Balsam failure brings international financial collapse one step closer

by William Engdahl

On June 10, German flooring manufacturer Balsam AG was put into bankruptcy, and four members of its board of directors were imprisoned for financial crimes. One week later, a Wiesbaden-based factoring firm linked closely to Balsam, Procedo, also went into bankruptcy when the group of insurance companies behind it refused to assume the fraudulent debt obligations of at least DM 2.1 billion ($1.3 billion) linked to its dealings with Balsam.

In an unusual public comment, former German Bundesbank President Karl-Otto Poehl, now chairman of the Cologne private bank Sal Oppenheim & Cie., told the press, "The intensity of criminal energy present in the Balsam affair is likely far worse than in the Schneider bankruptcy." The latter reference is to the large German construction firm Schneider AG, whose owner fled the country earlier this year leaving behind billions in bank debts and tens of thousands of jobs threatened. Poehl's statement rang alarm bells in the already nervous Frankfurt financial community.

Well they might. Though details are not yet public, there are reports of feverish activity by some 50 international creditor banks to Balsam to audit the real situation of the firm, whose management is believed to have covered up its bankruptcy for almost eight years by speculating massively in foreign exchange and other forms of high-risk derivatives trade.

According to a report published in the June 11 *Die Welt*, Balsam management left behind a staggering DM 10 billion worth of currency derivatives obligations, so-called "dollar options" contracts, most of which run until December. This means that the creditor banks, primarily Deutsche Bank and Dresdner Bank but including Poehl's Oppenheim, must assume the risk of those DM 10 billion in derivatives from Balsam. Should the fluctuations in the value of the dollar go against the bet of the Balsam management between now and December, the banks stand to lose sums in the hundreds of millions.

A mudslide that just won't stop

The Balsam affair is the latest in what appears to be an unending series of financial shocks of titanic dimensions in recent months. Some traders in the European banking community believe that the surprising weakness of the U.S. dollar against the deutschemark, as well as the heavy, continued selloff in German bond futures in recent days, could be tied to the efforts of the creditor banks to close out the huge derivatives positions of Balsam and Procedo.

The dramatic fall in market after market since early last January, is manifestly not calming down. Estimates of international bond analysts are that "paper losses" (most bondholders, including huge pension funds and private savers, have continued to hold onto their securities rather than try to sell) since January in government bonds of major industrial nations could easily total more than $500 billion.

While the average citizen has little idea of the esoteric world of bonds, these bonds form the very core of the global monetary and financial system, considered to be the "safest" investment. Government debt in the OECD countries has exploded since the oil and other shocks of the early 1970s, while investment in infrastructure has contracted to postwar lows.

The underlying structures of financial obligations are becoming fundamentally more unstable with each added shock. What is under way is without precedent in the history of international finance, as American economist Lyndon LaRouche has stressed in recent commentary.

Since the 1979 "Thatcher Revolution," every single government in the nations of the Organization for Economic Cooperation and Development has deregulated, removed its national currency controls, opened the doors wide to global financial flows, in effect becoming hostage to whims of huge speculative markets. This has been combined with the "Molotov cocktail" of financial derivatives. Beginning in New York and London, banks, financial firms, and even industrial companies have gone pell-mell into the largest speculative binge in history, borrowing to speculate on the future value of a given currency, interest rate, or stock or bond price, at the same time as the intensity of basic industrial and economic infrastructure investment throughout the OECD countries is generally at 20-year lows.

A simple test for the reader: Compare the geometrical increase in per capita public debt carried by citizens of every major OECD country over the past 25 years, with the decrease in absolute numbers of manufacturing employees in those same countries. Or, do the same comparison this time with the decline in per capita new public infrastructure investment for the period. In each case, the public debt has exploded exponentially, whereas the real economic wealth-creating resources of the national economy in question have

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contracted dramatically. This is the backdrop of the process now unfolding.

