The world financial crisis, and what to do about it

by Michael Liebig

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Currently there exists a pathological delusion in both Group of Seven (G-7) populations generally, and relevant institutions, that the world economy must be healthy, simply because the stock markets—i.e., "*my money*" invested there—have been growing during the past months. On this delusion, the American economist Lyndon LaRouche commented, "If anyone insists that the rising Dow Jones stock market index proves that the U.S. economy is growing, your reply ought to be, 'Oh, you mean that the cancer is growing?' " The fact is, "market values" are not economic values; economic processes are primarily physical-economic, not monetary or financial.

Conventional wisdom will concede that over the past two years there has been an unfortunate series of crises in the world financial system: an "Asia crisis," a "Russia crisis," a "Brazil crisis," a real depression in Japan's economy, and "irrational exuberance" on Wall Street, which was Federal Reserve Chairman Alan Greenspan's way of describing financial asset price inflation. (I would simply call it an utterly unsustainable financial bubble.)

But, conventional wisdom will categorically deny that all these financial and economic eruptions during the past two years, are simply different expressions, symptoms, or "fronts," of one global and systemic financial crisis. The manifold crises in different segments of the financial system can no longer be adequately explained just by concrete, localized situations or abnormalities. The recent financial disasters, as typified by the so-called Asia crisis, are not an arbitrary accumulation of isolated crises of different, specific origins. What is really important, is not the individual causality of the specific crisis episodes, but the causality for the series of crises.

Their denial of the global and systemic nature of the crisis, explains the complete failure of the crisis-management policies of the International Monetary Fund (IMF) and the G-7 governments and central banks. None of these institutions, to date, has in the least been able to re-stabilize the global financial system. These crisis-management actions have only "bought some time" for keeping the current system going, by actually worsening its overall condition, through a combination of vast bailout packages, IMF conditionalities, and massive injection of liquidity by central banks. Whenever, during the past two years, the financial situation was declared to be "back under control," the next, and worse, crisis was about to hit.

The LaRouche 'Triple Curve'

To understand the global and systemic nature of the crisis, one should look at it in terms of what has been called the "LaRouche Triple Curve," or "Typical Collapse Function," which provides a demystification of the multiply-connected relations among physical economy and monetary and financial processes (**Figure 1**).

The Triple Curve concept maps the exponential growth, first, of financial titles: stock prices, bonds, real estate values, and derivatives. That growth, in the past decade, has gone into the stratosphere. Second, the growth of monetary supply of leading world central banks. It has also grown exponentially higher, if at a slightly less rapid rate than financial titles. The third curve is the growth of the real physical economy globally, which has plummeted.

These aggregates are measured within the framework of both per-capita and per-square-kilometer values of physical-economic input and output. The rate of growth of physical-economic output has become consistently negative since the 1971-72 establishment of the "floating exchange-rate" monetary system. The characteristic of the relationship among declining net physical-economic rates of output; self-feeding, speculative growth of financial aggregates; and monetary expansion to sustain leveraged expansion of financial aggregates, is peculiar to the 1966-99 process, as distinct from the relations among these magnitudes for the 1946-64 interval.

To grasp the widening gap between physical economic output and exponential growth of financial-monetary aggregates, it is necessary to consider real household incomes in physical-economic terms, net capital-intensity of both physical production and basic economic infrastructure per capita and per square kilometer. The characteristic relationship of the curve of financial-monetary aggregates to physical-economic input-output, is "self-cannibalism" of the real economy as a whole, because there is no net physical-economic profit. Especially after the Carter-Volcker interest-rate measures of 1979-81, the composition of financial profit was shifted to

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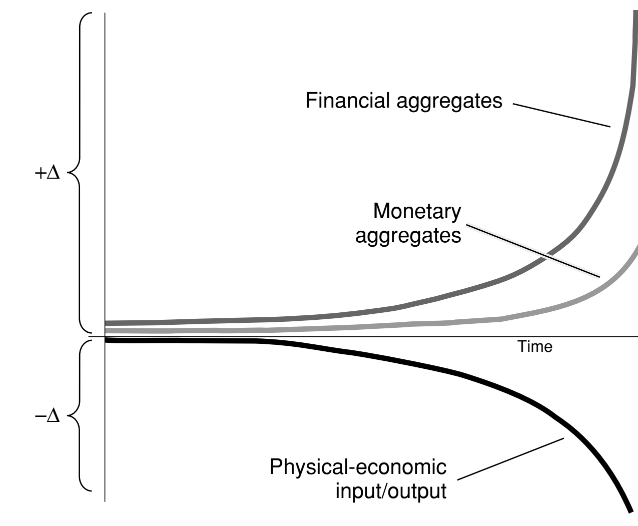
FIGURE 1
A typical collapse function



rely predominantly upon purely speculative forms of financial activity: the merger-and-acquisition mania, junk bonds, and derivatives.

