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The world financial system reaches a breaking point

by David Goldman

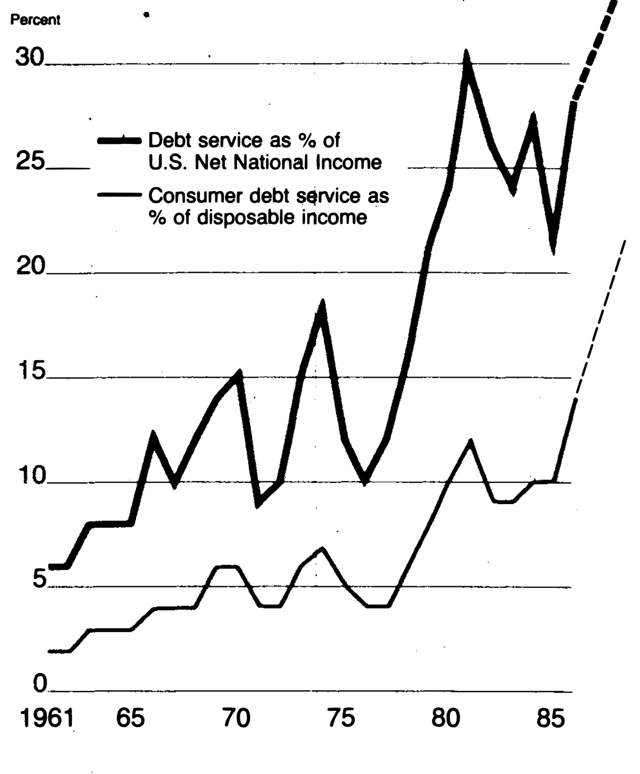
The following speech was given by Mr. Goldman on Dec. 29, at a conference of the International Caucus of Labor Committees in Herndon, Virginia.

The year 1985 has concluded in an orgy of speculation that makes the events of 1929 seem, by comparison, a bingo evening at a Methodist Church. The stock-exchange value of American equities has doubled since 1982, and comparable European values have more than doubled. These events merely guarantee that the "financial Armageddon," in the words of *Washington Post* columnist Joseph Kraft, will hit with even greater force during 1986.

President Reagan's signing of the Gramm-Rudman amendment, which compels the federal government to reduce spending by about a quarter-trillion dollars over the next five years, completes the national bankruptcy of the United States. In 1971, when President Nixon suspended gold backing for the dollar, the United States was bankrupt, except for the willingness of its creditors to hold unbacked American paper. After 1979, when Federal Reserve Chairman Paul Volcker dismantled the American economy, the United States asked its creditors to accumulate up to $150 billion of unbacked paper each year in return for goods we purchase abroad in excess of what we ship abroad. At present rates of increase, America's net foreign debt will reach $1 trillion by 1990—overshadowing the mere $800 billion in debt of the developing world.

Figure 1 depicts two measures of our national bankruptcy. The first shows debt service, that is, the interest costs of

