

# Russians Debate Impact Of Dollar, Market Falls

by Rachel Douglas

The \$40 billion-plus in cash dollars inside Russia, and the fact that Russian currency reserves are held chiefly in dollars, make the weakening of the U.S. currency a burning issue. The week of July 22, exchange points in Moscow were swamped by people trying to exchange their dollars for euros, or demanding reliable advice on what else to do. Finance Minister Aleksei Kudrin urged calm. Russian stock markets dropped sharply for the first time in months, the giant Gazprom falling by 11% on July 24.

Most striking is that the strategic dimensions and systemic nature of the crisis are now being openly discussed across a broad spectrum of Russian media, no longer only by competent individual economists such as Sergei Glazyev or Tatyana Koryagina. A July 19 interview with Lyndon LaRouche in the widely read weekly *Vek* (*EIR*, Aug. 2) set a standard of reference: the world monetary system is dysfunctional, and must be replaced with proven methods of national banking and productive investment.

Also on July 19, Prof. Stanislav Menshikov, in his weekly column for the English-language *Moscow Tribune*, took up the subject of the U.S. “bubble” economy. Menshikov wrote that Alan Greenspan’s explanations about an epidemic of corporate greed were an understatement, since “the long boom of the 1990s has brought about an asset price inflation that has gone wildly astray for the first time since the 1920s.” The major banks, said Menshikov, “have also been involved in crediting the bubble and helping it grow beyond reasonable proportions.”

An important third analysis, in the weekly *Ekspert* on July 22, by economists Oleg Grigoryev and Mikhail Khazin, is our *Documentation*. Two years ago, in “Will the United States Manage To Bring On the Apocalypse?” (*EIR*, Aug. 18, 2000), this team argued that the so-called New Economy was a hoax, and its collapse would turn the United States into the epicenter of a coming crisis. Recalling that their forecast was “not accepted by the public at that time,” Khazin and Grigoryev document that their arguments have been vindicated, and outline next stages for the crisis. Khazin was formerly an expert in the Ministry of Economics and the Presidential Administration. Co-author Grigoryev has worked with Sergei Glazyev.

In June 2001, when Glazyev invited Lyndon LaRouche to keynote Parliamentary hearings “On Measures To Protect the National Economy Under Conditions of Global Financial Crisis,” nobody in the Russian government was talking in

those terms. Now, they’ve had their agenda changed. Even Finance Minister Kudrin, devoted to globalization, has to recognize “certain signs of an international financial crisis,” as he delicately put it on July 25.

Kudrin was sure that the U.S. Federal Reserve and the European Central Bank would “take measures,” but he didn’t sound sure they would work. Market capitalization has collapsed already, said the Russian Minister, and looming now is companies’ inability to service their debts, threatening “the stability of the banking system.”

Kudrin has also acknowledged, that Russia’s own foreign debt service will be at least \$300-400 million higher in fiscal 2003 than projected in the government’s budget plan. Other officials in his ministry told *Nezavisimaya Gazeta* that the extra debt service could exceed \$2 billion. Every rise of the euro against the dollar by one cent, according to Presidential economics adviser Andrei Illarionov, increases Russia’s foreign debt by \$100 million. This is because Russia has debts to European countries, which must be paid in euros, but most of its export earnings are denominated in dollars.

## Seeking Economic Security

The budget already prioritizes paying \$17 billion on the foreign debt, 2003 being the peak year for Russia’s debt-service payments. This sum is over 21% of a budget with no wiggle room. There are practically no reserves for emergencies. Early Summer floods in southern Russia, for example, became the chief cause of a doubling of state wage arrears, to 3.2 billion rubles (\$101 million), in June; payroll was diverted to disaster relief.

No decisive policy shift has yet followed from these events. But, what the widely read daily *Argumenty i Fakty* (*AiF*) termed “intriguing, even mysterious events” have taken place in the Russian establishment, around economic policy. On July 8, President Vladimir Putin held a meeting of the Security Council, to which Minister of Economic Development and Trade German Gref delivered a report Putin had demanded on “threats to Russia’s economic security.” Putin ordered the Security Council to update its “national economic security concept,” which was originally composed by Glazyev during his 1996 time at the Security Council.

On July 11, Putin assigned Gen. Col. Vladislav Putilin to Gref’s ministry as a deputy minister. Putilin is a military organization specialist, who has headed the Organization-Mobilization Directorate (GOMU) of the Armed Forces General Staff since 1997.

Two more economic policy decisions are reportedly in preparation, which could lead to momentous changes under global crash conditions. According to *Ekspert*, Presidential Administration deputy chief Dmitri Kozak is preparing legislation to shift control over most of Russia’s natural resources—including oil, natural gas, gold, diamonds, and ferrous and non-ferrous ores—to the federal government, declaring them federal property. And on July 26, Pravda.ru

reported that a team under Sergei Pugachov—a former banker, now member of the Federation Council, and close ally of the President—is working on a “mobilization program” for the economy, which would enhance the state’s ability to guide the economy.

