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## III. From Lyndon LaRouche

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June 16, 1986

# Why the Banking Systems Will Experience a Blow-Out in 1986–87

by Lyndon H. LaRouche, Jr.

*LaRouche sent the following letter to The Economist magazine in London on June 16, 1986.*

**To: *The Economist***

**Subject: “Leviathan,” June 14 [1986] edition**

Gentlemen:

Your analysis of trends in government spending is dominated by two popularized, but blundering assumptions: the assumption that GDP, as currently defined, is anything but a very misleading yardstick for indices of economic output; and, the failure to distinguish the positive role of basic infrastructure expenditure within the total mass of governmental expenditure. In brief: A very different picture of this matter is presented, if one employs the yardsticks of physical economy, rather than the monetarists’ yardsticks embedded in your piece. Not only does the analysis differ fundamentally, but the policy options implied are mutually exclusive.

In simple first approximation, the proper yardstick for computing relative value of outputs and inputs, is 1967 “*per capita* market-baskets” for both producers’ and households’ goods. Such outputs must be measured for 1) Total population, 2) Total labor-force, and 3) Total of Operatives’ component of labor-force. By this standard, U.S. productivity slowed from Kennedy-era levels about 1966, reached a level about 1970, and has been in a roller-coaster sort of downslide from 1970–71 to the present date. During the so-called “Reagan economic recovery” of the 1983–85 period, the average rate of contraction of the economy was approximately 2.5% *per*

*annum*, and the rate of contraction is now accelerating.

The fallacy of GNP/GDP modes of national income accounting, is most readily recognized, if one analyzes a national economy as analogous to a consolidated agro-industrial enterprise. In this way, we distinguish between components of cost of production of physical output *per-capita*, and ‘the sundry expenses analogous to a private enterprise’s “overhead burden.” From this vantage-point, the outstanding feature of the U.S.A. and United Kingdom economies over the post-war period as a whole, but especially since the mid-1960s, is a relatively exponential growth of the ratio of “overhead burden” expense to direct costs of physical output. On the continent of Europe, the same trend prevails, but more slowly; the same trend exists for the case of Japan, but has developed much more slowly than in Western Europe.

There are two outstanding features of this process of transition toward the sort of economic scrap-heap called a “post-industrial paradise”: The collapse of the turnover in capital-goods industries, especially the critical machine tool sector; and a post-1966–70 collapse of investment in basic economic infrastructure. This physical-factors effect has been exacerbated on the monetary side, by the inherent instabilities of the “floating exchange-rate system,” and the intensification of this instability by policies akin to Mr. Paul Volcker’s “controlled disintegration of the economy” dogmas. The combined effect: Our monetary order has taken the form of “creative financial” modes of building a chain-letter in nominal assets, resting upon a process of contraction in the physical-economic basis.

In reality, since 1970–71, the effective policies of

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**Editor’s Note:** *EIR* first published this article in Vol. 13, No. 26, June 27, 1986, pp. 12–13.

OECD governments have been, to maintain public services at an approximately constant level (after adjusting for inflation). These portions of expenditure, including defense expenditures, have been approximately constant over the recent 15 years, if physical yardsticks are employed to compute the true rate of inflation. Recently, since about 1982, U.S. total expenditures on these accounts have actually been declining in total amount. However, the constant-dollar tax-revenue base, at prevailing rates, has been contracting at an accelerating rate, while the debt-service obligations of governments have been spiraling upward as a percentile of total governmental revenues.

All sensible observers tend to concur: “We can not simply continue in this way.” The difference lies in the analysis of the fault, and, correspondingly, in the proposed remedies.

The view more popular among governments today, is simply to cut away flesh and bone from government budgets, as needed, to attempt to overtake the rate of collapse of the tax-revenue basis. The contrary analysis leads to the recommendation, that all governmental expenditures but national defense and basic economic infrastructure ought to be frozen, while forcing an expansion of the tax-revenue basis.

The difference in outlook, is thus centered around the issue of expansion of the tax-revenue basis. During Mrs. Thatcher’s campaign for re-election, I had hoped that her government would be committed to a sharp turnabout in that direction, as she had appeared to adopt the gist of Mr. Norman Bailey’s<sup>1</sup> report on the “spill-over” impact of SDI. As you may recall, the grounds for my optimism on this account were swept away during the August-September period of that year.

