

Politicians Fiddle While Financial Architecture Burns

by William Engdahl

Hearing the glowing pronouncements from both the Republican and Democratic campaigns in the United States, one would never imagine that the world is teetering on the brink of a financial system cataclysm that will make 1929-31 pale by comparison. Yet, the euro has plunged to the all-time low of 90¢ to the dollar, and a sell-off in European telecommunications and high-tech stocks and in euro-denominated bonds is reaching what traders call “near panic” dimension. On Wall Street, the inflated NASDAQ stock index threatens to plunge to 3,000 or lower over coming weeks. And in Asia, the collapse of the so-called “recovery,” from Thailand to the Philippines to South Korea, is again causing alarm as international investment flows pull out. In Japan, where foreign investors had pushed the Nikkei stocks to booming gains over the past year, selling has caused renewed weakening of the yen and alarm that the Bank of Japan could be forced, as early as Aug. 11, to abandon its zero interest-rate policy.

The alarm bells are ringing loudest in the financial pages of leading European media. In the wake of the 10% plunge of NASDAQ in the week ended July 28, two of the most prominent financial publications of Europe, the London *Economist* magazine and the German daily *Handelsblatt*, as well as the London *Sunday Telegraph*, all devoted prominent space to warnings about the shaky U.S. financial edifice.

“Is the Bubble Set To Burst?” asks City of London fund manager Andrew Smithers, in the July 30 *Sunday Telegraph*. Smithers attacks the popular notion that the U.S. “economic miracle has defeated the old boom and bust cycle.” He points out that the U.S. economy today bears all the danger signs that Asia did on the eve of the 1997 currency crisis. “A large external deficit, deteriorating credit conditions, and a bubble stockmarket. The U.S. current account deficit is now 4.3% of GDP, credit spreads have jumped as lenders worry over the

explosion of debt, and the stock market is more overpriced than ever before.”

Noting that “share prices have gone crazy,” Smithers concludes: “It’s bound to end in tears, and the longer the party lasts, the worse will be the hangover.”

Smithers’s warning is echoed in the July 29 *Economist*, which devotes the lead in its Finance and Economics section to the growing problems of U.S. banks, problems long believed to be under control. The *Economist* says that U.S. regulators “have been sounding warning bells for many months that all is not well. [Federal Reserve Chairman] Alan Greenspan . . . has often voiced explicit worries about America’s banks.”

Addressing the paradox of recent record U.S. bank profits, the *Economist* points to “three events that shook investors.” Wachovia Bank in July set aside an added \$200 million to cover “loan losses,” Bank One announced big net losses because of a \$1.9 billion loan-loss provision, and First Union Bank announced a writeoff of \$2.9 billion to close its MoneyStore subsidiary, which lent to high-credit-risk families.

The *Economist* points to the record levels of corporate debt increase, some \$535 billion just in 1999, “mostly to buy other firms or their own equity. . . . Firms that pile on debt are less likely to be able to repay it; defaults are climbing. Moody’s, a rating agency, expects defaults on speculative-grade bonds to reach 8% next year.”

The *Economist* notes that the Federal Deposit Insurance Corp., the agency which guarantees U.S. bank deposits, thinks that “bond defaults are leading indicators of problems in the banking sector.” Under pressure to show their stockholders annual 15% profits, U.S. banks have been making ever riskier loans, a problem covered up by the Federal Reserve’s pumping liquidity into the banking system. However,

since about March, as the Fed, worried about inflation, made several interest rate rises, money supply has begun to contract and the economy to slow down. That slowing could quickly explode the number of bank loan defaults on risky loans.

Yet, the magazine points out, risky loans aren't the banks' only problem. Banks have increasingly become stock speculators, seeking to cash in on the booming stock market. They call this "asset management." A study by the CSFB international investment bank (Crédit Suisse First Boston) estimates that a 30% fall in the stock market, something which happened to the NASDAQ last April, would slash bank profits by 10% or more.

The *Economist* concludes on the ominous note: "If defaults and bad loans are starting to show up with the most moderate of slowdowns, imagine what they would look like if—a silly thought—America went into recession."

Commenting on the significance of the *Economist* warning, a senior London-based Asian banker told *EIR*, "I read the *Economist* piece, and I can tell you, it is very significant. In substance, it is correct; but, more than that, it is a warning of things to come."