The post-Bretton Woods period

On Aug. 15, 1971, President Richard Nixon effectively terminated the original 1944 Bretton Woods world monetary system, which was based on fixed exchange rates and the promotion of real economic growth.

Before, in the 1950s and most of 1960s, there were basically two reasons to buy a foreign currency: first, if you were travelling, or, second, if you were importing or exporting goods. In 1970, just before the collapse of the fixed-exchange rate system, foreign exchange trading worldwide was about $12 billion a day, or $2.9 trillion a year. World trade in 1970 was almost $600 billion. So, there was about six times more foreign exchange trading than there was actual foreign trade. Today, this proportion has completely changed. Less than 1% of foreign exchange transactions today are related in any way to the trade of goods and services, which would include currency hedging. That is, 99% of all foreign exchange transactions are purely speculative. According to the latest statistics by leading central banks, the worldwide volume of foreign exchange transactions has reached $1,500 billion each day.

During the late 1980s, derivatives emerged, as the prime vehicle for a qualitatively new type of financial speculation. Derivatives are futures, options, swaps, and other exotic instruments with which one bets on oscillations of currency and interest rates, stocks, bonds, and indices of stocks and bonds. Derivatives are synthetic financial instruments, because they are not based on production or transaction of goods. Derivatives are the result of a major shift of strategic thrust in the West's dominant economic, financial, and monetary policies since the early 1970s:

1. National financial markets were submitted to deregulation and liberalization;
2. Floating currency rates were introduced, replacing the fixed gold-reserve-based monetary system of the postwar period;
3. Financial markets were "globalized" through 24-hour electronic data links, which radically changed the character of the basic policy axioms of banking, beginning in the United States, and then extending into Europe and Japan;
4. The IMF's monetarist, neo-liberal axioms were made internationally hegemonic in the form of the IMF's "structural adjustments" and "conditionalities" policies.

These four factors have led, inevitably, to greater and greater volatility in currency and interest rates, in stock and bond markets internationally. This global financial volatility is, metaphorically speaking, the "oxygen" that allows derivatives speculation to "breathe." The Thatcher government in Britain and the Reagan/Bush administrations in the United States, phased out the successful economic policies of Kennedy, Adenauer, and de Gaulle, and replaced them with radical neo-liberalism, first in Great Britain and the United States, but later also in Japan, Germany, and France.

Today's global economy can be correctly called a global casino, where financial gambling is the prime activity, and where the production of real goods, investments in infrastructure, education, health, and so on, are increasingly being pushed to the fringe of economic life.

The stock bubble

The nominal capitalization of American stocks on all U.S. stock markets, including the New York Stock Exchange, the American Exchange, and the NASDAQ, reached $12.96 trillion in 1998. Now, at the end of the first quarter 1999, total U.S. stock capitalization stands well above $15 trillion (**Table 1**).

From Jan. 1, 1999 to May 3, 1999, the Dow Jones stock index increased from 9,181 to 11,004 points, that is, 20% in four months.

Europe shows an almost identical dynamic. For example, between 1978 and 1993, the Frankfurt DAX stock index needed eight years to double, reaching 1,000 in 1985, and

TABLE 1
U.S. stock market capitalization
(trillions $)

1980	1.52	1994	6.24
1988	3.10	1995	8.33
1990	3.53	1996	10.06
1992	5.46	1997	12.96
1993	6.28	1998	14.55

2,000 in October 1993. In January 1997, the DAX stood at 3,000; just six months later, in July 1997, the DAX stood at 4,000 points. In March 1998, the DAX index crossed 5,000. Currently, it stands at 5,400.

From the beginning of 1997 to April 1998, stock price indices rose 78% in Frankfurt, 63% in Paris, 80% in the Netherlands, 63% in Belgium, 52% in Sweden, 42% in Britain, and 83% in Switzerland. According to Deutsche Bank's subsidiary DWS, during 1997 the volume of German equity funds increased 80%, of Italian equity funds 124%, and of Spanish equity funds 388%.