How the bubble was inflated

On July 20, 1993, U.S. Federal Reserve Chairman Alan Greenspan signalled to the House Banking Committee that the Fed would raise short-term interest rates for the first time since 1989. Five years of interest rate reductions by the Federal Reserve were made in order to prevent a systemic insolvency crisis in the entire American banking system. By lowering rates and injecting large new reserves into the banking system, Greenspan allowed banks a "breathing space" of five years in order to earn risk-free profits speculating on U.S. government bonds. But, in the course of maintaining such historically low interest rates for so long, the Fed created a new Frankenstein monster, an "asset bubble" of grotesque dimension, as banks and financial firms speculated in stock and bond markets rather than risk new industrial loans.

The end-phase of that asset bubble, which began in U.S. stock and bond markets, was a record capital outflow from the United States, mainly by unregulated mutual funds, which hold some $1.8 trillion in assets, into financial markets across the globe. The "glamor" area of investment by U.S. mutual funds and others was high-risk "emerging markets" such as Mexico, Turkey, and Malaysia, which offered 70-100% profits to speculators, leveraged by various derivatives.

This speculative U.S. capital outflow reached the huge sum of $120 billion in 1993, more than double what it was in 1992. With it, the "asset bubble" expanded in ways never before seen. The same U.S. investment funds poured huge sums into the German and other European bond markets, creating bubbles in European and other financial markets in the final months of 1993 as well.

All these money-hungry speculators gambled that interest rates would continue to go down or, at worst, would not go up. But in September 1993, Federal Reserve Board members David Mullins and Lawrence Lindsay started to warn openly of the danger of creating a "Japan-style asset bubble" in the U.S. bond and stock markets. The inflation danger in U.S. financial markets was not the cost of living, but the soaring prices of stocks and bonds and financial assets. In testimony before the Senate Banking Committee on May 27, Greenspan admitted that the Feb. 4 decision to raise fed funds rates by one-quarter percent to 3.25% was directed, not at consumer or industrial price inflation, but at halting the "sharp rise in financial asset prices." That shift detonated the greatest instability in world financial history.

When the Federal Reserve acted on Feb. 4, it confirmed that the "one-way" bet on interest rates was over, and bond prices fell. But, curiously, European bond prices, especially in U.K. "Gilts" and German "Bunds," fell far more. The intense European market fall beginning February was triggered by "one major U.S. institution" doing panic selling of European bond futures, or derivative positions to raise cash

U.S. Federal Reserve Board Chairman Alan Greenspan, who helped create the gigantic speculative bubble in derivatives instruments. His Feb. 4 decision to raise interest rates triggered the greatest instability in world financial history.

to meet losses in the Japanese market. Despite repeated subsequent moves by the Bundesbank and other European central banks after February to lower key interest rates and otherwise attempt to stabilize German and other bond markets, the selling continues. U.K. bond values have dropped some 20% in four months, U.S. values by 15%, and German values by 12%, falls of a magnitude not seen in so brief a time since World War II.

This process quickly spilled into liquidation of holdings in major "emerging markets," starting with Mexico. Insurrection in Chiapas, political instability, and the assassination of the leading PRI presidential candidate created such a panic outflow of dollars from Mexico that the Federal Reserve was forced to step in with emergency funds to prop up the peso. Turkey, Malaysia, Poland, and other speculative markets of the past several years saw similar selling and capital flight. Despite dramatic coordinated measures by the Group of Seven central banks to attempt to stabilize the dollar, yen, and other key currencies, and with it the markets, huge panic selling resumed again the week of May 23 on the British and German bond markets, as a major U.S. "hedge fund," believed to be Steinhardt Partners, reportedly continued to liquidate its huge bond position, which had been bought with money borrowed from major banks.

Recent statements by the normally conservative Bank for International Settlements in its June 13 annual report underscored how terrified the major central banks are of the situation. Andrew Crockett, former Bank of England officer and the new general manager of the Swiss-based BIS, stated, "It would be a mistake to assume that policymaking would be made easier if financial instruments could be limited or capital movements controlled."