FIGURE 1
The debt-service explosion



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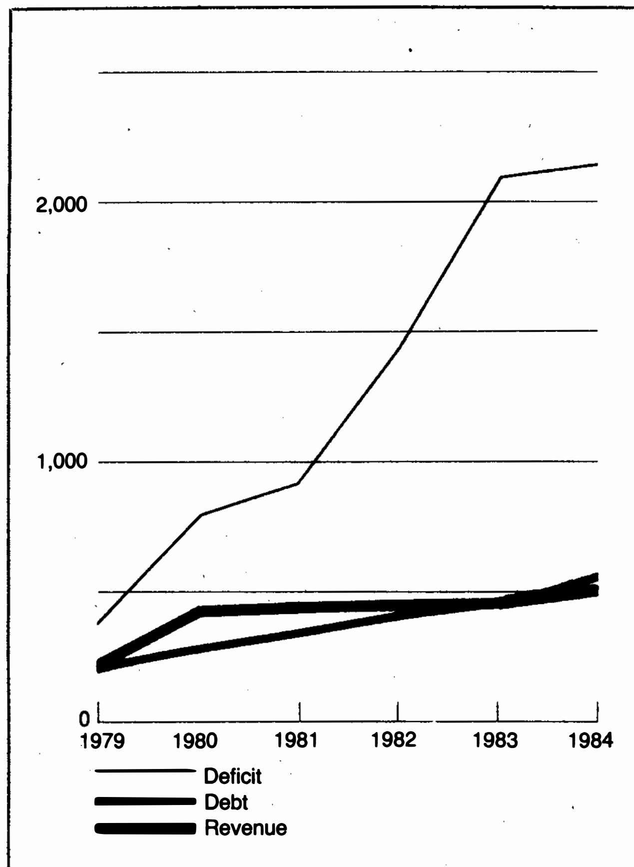
our \$6.7 trillion domestic debt, as a percentage of total sales in the economy, or nominal national income. In 1961, debt service took 6¢ of every dollar of income; in 1971, when the United States suspended gold backing for the dollar, it still took less than a dime. By the Volcker era, the proportion moved up to the 30% range. The dotted line shows our projection that debt service as a proportion of national income will rise far in excess of 30%. The second line shows how much of their after-tax income consumers must pay in interest on outstanding household debt. In 1961, the proportion was 2¢ on every dollar of consumer income; it has now risen to close to 15¢, and we project it to rise to about 20¢ during the next two years.

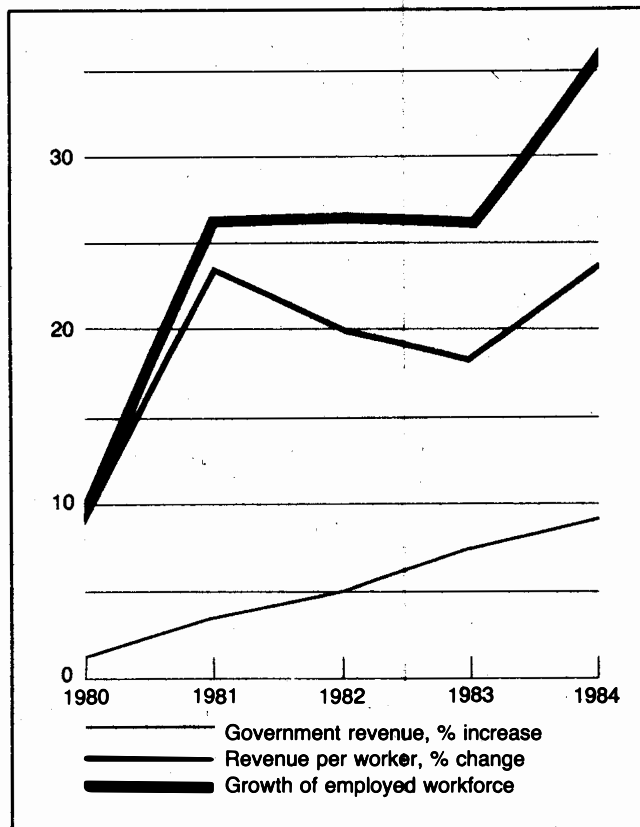
This also indicates by what means the fraudulent U.S. economic recovery will blow out. The U.S. trade balance now represents one-sixth of our total consumption of physical goods. We borrow abroad to finance the imports, and consumers borrow at home to buy them. Consumer debt has become the fastest-growing category of debt, growing at about 20% per year. The supposed consumer boom—pathetic in contrast to the actual 50% decline in household consumption, which *EIR* documented in its *Quarterly Economic Report* dated June 15, 1985—will crumble next year under the weight of debt service.

FIGURE 2
Growth of government revenue, budget deficit, and debt
(1967 = 100)