During March of this current year, the relevant gentlemen of Switzerland, had pointed to the portents of the post-1982 build-up of off-balance-sheet-lending accounts in the U.S. banking system, and had added the somewhat wishful view, that the Swiss and German banking systems were somewhat insulated from the disasters looming for the U.S. financial com-

munity. It is to be conceded, that since 1982 the Swiss and German banks have disengaged from the degree of risk which caused their trembling during August 1982; in that degree, a blow-out of the Ibero-American debt, or of portions of the U.S. domestic debt, would have far greater direct impact upon the more exposed U.S. financial system, than in Europe. However, no part of the non-communist world is prepared to withstand the chain-reaction impact of a U.S. financial blow-out.

This year, or next, the U.S. financial system will experience a blow-out, assuming that no radical change in policies intervenes to prevent this. Thus, measures aimed at patching up governmental deficits of OECD nations have about the relevance of rearranging deck chairs on the *Titanic*: the substitution of very short-lived cosmetics, for actually facing the real problem. Given the fact that governments currently seem to have the concentration-span of a very nervous grasshopper, exercises such as Gramm-Rudman-Hollings are clinically comprehensible, if not exactly sane.

On governmental expenditures. Over the post-war period into approximately 1970, there was a precise correlation between increased U.S. investment in basic economic infrastructure and rises in productivity of operatives. The two curves were separated by a lag-factor of, approximately, 18 months, and otherwise represented the most precise fit to be found in economics statistics. Over the 1966–70 interval, the rate of growth, of both, attenuated; and contraction set in after 1970–71. Today, not less than US\$3 trillion would be required to repair basic economic infrastructure to the quality of 1970.

What is needed, is the quality of tough decisions which reverse that 20-years policy-trend leading into the presently looming disaster, rather than the hysterical efforts of the U.S. Liberal Establishment to stake everything on continuing the old policy structures yet another few months.

It is not the Muscovite empire that is crumbling, but our own. True, the Russian system does not actually work by Western standards; excepting short-lived reforms by Peter the Great and Alexander II, it never did. Moscow could prevail only if we virtually destroyed ourselves, which is what Moscow has always believed, essentially, since before Ivan Grozny. Like ancient Rome, and Byzantium afterward, what might

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1. For more about Norman Bailey, see *EIR* Vol. 33, No. 50, p. 41-42, “Allard’s Hoax on the Subject of LaRouche,” by Lyndon H. LaRouche, Jr.

doom us is our propensity to destroy ourselves, by refusing to consider abandoning policy-matrices which a rational mind would view as massively discredited.

I do not believe that better seating arrangements at the captain's table would have prevented the *Titanic* from sinking.

Cutting government expenditures, as a substitute for addressing the failures of that policy which the cuts are intended to prolong another few months, is the symptom of an elite which has lost its capacity to rule effectively. Empires are not destroyed by conquerors, but by stubborn adherence to those customary opinions through which the empires destroy themselves.

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## Documentation

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*The following is excerpted from the June 14 London Economist's "The Gorging Leviathan" cover story.*

For longer than most voters in the rich democracies can remember, the growth of state spending has been one of life's certainties. Suddenly, it seems to be stopping. Politicians who have longed for this day may be tempted to conclude that Leviathan, once tamed, is now shrinkable. Others think the taming has upset so many people that they will soon be electing governments that promise to spend more on just about everything. Both shrinkers and boosters are going to be disappointed....

State spending has too long been increasing as a proportion of gross domestic product in all the coun-

tries belonging to the Organization for Economic Cooperation and Development. In 1960 it exceeded one-third of GDP in only two of the 24 OECD countries; now it does so in 23 of them.... The ratio jumped most in the 1970s, when GDPs grew less rapidly but governments forgot the old saw about cutting their coats to fit their cloth....

The ratio of public expenditure to GDP would not have risen as fast as it did in the 1970s if economic growth had retained its earlier zip. If the real GDP of, for example, Japan had grown in 1975–84 by the 8% a year it averaged in 1965–74, then the Y100 in 1984 would have been only 25% of GDP instead of the 33% it actually was.... Assuming that the world is not going to have two more oil shocks or a new bout of double-digit inflation that will have to be stopped by a slump, the chances of faster GDP growth—hence of there being room for more state spending without higher taxes—seem, on the face of it, quite bright.

Appearances deceive. One reason is the black economy. It allows people to earn and spend without paying taxes.... As taxes rise, more people decide to evade them....

Such figures suggest that every OECD country has already exceeded the limits of taxation....

Though voters expect the state to go on doing most of the things they are used to, they also want to pay lower taxes. This paradox is not new, but will become immeasurably more important. Those politicians who responded to it best will prove the most successful governors of the next few generations.