Japan's Interest-Rate Hike Could Collapse the System

by Helga Zepp-LaRouche

This article has been translated from German, and subheads have been added.

Despite the illusions of small investors who are being led by the nose, allowing themselves to be blinded by record numbers on the stock markets; and despite the promises of countless analysts, that the decision of the Japanese central bank to raise interest rates from 0.25 to 0.5% would have only an insubstantial influence on the so-called "carry-trade," this rate increase could actually have a dramatic effect on the world financial system, and could even generate a systemic collapse. "There is nothing in the global financial system, that is not ultimately connected to this yen carry-trade," said a continental European banker.

There are, worldwide, between $500 and $600 billion in investments outside Japan, which took place with the help of cheap yen credits, benefitting from the favorable interest rates. If the yen now starts to rise, on the basis of the rise in interest rates, the effect would be much greater than 0.25%. The main beneficiaries of the carry-trade are the big banks, hedge funds, and equity funds, whose derivatives trading has led recently to a worldwide pyramiding of all segments of the market. The gigantic bubble of the casino-economy has to grow; that is, it must make profits, and for this it requires a continuous flow of liquidity. At the moment that these capital streams start to flow in the opposite direction, because of the changed interest rates and exchange rates, panic and an interlinked cluster of risks could lead to a meltdown of the system.

Who Is Really To Blame?

A widespread misconception exists, that behind the "financial locusts"—which are massively participating in the carry-trade, and which are now snapping up everything that's not nailed down, including in Germany, from *Mittelstand* [small and medium-sized] enterprises—there lurks somehow "the U.S.A." and "Wall Street." Indeed they are involved; but as the *Economist* reported in its Feb. 3-9 issue, in an article headlined "Britannia Redux: A special report on Britain," the City of London boasts that it is henceforth the most important financial center in the world, and thus the British Empire has been revived in the form of globalization.

And London is not the capital city of a normal nation, but also that of the Commonwealth, to which, for example, the Cayman Islands, Bermuda, and the Bahamas belong. And

The City of London touts the re-emergence of the British Empire, in the new world of globalization.

according to the the CIMA, financial authority of the Cayman Islands, 7,481 of the 9,000 worldwide hedge funds are registered in the Cayman Islands, a British Crown Colony. These so-called offshore markets are subject to no banking oversight or regulation on the part of central banks or governments. In 1993, the "Mutual Fund Law" was passed, according to which the simplified establishment or registration of hedge funds in a deregulated system should be facilitated. The goal was that the Cayman Islands—which have already been, since the beginning of the bubble economy, with the creation of the Eurodollar market, an Eldorado of uncontrolled credit creation—should be made into even more of a pivot of the "finance industry."

Since the middle of the 1990s, the hedge funds were advised to have their financial operations registered in the Cayman Islands, where they could operate outside national laws and regulation. In this way, the hedge funds got the biggest share in the British financial system. In the course of time, the banks that had initially been the main credit sources for the hedge funds, became increasingly consolidated with these funds, which now, through their takeovers, are exploiting and sucking out the wealth of many nations.

How the Locust Funds Operate

A report by the consulting firm McKinsey & Co., from January of this year, points out that Wall Street and the U.S. are losing out to London as the center of world finance. And this is a matter of insanely huge arrangements: The Bank for International Settlements (BIS) reports that there are $370 trillion in outstanding so-called over-the-counter

BoE, Not BoJ, May Pop the Carry-Trade

The "yen carry-trade" in currency markets is at 97% of its highest volume ever; the Swiss franc carry-trade, about one-third the size, is at 93% of its record volume. As much as $250 billion worth of yen annually, may be being borrowed out of Bank of Japan currency emissions for speculation worldwide—BoJ's discount rate has only just been raised from 0.25% to 0.50%, compared to 5.25% for the Federal Reserve and Bank of England (BoE). Speculators or central banks playing the carry-trade make 1) that rate difference, just in overnight bank lending—potentially much more than in other kinds of speculation—and 2) additional profit from the steady cheapening of the yen against other major currencies, which the carry-trade brings with it. One fund manager acknowledged, "If you didn't have a yen carry-trade on, you didn't make money last year [2006]" in international currency trading.

Combined with the equally huge dollar-printing surge of the Federal Reserve's M3 money supply—for which there have been no published figures for a year, but is estimated by one economist to be growing at over 11% annually—the yen carry-trade is the ultimate source of the apparently vast liquidity, or "leverage," feeding global financial bubbles.

The flood of reserves out of the yen has gone into sterling, euros, and dollars; but first and foremost, into sterling. While the total volume of international currency reserves held by central banks has multiplied incredibly since 1995—from $1.3 trillion to $4.8 trillion—the sterling portion of it has risen from under 3% to 4.3%. But much more leverage-giving, in the 30% of those central bank reserves which are invested in bank lending, and not in government bonds, the proportion of sterling has risen rapidly to 12%. And the center of hedge-fund activity has shifted toward London and Britain's Cayman Islands tax havens.