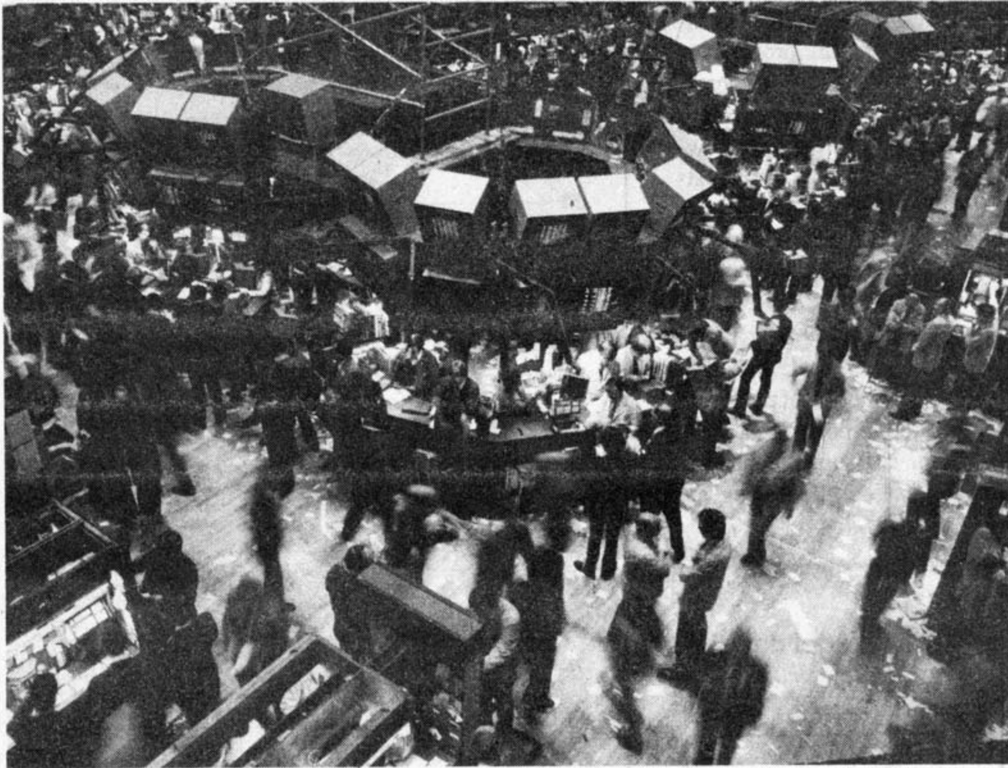
Source: IMF

FIGURE 3
Government revenue and the tax base



Source: IMF, BLS

Let us briefly, and finally, settle the question of the budget deficit. The deficit has nothing to do with excess government spending. After inflation, government spending has been falling for six years; net of interest payments to our creditors, it has been falling rapidly, to the detriment of our national defense and basic infrastructure (**Figure 2**). The problem, as the graph shows, is that revenues have been flat, while the deficit and debt have continued to rise. Now, the American economy employs 112 million workers, 10 million more than in 1979; six out of 10 mothers with small children are working. With all this employment, what happened to revenues? **Figure 3** shows what the problem is; despite the rise of the workforce, revenue per employed worker has been falling, even in undeflated, nominal dollars. Look at what sort of employment is available, and the problem is obvious: How much in taxes can you squeeze out of a housewife working 20 hours a week at Burger King?


NSIPS/Philip Ulanowsky

1985 concluded in an orgy of speculation that makes the events of 1929 look mild by comparison. Here: the New York Stock Exchange.

With five out of six employed Americans flipping hamburgers or shuffling papers, mostly at mi
American tax base has rotted away. We have a budget deficit for the same reason we have a trade deficit: We can no longer produce the physical goods we require for continued existence. Now this reality has caught up with the financial system.

The banking system is bankrupt

Except for one special circumstance, to which I will refer in a moment, the American banking system is bankrupt. The failure this year of 113 banks, the highest number since the 1930s, is of far less significance than the collapse of the Maryland and Ohio state insurance system for savings and loan institutions. Under the spur of banking deregulation, the savings and loans have abandoned their traditional home-financing business, in favor of speculative real-estate transactions. The traditional savings account has disappeared, in favor of high-interest, short-term deposits, whose departure can empty a bank of funds within hours. The entire $800 billion savings system is rotten, and the federal government's capacity to salvage it is comparatively much weaker than that of the already bankrupt Maryland and Ohio state insurance funds. One out of six federally insured S&Ls is losing money, and one out of seven is technically insolvent.

