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Advanced sector debt default could happen

by Richard Freeman

Throughout the 1990s, there has been talk of the increased prospect of the blow-out of financial markets, especially the $35-40 trillion worldwide derivatives market. But never was there discussion of default of advanced sector nations on their government debt obligations. Of course, this was the matter of the day during 1979-82, with respect to Third World countries, but never the so-called advanced world. That is changing.

What is happening, as economist Lyndon LaRouche outlined in his ninth economic forecast (see *EIR*, June 24, 1994), is a collapse of the world monetary and credit structure, not merely a collapse of monetary values. This is epitomized by declining government revenues and the increase in government obligations, which are unpayable. A dichotomy between fictitious and real economic activity is driving the disintegration.

The announcement of the prospect for debt default occurred in what would seem a most unlikely place: the *Financial Times* of London, the flagship publication for the Rothschild and Lazard-Pearson banking groups. In an Oct. 31 article entitled "Risks of the Southern Comfort Zone," columnist John Plender warns that sovereign nations in the "industrialized West" may default—a prospect unheard of, at least since the Great Depression of the 1930s.

Plender writes that "a well-known anti-inflation hawk, Mr. Eddie George, governor of the Bank of England, argues that the markets are too pessimistic about the inflationary prospect." Plender works from the monetarist calculus that if inflation goes up, then interest rates must rise to counter it, and hold inflation in check. Yet, inflation is not rising, at least officially. In fact, most major European nations and the United States have official inflation rates of 2-5%. Under the monetarist calculus, interest rates should be falling. But instead they have risen 225 basis points in America during the last 12 months, and started to rise in Europe with the Aug. 11 rate increase by Sweden. Plender implies that Bank of England Governor George also thinks rates are too high. "Current high rates of interest are prohibitive for government borrowers everywhere," Plender writes. Then why should rates be rising?

Plender answers, *"In the end, the question turns on the nature of default risk.* The markets are saying that current levels of debt are unlikely to be serviced in full, especially in what economist David Roche of Independent Strategy likes to call the Southern Comfort countries" (emphasis added). Included in this zone of countries are "Sweden and Finland and on occasion the U.K., along with Italy, Spain, Greece, and Portugal." Canada and Belgium "qualify for club membership." These nine advanced-sector nations pay a "risk premium against the possibility of an internal default."

Plender makes clear that by "government default," he largely means that governments will "monetize debt by borrowing from the domestic banking system—the modern equivalent of printing money." But the traditional prospect of complete default is also considered.

Plender's column is a double-edged sword. On the one hand, it advances the viewpoint that governments must launch a new round of ferocious budget-cutting, including cutting vital infrastructure, in order to bring their budgets more into balance. This approach was signaled a few weeks before by Hans Tietmeier, the head of the German Bundesbank. Such a plan could make the prospects bleak for implementing a "Productive Triangle" of Eurasian infrastructure development and reconstruction, as LaRouche has proposed.

On the other hand, Plender's article shows that there is a growing awareness among the world's financial elites that

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the financial markets are millimeters away from a gigantic disintegration-implosion. The in-fighting over the spoils is intensifying.

Fall of the House of Windsor

The conceptual starting point to comprehend what is now going on, is that simultaneous with the disintegration of the elites' financial power, the House of Windsor itself—the "primate among parasites"—is coming unglued. From the standpoint of certain insiders, the sovereign debt of core industrialized nations may have to be sacrificed, as no longer possible to service, in order to keep funds flowing into their private family trust fortunes, or *fondi*. The short-sightedness of that strategy is evident: Governments have always bailed out the *fondi* during a time of crisis. If governments are liquidated, they cannot play that role.

What role governments do and should play in the eventuality of a crash was addressed on Sept. 9 by Andrew Crockett, general manager of the Bank for International Settlements (BIS), in a speech delivered at Maastricht University, in the Netherlands. The BIS is the central bank for all central banks. Crockett departed from the central bankers' usual code of silence, to state some things publicly that one does not expect to hear from a gray three-piece-suit type. This speech was featured, belatedly, in the Oct. 26 *Financial Times,* but only fragmentarily. *EIR* has obtained the full text.

