US intervention cannot halt Japan breakdown

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19 June 1998

One week ago Treasury Secretary Robert Rubin was telling the US Congress that no intervention would be undertaken to stop the fall in the Japanese yen. It was up to the government in Tokyo to take action, he insisted.

But just days later the US Federal Reserve Board joined with Japanese financial authorities to organise a $6 billion bailout to stop the plunge in the yen. What had changed in such a short period?

When Japanese Prime Minister Hashimoto spoke to US president Clinton late on Tuesday night to urge American intervention, the signs of a global crash were clearly evident. The yen was in free fall, having dropped from 141 to the dollar to 146, partly as a response to Rubin's remarks, and was set to reach 150 in the next 24 hours.

Fears were being expressed across Asia that the plunge of the yen would set off a series of currency devaluations, sparking a "second wave" financial crisis. Chinese authorities had made it clear that their decision not to revalue the yuan was being reconsidered in light of the yen's collapse and the refusal of the major financial powers to halt it.

A devaluation of the yuan would almost certainly see the breaking of the Hong Kong-US dollar peg, setting in motion a new round of devaluations across the region — an Asian beggar-thy-neighbour currency war.

Just hours before Hashimoto's call, concerns over the global consequences of the Asian crisis were articulated at a conference in Australia. The World Bank's senior official for the Asian region, Jean-Michel Severino, warned that all East Asian economies were in a slump, and faced a contraction of up to 15 percent.

"We are talking about a major recession and probably a depression in this part of the world. This depression may be very long-lasting if one does not manage it very, very carefully."

His warnings were endorsed by Thai Commerce Minister and Deputy Prime Minister Supachai Panitchpakdi who said the continued fall of the yen could spark a global recession. "If the yen would drop with no limit or bottom, then the second Asian crisis would mean a first-world economic depression," he told reporters.

The plunge in the yen on Tuesday was accompanied by a sharp fall on the stockmarket — the Nikkei index tumbled below the crucial 15,000 mark. The combined yen-Nikkei fall hit the Japanese banks from two sides. With some 30 percent of the loans raised by the banks denominated in dollars, every fall in the yen undermined the solvency of the banking system. At the same time, the fall in the Nikkei devalued the banks' share portfolios, further weakening their financial position and threatening to put them under the 8 percent capital adequacy ratio demanded by the Bank for International Settlements (BIS).

The increasingly perilous state of the entire banking system is illustrated by the Bank of Tokyo-Mitsubishi, the world's largest bank. In the wake of the 11 percent yen devaluation since March it has seen its capital adequacy ratio drop from 8.52 to 8.2 percent, very close to the level below which it would not be permitted by the BIS to trade.

If the yen-Nikkei slide had continued at the same rate as on Monday and Tuesday — and there was nothing to indicate that it would slacken — then it would have only been a matter of time, possibly only a few days, before bankruptcies of major companies, banks and financial institutions were announced. Intervention on the markets was needed to prevent a major financial crisis.

No doubt in pressing for such action, Hashimoto would have warned Clinton of the global consequences of a financial collapse in Japan. His point would undoubtedly have been pressed home by the 200 point fall in the Dow Jones index on Monday, amid signs that the US stockmarket was beginning to feel the effects of the deepening Asian crisis.

The US-Japan intervention has quelled the immediate turmoil in the markets, but the fundamental problems remain and are worsening by the day.

Already market observers are warning that the effects of the US intervention will rapidly wear off and the yen could resume its slide as early as next week. Within 24 hours, the London-based *Financial Times*, in one of a series of editorials on the Japan-Asia crisis, warned that "policies that simply buy time will not pre-empt deflation in Japan" and that "without decisive action, disaster lies ahead."

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Japan and Asia

The threatened meltdown in Japan is intimately bound up with the crisis in the rest of East Asia — the full extent of which is only now coming to light.

Since the collapse of the Thai baht last July, the five most affected countries — South Korea, Thailand, Indonesia, Malaysia and the Philippines — have experienced a capital outflow of around $115 billion, an amount equivalent to 10 percent of their combined Gross Domestic Product. In addition, bank credits have been reduced by $88 billion, amounting to 8 percent of GDP. This means these countries have suffered a withdrawal of funds equivalent to 18 percent of GDP virtually overnight.

The expected contraction in overall economic activity ranges from around 4 or 5 percent for Korea and Malaysia to as much as 15 or 20 percent for Indonesia.

The Asian banking failure is one of the biggest in world financial history. According to calculations by the Morgan Guaranty Trust Company the funds required to recapitalise the banking system in Japan, Indonesia and Malaysia amount to 20 percent of GDP and as much as 30 percent of GDP in Thailand and South Korea. This compares with a recapitalisation of 4-5 percent of GDP for the US during the savings and loans crisis from 1984 to 1991 and 12-15 percent of GDP for Mexico in 1995-97.

The debt burden of the Japanese banking system, estimated to be at least $600 billion, has rendered ineffective all attempts by the Japanese government to stimulate the economy through increased public works spending.

The theory behind such interventions is that as increased government spending stimulates the economy, businesses will increase their investment, thereby providing an additional stimulus, resulting in further investment and expanded economic activity. In Japan, however, this virtuous circle has failed to materialise because the banks, weighed down by non-performing loans, are unable to provide the funds necessary for increased investment. Consequently, the stimulus rapidly peters out.

This is why even as the country's largest ever recovery program passed through parliament this week, it was written off as providing at best only a temporary boost to the economy.

Even the Bank of Japan downplayed the impact of the $117 billion package. Its implementation was "assumed to boost demand through additional public works and special income tax deduction," the bank said, but these "positive effects of the fiscal policy may be weakened, if the ongoing rapid deterioration in employment and income conditions further dampens the overall economic activities."

The Clinton administration, together with the governments of the European powers, has demanded that Tokyo take action to wipe out the crippling bad debts and "restructure" the banking system.

Accordingly, the intervention to rescue the yen was accompanied by a statement from Rubin that the US was looking forward to "the implementation of a comprehensive action program that will create the conditions that are essential for a healthy and prosperous economy."

Hashimoto replied that Japan would "expeditiously restructure the financial system, including the prompt disposal of bad assets."

But, as usual, the diplomatic exchanges did not even touch on the real implications and consequences of a "restructure" of the Japanese banking system and the elimination of bad debts.

The extent of the bad debt is unprecedented in world financial history — roughly equivalent of the GDP of France. To eliminate it means a program of bank closures, the shutting down of insurance companies and other financial institutions, the forced sale of land, building and other assets, the closure or amalgamation of industrial firms and corporations. Unemployment, already at a post-war high of more than 4 percent, would soar to double-digit levels.

In short, "restructuring" of the banks means plunging Japan into a recession not seen since the 1930s, and unleashing a far-reaching social crisis.

This is why the Japanese government has been so resistant to the demands of the US and its European allies. But, as the events of this week show, time is running out and Japan is heading into a breakdown, the consequences of which will reverberate throughout the world economy.

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