The $80 billion bankruptcy of the Farm Credit System, the principal source of finance for American farmers, crushed the finances of U.S. federal government agencies, which together sponsor over $500 billion in outstanding debt. At risk is not merely the $220 billion of outstanding farm debt; the Treasury Department's decision to force the Farm Credit System to foreclose on delinquent loans has, in any case, doomed the entire outstanding debt of the farmers. The failure of one federal agency, namely the FCS, will bring down the entire alphabet soup of agencies which support the trillion-dollar mortgage market.

The special circumstance which has delayed the collapse of American banking institutions is the growth of the narcotics traffic. In 1978, we wrote in the book *Dope, Inc.*, that dope was the world's largest business, second only to petroleum; now it has outstripped oil by a wide margin. Some $200 to $300 billion in sales of illegal narcotics leaves the United States every year, of which about $100 billion returns in the form of traceless inflows of capital. These capital inflows have provided a temporary source of liquidity to an otherwise-bankrupt banking system, permitting the major international banks to continue functioning, while even the strongest farm and regional banks go under.

The relative importance of narcotics traffic has increased even faster than the absolute size of the global dope market, for the simple reason that all other commodity prices have collapsed, by more than 30% since 1980. Illegal money flows

are the only source of new liquidity in the international markets, and a major replacement for sources of liquidity that have been lost to the collapse of prices in world trade. We will first examine the condition of the world's major debtors, and return to examine, in conclusion, how narcotics revenues have taken control of the American financial system.

Global debt crisis

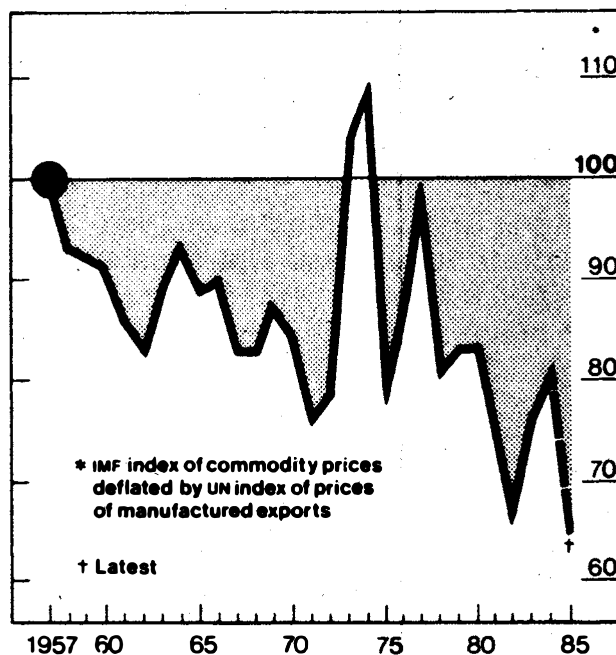
The most probable breaking point for the world financial system is located in the unpayable $800 billion debt of the developing nations, and the $2 trillion offshore banking market tied to that debt. Treasury Secretary James Baker III offered a program to contain the debt crisis at the October annual meeting of the International Monetary Fund in Seoul, South Korea. Baker's scheme, the first official American admission that the debt crisis is *global* in nature, is prima facie fraud, on two counts. First, Baker's promise of new bank loans for the debtors presumes that the debtors will auction off major national assets, e.g., their petroleum companies, for a fraction of their underlying value, in return for additional loans. Second, even were the debtors to permit the banks to take over their national assets, the way a loan shark takes over a family business, Baker's plan assumes that they will continue to pay out, net, almost $50 billion a year to their creditors.

But there is such a thing as a reality principle in the world economy, and this reality principle demonstrates the miserable ineptitude of the U.S. Treasury. Let us examine the relentless spread of depression in international trade. World exports, running this year at a flat $1.7 trillion annual rate, remain 10% below their 1980 level. The collapse of the dollar volume of trade reflects a more than 30% fall of the price of all commodities since 1980, including a 10% fall in the 12 months through 1984.

The industrial nations' imports of raw materials are even more depressed, at 12% below the 1980 level. For the largest Ibero-American debtors, the situation is much worse: An *Executive Intelligence Review* study included in our Oct. 15, 1985 *Quarterly Economic Report* showed that exports to the United States of a basket of 18 agricultural and industrial commodities fell by 34.9%, in terms of physical tonnage, during 1980-83. The Ibero-Americans, meanwhile, increased their exports of energy-intensive intermediate goods by a staggering 15
Economist estimated the decline in all raw materials producers' terms of trade at almost 50% since 1978 (**Figure 4**).