Dangerous Inflationary Trend

An equally alarming feature appeared under the title "An Alan Greenspan Does Not a New Era Make," in the Aug. 1 *Handelsblatt*. Written by two German bankers, the article reviews the dangerous expansion of U.S. debt, deficits, and stock inflation, underlining that in many respects, the situation has gone beyond that of the pre-Crash 1920s. The authors cite dismaying statistics:

- During the 1990s, the S&P-500 U.S. stocks increased 400%, the NASDAQ by 1,180%. In Germany, the "New Market" in only three years of existence went up by 1,600% at its peak in March.
- If stock price gains in the United States continue as they have in the last five years, this would require, at least according to traditional measures, a yearly profit growth of 40% by the average listed company.
- The ratio of stock market capitalization to GDP in the United States is now much higher (170%) than in 1929 (110%). Exchange trade turnover of securities today equals 250% of GDP, compared to 130% of GDP in 1929.
- The daily turnover of over-the-counter interest rate and currency derivatives increased by 85% in the last three years.

"Various voices are now warning of a speculative bubble that could soon burst," *Handelsblatt* warns. It points to the excessive money-creation of Greenspan's Federal Reserve since the crises of 1997-98 as the cause for the present excesses in credit markets, because speculative bubbles only can emerge as long as there exists "a monetary cover to finance the inflationary price structures of stock markets."

The authors argue that the Federal Reserve itself has given birth to "the speculative forces within the U.S. economy"—a sharp contrast to the popular myth that the Fed is the guardian

against inflation. In the autumn of 1998, when the Fed lowered interest rates three times, "this was the signal investors had waited for. As the balance between risk expectations and profit expectations of investors changed, the speculative forces and the wild development of Internet stocks, even after the temporary switch to a more restrictive monetary policy, went out of control until March 2000." Added to this is the enormous expansion of consumer debt, far exceeding that of the 1920s; the astronomical growth of the derivatives market; and soaring foreign indebtedness, as shown by the record current account deficit (in the 1920s, the United States had a surplus). Nobody can say when the bubble will burst, the authors conclude, but "it just can't go on like this."

Unusual among the world's financial press, this article is an echo of Lyndon LaRouche's warning that we have entered a hyperinflationary period, comparable to that of Weimar Germany in 1923.

An 'October Surprise'?

The growing pressures evident in U.S. financial markets, nervousness over the bloated NASDAQ Internet and dot.com bubbles, and the likelihood that the Fed will be forced to raise U.S. interest rates to "preempt inflation," are setting the stage for what might well turn into a nasty "October Surprise" in financial markets. "October is generally the month where things go wrong in markets," remarked City of London fund strategist Stephen Lewis. "I think we could be in for a very ugly period from August into October on the markets."

But concern is by no means limited to the inflated U.S. credit structures. In Europe, the euro, which began its existence on January 1999 at \$1.18 to the dollar, has plunged back to the lows of late spring, following a temporary rebound. The last time this level was reached, European Union finance ministers held emergency meetings to try to stem a crisis of confidence. The renewed fall, beginning in late July for no apparent reason, according to currency analysts, is beginning to cause alarm in Euroland bond markets. "Interest rate spreads between Euroland corporate bonds and comparable government bonds are beginning to increase," said Lewis. "The feeling is growing in these markets that the captains are away at the holiday beaches while the ship heads into the rocks. The negative sentiment on the euro is spilling over into bonds."

Elsewhere around the world, the major economies of Ibero-America, especially Brazil and Argentina, have been hit hard by the recent interest rise by the U.S. Fed. Totally dependent on foreign investment to prevent blowouts of their banking and financial systems, they have been forced to match Fed rate hikes point for point, depressing already severely depressed economies. While a full-scale crisis is not yet evident, with a foreign debt as of January 2000 of \$248 billion for Brazil and \$149 billion for Argentina, these economies are vulnerable to any new shocks.

The world's second-largest industrial economy, Japan,

is showing signs of new troubles. The Nikkei stock market recently fell sharply below 16,000, after reports of large selling by foreign investors. The debt ratios of the Japanese private and government sectors are so extreme, that no long-term solution is possible based on the prevailing rules of the game, either for Japan, or for Southeast Asia, for which Japan is the economy with by far the greatest impact.