Besides central bank liquidity pumping, begun in spring 1995 and dramatically escalated since October 1998, so-called index funds have been driving up stock indices. In addition, a stock buying frenzy by small investors, reaching levels of mass hysteria, has been bloating the stock bubble. The incomes of 41% of all U.S. households depend on "capital gains" from their stock investments, mostly through mutual funds. This has led to an extreme form of the "money illusion," through which fictitious capital gains translate into consumer spending, not investment into the economy's physical capital and infrastructure base. This is the background to the United States' merchandise trade deficit, estimated to be around $300 billion for 1999 ($248 billion in 1998).

September-October 1998: near-meltdown

In its spring 1999 Quarterly Review on "International Banking and Financial Market Developments," the Bank for International Settlements summarizes the near-meltdown in late 1998: "Global financial markets suffered from extremely volatile conditions in the fourth quarter of 1998. The flight to safety and liquidity which developed in the wake of the Russian debt moratorium in August reached a climax in October. Benchmark yields and equity prices retreated, while credit spreads widened markedly. Massive deleveraging and, in the process, the near-collapse of a major hedge fund, added to price swings and further contributed to a drying-up of liquidity in a wide range of markets and instruments." These events "created the risk of a systemic failure," writes the BIS.

In late September 1998, the Federal Reserve had made an unprecedented intervention, by coordinating the bailout of the Long Term Capital Management hedge fund. LTCM owed not only $120 billion to the 16 American and European banks which had injected about $4 billion into the hedge fund, after trading losses had all but wiped out LTCM's core capital (estimated at $2-3 billion); the real exposures of LTCM, including its notional value off-balance-sheet derivatives obligations, was $1.25 trillion. However, as alarming as such enormous leverage is in one single hedge fund, it was the banks tied to LTCM, which had a much larger exposure, in which the real systemic risk lay. In early October 1998, in addition, BankAmerica took a $357 million loss write-off because of its participation in the D.E. Shaw & Co. hedge fund, and bought $20 billion in outstanding securities and derivatives contracts from that hedge fund, in order to bail it out.

Financial asset inflation

In this near-meltdown condition of the world financial system, the G-7 governments and central banks engaged in an unprecedented series of interest rate cuts, liquidity pumping, and various bailout schemes. The aim of the so-called "Alan Greenspan miracle"—successive U.S. interest rate cuts on Sept. 29, Oct. 15, and Nov. 17, 1998, plus massive repurchase of U.S. Treasury bills held by private banks, in return for short-term cash, and similar ways of injecting liquidity into the banking system—was to postpone for some time the inevitable systemic breakdown. The U.S. interest rate cuts were followed worldwide. The Bank of England has cut rates six times since, and in Japan, short-term interest rates presently stand at 0.23%! The events of September-October 1998, demonstrated that the financial crisis had fully hit the G-7 core financial systems, not just Asia, Russia, Brazil, and other "emerging markets."

Since October 1998, G-7 central banks have triggered a massive inflation in financial asset prices in the G-7 sector, which we have sketched above. The "boom" in stock prices is simply the symptomatic expression of monetary and financial asset price inflation—hyperinflation, to be more precise. This inflationary crisis management is designed to buy time in postponing the financial collapse. However, the financial asset price inflation is, in reality, accelerating the disintegration process.

Since the summer of 1997, and in particular since the autumn of 1998, the global and systemic nature of the financial crisis has become obvious for anyone who cares—or dares—to look at reality. Moreover, the global financial crisis has become a world economic crisis. The world's physical economy—production, capital investment, infrastructure expenditures, employment, living standards, and trade—has been in accentuated decline since 1997. In 1998, the dollar value of global merchandise trade shrank by 2%, and in 1999, world trade in goods is expected to decline at least by 5%. Were present trends to continue, the global economy would head into a full-blown depression. Much more should be said about the accelerating decline of the world's physical-economic potential since the 1970s, and since 1997 in particular, but that is not possible here for time reasons.

The financial crisis and war

There is a fundamental causality behind the British-American-Commonwealth (BAC) power group's drive for strategic confrontation with Russia and China, and for escalating military conflicts, in the Balkans, the Middle East, and elsewhere. I must emphasize here, that the BAC should not simplistically be confused with "the United States"; the BAC has influence within the Clinton administration, but is not in control of the U.S. government.