The 12% decline over 1979-84 in OECD nations' absorption of commodity imports, mainly from the developing sector, compares to a 58% rise between 1975 and 1979, the last period of industrial growth in both the developing and developed nations. This 70% swing in commodity export growth rates between the two periods explains the devastating fall of commodity prices, and makes the present situation parallel

FIGURE 4
Terms of trade*
Exporters of primary products 1957 = 100



Source: *The Economist*

the 1929-34 period, when commodity prices fell by approximately 50% overall.

OPEC's decision in December to raise rather than restrict exports, provoked by Anglo-Norwegian-Soviet dumping of crude oil, has already pushed crude oil prices down by more than 10%, and threatens to bring oil prices down by an additional 25%. The situation is even bleaker in some other markets. After the bankruptcy of the Tin Producers' Council last October, it is expected that the re-opening of tin trading will occur at roughly half the previous price level for the widely-traded metal. In this context, a further 20% decline in raw materials prices during the next two quarters would be no surprise.

The London *Economist* described the effects of the price collapse as a $65 billion "poor man's gift" to the industrial nations, and warned bluntly that a financial crisis would ensue unless something were done about it. The situation is even worse than the commodity indices show. An *EIR* study demonstrated that the biggest Ibero-American debtors lost 35% of their export prices between 1980 and 1983 alone, i.e., an amount even larger than the decline in the prices they obtained for those exports traded on global commodity markets. That reflects the devaluation of their currencies under International Monetary Fund programs during the period.

Since the devaluation-bred decline of export prices is mirrored in higher import prices as well, the Ibero-American debtors' terms of trade fell, overall, by roughly 60% during the same period. That is, the major debtors must export 60% more, as well as import 60% less, in order to earn the same volume of dollars for debt payments. The resulting squeeze on their economies has cut domestic consumption in the range of 30%—exact numbers are incalculable from available data—and wreaked even more damage upon those countries' future, through the suspension of all infrastructural improvements.

The 15 worst-off debtor nations paid $32.4 billion in interest

additional $2.6 billion in repayment of principal. During those 12 months, the developing nations shipped, net, $35 billion to their creditors.

Adding $25 billion in flight capital looted from these countries to the net capital export figure, we see that *the debtor nations are paying out $60 billion annually in hard cash to their creditors.*

We can see that Treasury Secretary Baker is attempting to hold the financial system together with mirrors. Even if the so-called Baker plan were put into effect, it would do no better than to reduc

oping nations to a mere $45 billion per year, rather than the $60 billion registered over the past 12 months. Even that monstrous degree of looting ignores the devastating damage done to the economies of the developing nation through the huge shift in their terms of trade, which is, by an order of magnitude, the biggest problem of all.

By the London *Economist*'s judgment, the developing nations coughed up an additional $65 billion, the "poor man's gift," in the form of a 10% decline in commodity prices during 1985. But, as indicated above, the overall decline in terms of trade since 1980 is 60%, and 60% of the non-oil developing nations' annual exports of about $725 billion adds up to $435 billion.

The *Economist* survey, published Nov. 30, 1985, observed that the $65 billion cut out of developing nations' export earnings this year amounted to 0.7% of the industrial nations' Gross National Product. "Since real GNP growth in the OECD countries is running at an annual rate of about 3%, a quarter of it comes courtesy of cheaper commodities. The full bonus is probably even bigger, because anything that cuts prices directly will produce such second-round benefits as smaller wage increases and lower interest rates," the *Economist* concluded.

Taking 1980 as a base, and using *EIR*'s more comprehensive measure of terms of trade, we find that the price-reduction of non-oil developing nations' exports since then, at $435 billion, amounts to a full 4.8% of total sales (GNP) in the industrial world—or considerably more than their total reported "real growth." Leaving aside the fact that the real growth numbers, as reported in GNP terms, are at best misleading and at worst completely fraudulent, the broad result is correct. Without the collapse of developing nations' export earnings, the charade of economic recovery could not be maintained anywhere in the industrial world, with the possible exception of Japan.

