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Will Russian default become the 'Kreditanstalt' of 1998?

by William Engdahl

On Oct. 14, 1997, Federal Reserve Board Chairman Alan Greenspan warned that the integrated electronic trading in global financial markets has created "mechanisms for mistakes to ricochet throughout the global financial system." By the end of the week of Aug. 28, 1998, in the wake of the collapse of Russian state finances and currency, the world had been plunged into just such a condition, of a systemic rolling collapse, a process which is just heating up. Stock markets from Tokyo to Frankfurt to Budapest to Mexico City, from New York to Johannesburg, are all collapsing at rates unheard of in recent memory, with no bottom in sight.

The commodity price index, CRB, has fallen to its lowest in 21 years. The price of gold has fallen to $273 an ounce, down from more than $400 a year and half ago. Oil prices, now at ten-year lows, continue to plunge, threatening the state finances of countries from Mexico to Venezuela to Russia to members of the Organization of Petroleum Exporting Countries. Japan's stock market has plunged to its lowest level since 1986.

The global dimension of the situation is leading some observers to ask whether the Russia default will become the "Kreditanstalt" crisis of 1998, a reference to the May 1931 collapse of Austria's largest bank which brought down Germany's Danat bank, and triggered a chain-reaction banking and economic crisis which plunged the world into depression. In reality, the situation holds potential for orders of magnitude worse crises. The world has entered what economist Lyndon LaRouche warned of in June 1994, in his Ninth Forecast, namely, a global systemic collapse which will rival that of the Black Plague devastation in Europe in the 14th century—that is, barring emergency action by governments to build a new monetary order.

In fact, many people have begun to rethink whether a New Bretton Woods agreement, as LaRouche has suggested, including provisions for fixed currency exchange rates, is indeed overdue (see *Commentaries,* below).

The de facto default on Aug. 23 on Russia's sovereign debt owed Western institutions was nominally the detonator of the ongoing global shocks. The meltdown of Russian financial markets has triggered waves of near-panic selling across the markets of eastern Europe. At the same time, fears of the fallout from Russia's de facto state debt default on some $40 billion worth of ruble-denominated domestic debt held by Western banks—mostly German, Swiss, and Austrian—sent those countries' stock markets into a tailspin. And, billions more in Eurodollar loans of the Russian government and companies has not even yet been discussed.

The German DAX stock index as of Aug. 27 had lost 19% since its peak on July 18, when the Russia crisis began to set off alarms. The French CAC stock index has dropped 15%, and the Czech market has fallen 23%, Austria 27%, and Hungary 39%. The currencies of eastern Europe, until recently an island of relative calm, have begun a major sell-off as foreign investors begin to flee all so-called risky markets for the presumed safety of AAA-rated government bonds. But, not even all government bonds are being sought out. The most in demand are, curiously, German government bonds and, more understandably, U.S. Treasury paper.

Russia disintegrates

In Russia, it would be difficult to conjure up a more disastrous scenario than the current reality. On Aug. 26, German Finance Minister Theo Waigel declared that Russia could expect no aid from either the International Monetary Fund (IMF), the Group of Seven, or the European Union. "Russia must do it by itself," he declared. Rapidly assessing that the

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odds at this point that Russia would do "it" were nil, international and domestic holders of rubles abandoned hope of a miracle rescue and made a panic exit, driving the ruble's official exchange rate to the dollar down 12% before trading was closed for the day. The trade remaining in the ruble-deutschemark rate plunged 41% in one day. The following day, convertibility of the ruble, a cornerstone of past years' IMF reforms which was used to lure foreign capital into Russia, was suspended entirely. "At this point no foreign banker is going to go near Russia for a long, long time," commented K.A. Olsen, an economist for a large Scandinavian bank dealing in Russia.

In effect, the Russian authorities are imposing capital controls. But controls alone, in the absence of an effective government dedicated to more than the interests of the tiny group of Russian billionaires, will still mean untold misery for the Russian population.