To understand why the financial crisis became an eco-

nomic crisis, and then a military-strategic crisis as well, one must comprehend the Clausewitzian transposition of the financial-economic crisis into a military-strategic crisis. Economic-financial problems, which governments are politically unwilling and/or incapable of resolving effectively, by means of economic and financial policy changes, tend to get "resolved" by "other means." During the October-November 1998 turning point in the global financial crisis, the BAC's current confrontation/war drive was enacted. First came the undeclared war against Iraq, using the faked Butler report as a pretext. Second came the drive to qualitatively transform NATO, by ramming through the neo-imperial "New Strategic Concept" for NATO. Then, came the current war in the Balkans, which could have been diplomatically averted, if Russia's and the United Nations' involvement had not been deliberately obstructed, before March 24.

For the current global strategic situation, the Clausewitz dictum, that "war is the continuation of politics by other means," remains as valid as ever. "Politics" is the totality of political, economic-financial, social, and cultural factors. The content of politics is primarily determined by the existence or absence of economic, social, and cultural development. Ultimately, what decides if there is war or not, is whether there is development or not. A politics of development does not need a continuation "by other means." A strategy of development is "self-sufficient," so to speak, because it can achieve its aims by economic, political, and cultural means. A politics of economic, social, and cultural decline, erosion, and disintegration, however, necessarily leads to its continuation by other means—confrontation, pressure by force, and war. And war may take many forms: conventional war, civil war, irregular war, or war with weapons of mass destruction. A strategy of non-development inevitably leads to an "entropic quantum jump" into the regime of war.

What needs to be done?

The salient question at this point is, will the Clinton administration, in cooperation with continental Europe, China, Russia, and India, as well as others, muster the will to dump the disastrous "crisis management" policies, in favor of a radical reorganization of the world financial system? Will they go for a New Bretton Woods system, as designed by LaRouche? Will they create national banks, like Germany's postwar Kreditanstalt für Wiederaufbau, providing low-interest, long-term credit for great national and transnational infrastructure projects, like the Eurasian Land-Bridge, revitalizing the world economy? Were the United States and continental Europe to fail this test of history, then the task of leading the world out of the crisis would fall to the large nations of the once-developing world, most emphatically China and India.

The fundamental issue before us, therefore, is, what will life be like after the inevitable financial breakdown? What emergency measures will have to be adopted to ensure that the financial breakdown will not bury the real economy under it? It should be clear, that there exists no magical "post-collapse reorganization kit," but there are basic principles that need to be followed:

- Sorting-out fictitious capital. Speculative, fictitious financial paper must be written off by governmental action, if it has not been wiped out beforehand by the market collapse. Financial paper of an unclear nature must be frozen. State debt must be frozen, so as not to impede the continuation of basic state functions.
- Financial paper backed by productive, physical economic assets must be protected. The financial resources of pension funds, health insurance, and other vital social services or educational institutions must be protected. The citizens' "regular" savings must be protected. Private banking functions directed to these real economic and social areas must be preserved.
- By way of exercising national financial sovereignty, the state must issue low-interest credit which is to be exclusively directed toward reactivating and expanding industrial, *Mittelstand* (i.e., small and medium-sized firms), and agricultural production and infrastructure, on the technological level of the "Third Industrial Revolution." To that end, the private banking system—with its account management and customer expertise—is to be used.
- The state provides low-interest credit for large-scale, high-technology infrastructure projects on a national and multilateral scale, as typified by the Eurasian Land-Bridge. These projects will be the key catalyst for overall economic reconstruction and regeneration.
- A new, stable, fixed-exchange rate, gold reserve-backed world monetary system must be established by governments.

Let me conclude with a quote from LaRouche: "I would recommend to people who want to understand what I am saying, to look back at what a senior economist of the United States, John Kenneth Galbraith, said about the great crisis of 1929-31. Galbraith made a famous statement in saying that you have to realize that 'It's only paper,' which has been collapsing on financial markets. . . . If stocks pertain to an industrial company, so what? As long as the company functions, we don't care what the price of the stock is. . . . We have to protect the nations; we have to protect the integrity of the currency, and securities of governments. We must protect industries, keep them functioning. We must protect agriculture. We must maintain the continued functioning of basic economic infrastructure, and we must do all the things which defend the lives and well-being of the people. The main thing is to get back into real economic growth, and say, with a sigh of relief, 'It's only paper, it really wasn't value anyway. It was only fictitious value.' Let it fall, but let it be done in an orderly way through government bankruptcy reorganization of the relevant institutions," in the United States, continental Europe, China, Russia, India, and all others who are willing to collaborate in the effort to work ourselves out of this crisis of civilization.