NSIPS/Laurence Hecht

With the enactment of Gramm-Rudman, the American population is thrown on the scrap heap.

ring the

The developing nations are politically, financially, and economically exhausted after five years of looting at an accelerating pace. Their economies, deprived of spare parts, let alone infrastructure investments, cannot maintain the same rate of exports, and their social structures cannot withstand the concomitant spread of mass starvation and epidemic disease.

What does this mean for the world banking system?

The cancerous Eurodollar market

Figure 5 displays the position of the $2 trillion offshore market on three levels. The middle line is the total size of world trade, or $1.7 trillion. The bottom line is the total size of the offshore markets, which crosses and exceeds the line representing world trade. These two measures are roughly comparable; to the extent that there is any real, underlying income supporting the offshore, or Eurodollar market, it is the exchange of goods in international trade. We see that the Eurodollar market has nearly doubled in size since 1979, while world trade has stagnated.

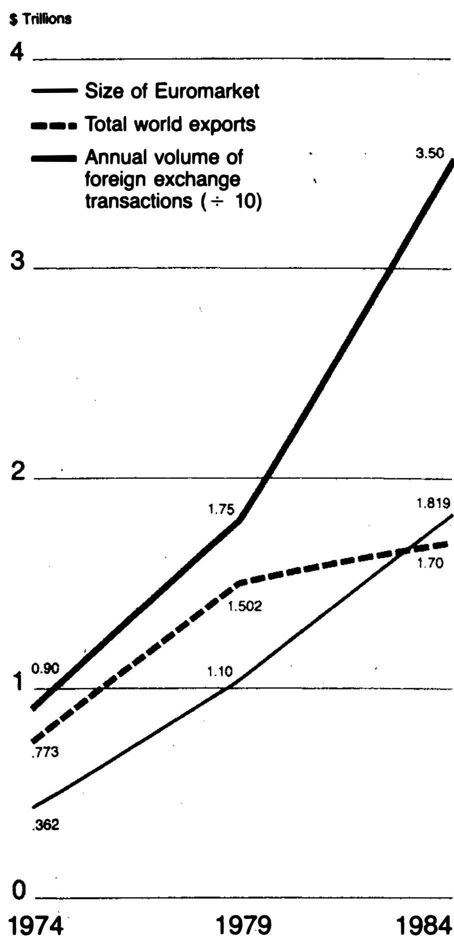
The top line represents the monthly—not annual—vol-

ume of foreign exchange transactions on the international markets, that is, the amount of dollars, deutschemarks, yen, and other currencies that exchange hands; $23 changes hands each day for every dollar of merchandise exports. That is to say, that a speculative cancer has grown on top of a banking system, whose own real basis for payments has meanwhile rotted way.

Historically, the growth of Eurodollar market deposits began with the boom in international commodities trade during the last years of post-war economic growth. The Eurodollar market mushroomed in the wake of America's Aug. 15, 1971 suspension of gold backing for the dollar, and the 1973 reversion to "floating exchange rates." These amounted to a grand deregulation of the financial system, spurring a geometric growth rate in Eurodollar market operations.

Developing nations deposited their commodity earnings with London banks, which treated these as the equivalent of compensating balances for loans to the same countries.

FIGURE 5
The 'offshore' market



During the 1969-74 period, before the first big rise in oil prices, OECD countries' imports of raw materials rose by 240%, from $25.9 billion to $62.4 billion. In the same period, the Eurodollar market ballooned from a small pool of funds serving (initially) the Soviet Union, which did not want to hold dollar balances in the United States, and assorted dirty money, into the major source of new international lending.

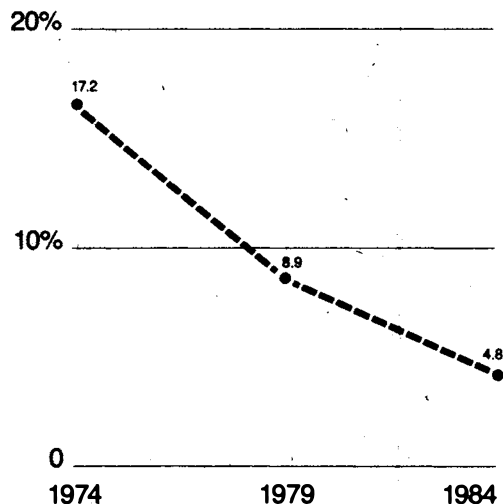
As of 1974 (**Figure 6**), OECD nations' raw materials imports were equal to about 17% of total Eurodollar deposits of $362 billion. By 1984, when Eurodollar deposits (by the narrowest measure) were at $1.8 trillion, trade in raw materials covered less than 5% of total deposits.