With ten years of record government fiscal “stimulus,” which has made Japan into the world’s most indebted G-7 economy, and with debt estimated to rise to 132% of GDP by year-end, the country is still sitting on a mountain of bad bank loans and falling real estate prices which paralyze any real sustained new investment. For the past year, Japanese banks had barely managed to control the bank debt problem by creating a fraudulent myth of “Japan’s recovery” as an Internet “New Economy.” Record foreign investment inflows to buy Japanese stocks over the past year or more had allowed banks to sell their stock holdings in other companies, and use the gains from inflated stock values to reduce their mountain of bad debts.

The surprise reversal of the Japanese government, in declining to bail out the bankrupt large Sogo retail group, with more than \$18 billion in debts, on June 13, in the wake of an unprecedented public outcry against further taxpayer bail-outs, has refocused attention on the unsolved financial problems in Japan. Since July 13, for the first time in months, foreign banks have begun to demand a “Japan risk premium,” as the price for lending to Japanese banks in the interbank market. In the wake of the November 1998 collapse of Yamai-chi Securities, Japanese banks were put into a major funding crisis by imposition of a huge interbank risk premium, forcing the Bank of Japan to implement the drastic solution of drawing interbank interest rates down to zero.

In the wake of the Sogo collapse, and the shock that public funds will not be available to rescue other insolvent companies, in construction and real estate especially, there has been a flood of stock selling. In addition to foreign selling, however, Japanese banks are reported to be in a major stock liquidation of their own, to raise cash for a likely avalanche of new bankruptcies. This has pushed the Nikkei Dow stock index below 16,000 for the first time this year, and the prospect is that it will fall far lower as the Sept. 30 fiscal accounting deadline nears. From the background of such a situation, where Japanese policymakers realize that traditional crisis management measures are wholly inadequate, we can expect a greater urgency to expand on the Chiang Mai initiative for an Asian Monetary Fund, which is a useful step in the direction of the New Bretton Woods financial reorganization called for by LaRouche.

“All it takes is some unexpected shock, some trigger such as a U.S. bank in trouble, to set this one off,” said a nervous senior European banker. “It could happen when people least expect it. August to October will be a very ugly time in financial markets.”

Italians Look to a New

by Lilitana Gorini

On July 13, the Italian Senate unanimously approved a bill for “debt relief for poor countries,” shortly after it had been approved by the Chamber of Deputies. There, the bill had been introduced in the Foreign Affairs Committee, and then on the floor, by Hon. Giovanni Bianchi. Bianchi, a member of Parliament from the Italian Popular Party (PPI), had introduced the bill on June 23, the same day that American economist Lyndon LaRouche was the main speaker at a conference entitled “Towards a New Bretton Woods,” in Cenacolo Hall in the Parliament building in Rome (see *EIR*, July 7, 2000).

Bianchi and the Italian Minister for Parliamentary Relations, Patrizia Toia (PPI), were the hosts of that conference, although they were unable to attend personally. In the following interviews, Bianchi and Toia comment on the passage of the bill, in the context of the Jubilee year and the failure of the Okinawa summit—which, unlike the bill, did not face up to the reality of the “financialization of the economy,” as Bianchi calls it—and also on LaRouche’s proposal for a New Bretton Woods financial and monetary system, which is seen as the natural outcome of such a debt reorganization for poor countries.

Minister Toia also comments on the upcoming visit to Virginia of a number of Italian Members of Parliament, led by Bianchi, to see Gov. James Gilmore (R), and to prevent the execution of an Italo-American citizen, Rocco Derek Barnabei, scheduled for Sept. 14. Toia, who has been very active in the fight against the death penalty and for human rights, recalls in the interview that Pope John Paul II has called on Governor Gilmore to stop the execution and to allow a DNA test which could prove Barnabei’s innocence.

The importance of the law on debt relief for poor countries, approved by the Italian Parliament, was emphasized also in the Catholic daily *Avvenire* on July 14 by Mgr. Attilio Nicora, who chairs the Committee on Debt Relief of the Italian Catholic Bishops Conference in the Jubilee year, and who was invited to testify before the Foreign Affairs Committee. Monsignor Nicora emphasized in particular Chapter 7 of the law, which “commits the Italian government to support in international venues, procedures which demand that the International Court of Justice change the present rules on international debt.”

Minister Toia emphasized to *Avvenire* the role that Italy can play to “wake up other members” of the Group of Eight, taking action, “if need be, unilaterally.”