What might turn the carry-trade's large, "free" profit margins into losses and a "reversed leverage" crash? Closing the interest rate differentials, *and* a reversal in the constant cheapening of the yen. The Bank of Japan is in no position to cause this. It was under so much pressure over the Feb. 21 interest-rate hike, that it printed and emitted 2.1 trillion yen (about $18 billion worth) into the banking system the previous day, to keep the yen from rising—and so far, it has not. Swiss National Bank head Jean-Pierre Roth attacked the carry-trade in the Swiss franc on Feb. 22, and warned of a round of rate increases, but the Swiss also have relatively little leverage.

But the Bank of England, and the City of London, increasingly in the driver's seat in overnight reserves and as a world financial center—*could* pop the carry-trade, by starting a plunge in the pound which would torpedo the dollar. The BoE is threatening. Twice in the past month, BoE governor Mervyn King has issued statements or reports, calculated to send the pound sliding from its landmark highs of late January.

Last time the carry-trade was at record levels and then was punctured and quickly "unwound"—in 1998, with the Russian GKO bond default and subsequent LTCM hedge-fund meltdown—the dollar fell by 20% over the following two years. Lyndon LaRouche has warned repeatedly that London, and some stupid U.S. economic interests—are threatening to trigger a *further* 20% dollar plunge, and international monetary and financial chaos.

—Paul Gallagher

(OTC) derivatives. The largest type of derivatives are interest-rate derivatives, with $262 trillion, of which 34% are handled in London, and 24% in New York and Chicago. The third-largest category of derivatives is the $38 trillion in foreign-exchange (currency) derivatives, of which 49% are handled in London, and only 16% in New York. And these bubbles are increasing at such an insane tempo that their assets in 2006 grew around 63% (!) in London, and "only" 13% in the United States.

But no one, no government, and no central bank, knows the real dimensions of the financial activities of the "financial locusts," who suck the guts out of valuable industrial firms and other objects of speculation worldwide, for their own profit, and then leave them in ruin. Because there is no transparency for these activities, as German Finance Minister Peer Steinbrück has many times complained. And if one accounts for the enormous volume of loot taken by these "robbers and plunderers" (to quote a spokesman for the British GBM trade union), it is not surprising that Great Britain and the U.S. Administration have, so far, directly opposed all efforts for re-regulation of this predatory monster.

When [Social Democratic leader] Franz Müntefering in the Summer of 2005, first enunciated the concept of "locusts" for the hedge funds and equity funds, he was absurdly accused by the international financial press of anti-Semitism. Since then, they have constructed the myth that Germany, through these statements and its repeated demands for transparency or even regulation, has caused irreparable damage. In truth, this is a veiled slander campaign by the international financial circles, which John Perkins described in his book *Confessions of an Economic Hit Man,* which is well worth reading.

The fact is, that the completely lawless piracy of the locusts has not only led to enormous losses of public property, but also the limitless greed of the speculation-driven willingness to take risks, poses the greatest danger to the world financial system in a long time. The enormously increasing volume of the carry-trade, backed by the ascent of the hedge funds, could at any moment detonate the system, for the locusts coldbloodedly make use of the fact, that interest rates do not fluctuate with supply and demand, but are fixed by the central banks. Since Japan went along with the pressure from Washington and London to keep its interest-rate rises minimal, for years there has been a de facto zero interest-rate policy, which allowed a spiral of speculation to take off by means of the carry-trade, pumping liquidity into the various bubbles. But now, eight members of the Board of the Japanese central bank have shown more interest in the stability of the yen than in the potential chain reaction that these interest-rate increases could let loose.

In September 1998, as a result of the Russian state's default in August, the LTCM hedge fund, which was at that time the world's largest, threaten to go bankrupt, which in turn threatened the meltdown of the world financial system, as the BIS said in its annual report. Only because the 16 largest banks in the world put together a giant bailout fund of over $4 billion for the LTCM hedge fund, which stabilized over $100 billion in derivatives, was a crash of the system averted.

Since then, the number of hedge funds and the volume of their raids has grown many-fold. The global financial system, with its totally over-indebted banks, is today a minefield, in which literally thousands of mines are going off and could set off a mega-collapse. Thus, for example, a new war against Iran would be the death-knell for the financial system, which would throw the world into chaos, and it cannot be excluded that part of the financial oligarchy sees this as the only way to try to keep their control, or to prevent their replacement by those who are oriented toward the common good.

A New Bretton Woods Now!

There is only one way out: a U.S. government liberated from Cheney and Bush must, together with Russia, China, and India, place on the agenda a new organization of the global financial architecture, in the tradition of Franklin D. Roosevelt, as Lyndon LaRouche has proposed, and as is currently being discussed in the American Congress. The hedge funds, equity funds, and their virtual assets will have no place in such a new system. The best thing that the nations of Europe could do in their own interests, is to work for this New Bretton Woods.