The Eurodollar market seems to work according to the old joke, that the entire population of Tel Aviv lived by selling the same bottle of orange juice back and forth to one another. As I reported, the dollar volume of international trade has not grown since 1979. Nonetheless, the volume of global foreign exchange trading has doubled, from $75 billion to $150 billion *per day*. That is exactly 23 times the total value of international trade.

The 'underground economy'

However, in all such speculation, there are (by definition) as many losers as winners; everyone can't make a living in the permanent floating offshore crap game. What has held the Eurodollar market together, rather, is what economists politely call the "underground economy," i.e., $500 billion a year in global narcotics traffic, $100 billion a year in illegal arms traffic, and several hundred additional billions in flight

FIGURE 6
Commodity trade earnings as % of Euromarket liabilities



If the Eurodollar market was commodity-based in 1973, it is narcotics-based today. During the first half of 1985, almost half of America's $120-billion-a-year balance of payments deficit was financed by parties unknown, who took precautions to ensure that their investments in the United States were hidden.

capital, tax evasion, and assorted types of swindling.

If the Eurodollar market was commodity-based in 1973, it is narcotics-based today. Skeptics are referred to the balance of payments tables for the United States.

During the first half of 1985, according to official government numbers, almost half of America's $120-billion-a-year balance of payments deficit was financed by parties unknown, who took precautions to ensure that their investments in the United States were hidden. Analysts at the Federal Reserve Board, the Commerce Department, and the International Monetary Fund believe that the biggest source of revenues from these parties unknown is narcotics traffic, and that the second biggest is flight capital from developing countries.

That is, in hard numbers: The United States was importing $124 billion per year more than it was exporting, as of the first half of the year (**Figure 7**). The graph shows the trade deficit, and how it is financed; the second line is the reported deficit, and the top line is the trade deficit adjusted for what it would cost us to produce the same goods at home. Underneath, we see where the money comes from to finance the deficit; more than two thirds derives from illegal sources.

Some $50 billion of that is reported in the official data, as "net errors and omissions." In other words, we could not account for $50 billion a year in money coming into the United States, enabling us to pay for our trade deficit.

That is not the end of it. American companies, and various U.S. government agencies, are borrowing at a $35 billion annual rate from the offshore entity known as the "Eurobond market," founded, in the first place, to enable parties unknown to buy income-yielding securities without being traced. This market used to be a relatively small, dirty corner of the world financial market; it is now "closely lagging" behind the U.S. government debt market, the largest market for securities in the world, according to Crédit Suisse-First Boston, the London firm which dominates this market.

Fifty billion dollars a year of "errors and omissions," plus $35 billion a year of "Eurobonds," adds up to $85 billion, or more than two-thirds of our annual external financing requirement, from sources the U.S. government cannot identify.

These are the funds that are buying up American corporations, financing a Mississippi bubble of speculative takeovers on Wall Street.

Whether the savings and loans, the farm banks, the Third World debtors, the oil producers, the bloated real-estate market, or another time-bomb will go off first, is not within our means to predict. America's creditors may pull the plug on the finances of the U.S. government at any moment, as the International Monetary Fund and the Bank for International Settlements warned bluntly in their most recent annual statements. They have not done so, only because President Reagan's capitulation to their demands has enabled them to obtain the political results they want, without pulling the plug immediately.

One way or another, the issue will be decided in 1986. Reality has caught up with 20 years of encroaching economic disaster. The coming year's financial upheaval will either give the United States opportunity to employ its sovereign powers, and take the world financial system back from Dope, Inc., or it will give Dope, Inc. the means to crush the sovereign power of the United States forever.

FIGURE 7

U.S. trade deficit: financied by 'parties unknown'