The focus is now shifting to the banks in the West which helped create, since 1995, one of the world's more spectacular speculation bubbles in Russian GKO and other financial paper. In that year, Crédit Swiss First Boston (CSFB), a major Swiss bank group, devised a scheme which would allow de facto insolvent Russian banks to give the appearance that Russian government finances were finally improving, and thus opening the way for large new dollar credits from the IMF and the World Bank.

According to on-the-scene observers, CSFB convinced the government, then headed by Viktor Chernomyrdin, to select a handful of private banks to receive government deposits of tax and other revenues. The banks then used this money as a deposit base to bid on sweetheart deals for Russian raw materials assets at deliberately cheap prices, creating the present system in which banks own large industrial groups. The banks, in turn, lent sizable funds to the state at minimal interest, funds they got in the first place from the state, which then allowed Russia to get the funds from the IMF which helped stabilize the ruble. Once the process was up and running, the appearance of a Russian "economic turnaround" was used to lure greedy Western banks into the pyramid scheme of GKO short-term debt.

CSFB has now been dealt huge losses in Russia. The bank has admitted to losses of up to $500 million, but banking community rumors say losses easily could surpass $2-3 billion and force the merger of CSFB with a larger bank. However, one candidate that is mentioned, Germany's Deutsche Bank, itself is reeling from losses in Russia, as well as in Asia. On Aug. 26, Standard & Poors downgraded Deutsche Bank from the coveted "AAA" rating, and called its outlook "negative."

German banks have rushed to create the impression that their risk in Russia is tiny, claiming that 90% of it is covered by Hermes state credit guarantees, i.e., by German taxpayers. The reality appears to be quite different. In a discussion with *EIR*, an official with the London-based bank rating agency IBCA-Fitch, while trying to downplay the Russian risk, admitted that the German banks have yet to reveal the full truth. "The German banks have so far only revealed their long-term loan exposure in Russia not covered by Hermes, a very low figure of several billions. Total German bank loans to Russia, according to BIS [Bank for International Settlements] data, are at least $56 billion. But that also does not include German bank trade financing of Gazprom and other trade not covered by Hermes. Nor does it include bank holdings of Russian GKO and other government debt which, at this point, I would call worthless," he said.

There is a strong suspicion in some quarters that German and other European banks with large Russian holdings are simply trying to hide the losses until the panic subsides. That could be some time off, as events are now developing.

Eastern Europe may be next

During the last week in August, the Polish zloty, Hungarian forint, and Czech koruna all fell sharply, the first such fall in months. The stock markets in those countries have been falling for weeks, but a drop in currency suggests panic flight by foreign investors out of those countries entirely, a forboding sign. Spread of the contagion to eastern Europe could be devastating for the German economy. In 1997, German trade with eastern Europe, notably Poland, Hungary, and the Czech Republic, exceeded that with the United States for the first time. German investment in those countries has been major, and a crisis there could have a severe impact on Germany, the heart of the EU economies.

"The spread of this crisis into the heart of European markets could threaten launch of the euro next January," London Bond Broking Ltd.'s Stephen Lewis told *EIR*. "Already we are seeing stresses between the various currencies of the euro-11 countries for the first time since May parities were fixed. If this divergence between government bond prices in Spain, Italy, and Finland, with that of Germany, widen, it could spell real trouble for the new European Central Bank."

The issue that began to spread alarm on Aug. 21, has been hushed up by the same banks which are desperately trying to hide the extent of their Russia exposure. "What really spooked the markets was the speech Friday of Prime Minister Kiriyenko," Lewis said. "When he told the Duma [Parliament] that Russia was 'about to enter' a major financial crisis, Western banks had a shock realization that the worst was about to hit. That brought up the real prospect of default by Russian banks, which are believed to hold some $100 billions in ruble forward contracts with Western banks. But these are over-the-counter derivatives deals which are off-balance-sheet of the banks, and are not covered by any Hermes or other guarantees. A derivatives default of this scale has never before been faced. The Bank of New England derivatives exposure in 1991 was $10 billion, as was Drexel Burnham."

Such a default could trigger a chain-reaction default throughout the entire global banking system, exactly as LaRouche and *EIR* have warned.