Crockett said that financiers are suffering from "financial crisis myopia," not looking beyond the last crisis as soon as it is over. He rattled off a "series of episodes" during the last 15 years, that includes, "the LDC debt crisis, the savings and loan debacle in the United States, the collapse of junk bond values, and the real estate lending crisis, to name just a few." Then, he mentioned, as an implied sequel, the "potential dangers in the growth of the derivatives markets."

What should central bankers do, were the derivatives market to fail on a grand scale? Crockett asked. Why not just let "greedy investors . . . learn their lesson?" This approach, he argued, will not work because "the *political process* is not willing to accept the consequences of the full application of market disciplines. . . . *It has to be recognized that an external shock, coming against the background of financial fragility, could lead to a serial collpase of a number of institutions.* Whether right or wrong, the Darwinian solution [of unbridled collapse] would not, I suspect, survive the test of *political acceptability.*" Crockett has thus laid out the bankers' perception of the terms of the debate, as the House of Windsor, and associated financial power, melts down. Of course, the BIS bankers have not visibly altered their behavior: They continue to bull forward the derivatives market.

Public debt crisis

Irrespective of Plender's reasons for writing his dire Oct. 31 column, the debt crisis of major industrial nations is severe. Over the past 30 years, in most western economies, the fictitious paper economy has swallowed up the physical economy. When all that an economy produces is fictitious values in the form of derivatives, there is nothing real to tax. Derivatives also wildly distort the Treasury market. The result: The buildup of government budget deficits and huge outstanding debt obligations.

Consider some of the danger spots, which lie in the "Southern Comfort" zone:

- Sweden: In the last week of October, in a clearly political move, Moody's Investor Service put Sweden's Aa2 foreign currency debt rating on review for possible downgrading. Sweden's foreign debt, as well as its internal public debt, represent major problems. Sweden's domestic bond prices have plunged by 38% during 1994. Its banking system is in chaos. Yet, to prevent capital flight, Sweden's Riksbank, its central bank, raised interest rates on Aug. 11. This tightening further hurt bonds. Sweden's domestic debt is very high, equal to 92.9% of Gross Domestic Product, and increasingly unpayable.
- Canada: Like Sweden, Canada has an external and internal debt problem. Such crises tend to interpenetrate and aggravate one another. Canada has run a constant balance of trade surplus; yet during all but 3 of the last 20 years, it has registered a current account deficit. The reason: Its foreign debt is so large that its remittances, in the form of payment of interest on that debt, overtop the combined trade surplus and Canada's foreign earnings from its own foreign investments. The yield on Canada's 10-year domestic bonds is 9%, even though Canada's official inflation rate is 2%. This creates an extraordinarily high 7% "real yield." This is a version of the "risk premium" that Canada pays because of the possibility of "default."
- Belgium and Italy: Belgium's government debt to Gross Domestic Product ratio is 146.3%. The rate on Italy's long-term bonds has now shot above 12%, and because of that another 50 trillion liras, approximately $35 billion, has been added to Italy's budget deficit.

Up to two-thirds of new government debt in many of these countries is issued in very short-term bills; no one will buy long-dated bonds, because the markets are blowing out.

The danger is not confined to the "Southern Comfort" zone. As *EIR* reported last week, on the basis of comparing October 1993 to October 1994, the composite average rate of return for all U.S. Treasury instruments—ranging from one-year notes to 30-year bonds—*fell by the largest cumulative 12-month amount ever recorded in 60 years in America.* Moreover, much of the foreign debt of the countries in the "Southern Comfort" zone is dollar-denominated. While these countries' internal debt is earmarked in each country's internal currency, this debt is hedged on the world derivatives markets. Most of it is now offset by a counterpart instrument *denominated in dollars.* Thus, were a few of these countries to default, the dollar, the world's once dominant currency, would be next.