in 2005, led by Egypt, Colombia, and Saudi Arabia, where prices had more than doubled." This rally "was driven in large part by massive inflows of foreign capital."

Another high-yield, high-risk market receiving huge capital inflows in 2005 were corporate bonds, including junk bonds. "In recent months there has been no let-up in the rapid pace of mergers and acquisitions (M&As), including leveraged buyouts (LBOs). Acquisitions totalling $3.2 trillion were announced in 2005, up almost 30% from 2004, and the highest level since 2000. More worrisome for credit investors, LBOs in 2005 reached their highest level since the buyout frenzy in the late 1980s—a frenzy which contributed to a sharp increase in corporate defaults soon afterwards. Furthermore, in contrast to the 1980s, the recent increase in LBO activity was not limited to the United States. Indeed, more than half of all deals involved firms outside the United States, mainly in Europe but also in Asia," declared the BIS report.

Another indication of the nervousness behind the scenes was presented by the two-day conference on March 16-17 of the Financial Stability Forum (FSF) in Sydney, Australia. The top issue of the gathering was "risks and vulnerabilities" in the global financial system. Participants included top representatives from central banks, finance ministries, financial supervision agencies, and international financial institutions. According to a BIS press release, FSF "members pointed to several developments with the potential to cause strains in financial systems. These included further growth in external imbalances, high levels of household sector indebtedness in some countries, and low risk premia reflecting a high degree of liquidity and the continuing search for yield in markets. Members reviewed some areas of ongoing concern, including issues related to counterparty risk management, hedge funds, operational risks, and valuation practices for complex financial instruments."

The latter issue refers to credit derivatives. Concerning the abundant liquidity right now invested in high-risk assets, the BIS release warns of "a sudden reversal in risk appetites, especially if it were accompanied by unexpected increases in global bond yields or a sharp increase in asset price volatility."