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## Documentation

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# Will America Manage To Bring On Apocalypse?—II

*Appearing in the July 22 issue of the Russian weekly Ekspert, this article by economists Oleg Grigoryev and Mikhail Khazin came with an editorial introduction, proclaiming that “the crisis in the American economy is far from over” and urging attention to the coming “collapse of the world derivatives market.”*

How long will the American (world) economy exhibit the symptoms of crisis, and what will their long-term impact be? Practically all people in business are asking these questions, from the executives of giant corporations to middle-level traders. Answering them requires an examination of the real causes of the crisis—not only technical causes, but global ones. Otherwise, it is impossible to assess the underlying tendencies, which are determining the course of the processes unfolding.

### The Structural Crisis

To begin with, take the technical causes. The crisis in the U.S.A. is markedly structural, which defines its depth and scope. In the 1990s, a sector developed in the American economy that became known as the New Economy. Investment in this sector greatly exceeded the potential return on such investment. It was assumed that consumption of this sector’s goods and services would grow so rapidly (several times faster than the rate of growth in the economy as a whole), that with time there would be a return on investments in this sector, with an enormous margin of profit. This calculation did not prove to be justified. By 2000, it became clear that the new sector was unable to break even, never mind provide a profit to investors.

In theory, this awakening should have come sooner, but a certain role was played by massive propaganda about the amazing growth of productivity, which allegedly would result from the introduction of the new technologies. Now it is understood, that there was no such growth of productivity—this was indicated, for example, in research by the McKinsey company. Their studies showed that almost the entire increase

in labor productivity actually came from just six sectors: retail trade, wholesale trade, securities trade, semiconductors, computer manufacturing and telecom services.

In all other sectors of the economy, there was either a slight rise or a slight fall in productivity, which balance each other out.

Allow us here to quote the first version of this article of ours, published in *Ekspert* two years ago (Nov. 28, 2000) and not accepted by the public at that time: “So far, the new information sector has had no significant impact on the traditional sectors, in the sense of any significant increase in the latter’s efficiency, labor productivity or rate of profit.” In sum, we now have the classic case of a structural crisis, in which the volume of resources needed to maintain and develop one sector of the economy is out of all correspondence with its volume of sales [by that sector] to end-users.

### The Crisis and the Stock Market

According to the classic prescription, interest rates need to be raised during a structural crisis, in order for the dying sectors to cease to exist, as rapidly as possible. It is desirable to accompany this with an active government policy (with budget measures, as well as protectionist ones) of support for that sector of the economy which is slated to compensate for the losses.

Such a policy should have been initiated in 1998-1999, or even earlier (let us recall, that the National Association of Production Managers’ production index peaked in 1999). The problem was, however, that the part of the U.S. economy that would have been levelled through such a restructuring, now comprises around 12-15% of GDP. Another segment, of approximately the same size, is associated with the service sector that grew on the basis of the New Economy during these years.

The U.S. elite was not prepared to admit the inevitability of slashing almost one-quarter of the national economy—especially insofar as the effects of such a restructuring would hit differently in different places. Hardest hit, for example, would be the Wall Street investment banks—the U.S. financial elite, which controls not only the Federal Reserve System (as direct shareholders), but also the Democratic Party (being the source of practically all of its campaign contributions) and, in part, the Republican Party (approximately 30% of the Republicans’ campaign contributions came from this source).

Therefore the U.S. Federal Reserve, instead of raising interest rates, first kept them steady for a long time, and then—when the symptoms of crisis surfaced full force—began to lower them. This temporarily ameliorated local problems, but deepened the general crisis.

This action has prolonged the existence of clearly non-viable sectors of the economy, which are sucking the juice out of other, quite viable parts of the economy, including by absorbing the majority of available credit. After the new President took office, and especially after Sept. 11, U.S. mon-



*Some Russian economists also foresaw, in published articles two years ago, the collapse of the U.S. New Economy and specifically the collapses of firms like WorldCom. Now they are causing new debate in Russia over the prospect of a 25% “wring-out” of America’s GDP.*

etary authorities somewhat corrected their policy (in this, a certain role was played by splits among the sponsors of the Republican Party). Alongside the strong dollar policy and the lowering of interest rates (a fairly strange combination of policies, and, in fairness, it should be noted that Treasury Secretary O’Neill has always been skeptical about the strong dollar policy), they began a sharp increase of protectionist measures and direct budgetary-spending support for the economy.

We should note that this cannot succeed, because the main help—both “liquidity” and budget funds—is going precisely into those sectors of the economy, which should dramatically shrink in the process of restructuring (banks and other financial institutions, as well as defense orders, all connected with the New Economy).

Beyond a doubt, this situation played a big role in the accounting scandals of recent months. New Economy companies had to show growth in sales, in order not to forfeit their ability to attract capital. At the same time, Old Economy companies had to hide, from shareholders and investors, their losses from unprofitable investment in new technologies. They also had to mask the problems they have had in connection with attracting capital, in competition with new, seemingly more lucrative sectors.

The average P/E ratio for the market as a whole during the 20th Century was approximately 12-15, whereas in the past year it has hovered around 40 for the S&P 500 and the Dow Jones. Since this ratio usually falls during a crisis to below the average level (to about 8-10), it may be forecast with confidence that the U.S. stock market will decline still farther, by a factor of two or three. If we take into account

that negative phenomena are not going to disappear before the completion of a restructuring of the American economy (i.e., the reduction of U.S. GDP by approximately one-fourth); and that companies’ earnings will continue to decline; the stock markets could fall even lower.

The more the indexes fall, the more assets will be devalued within the U.S. financial system, which will aggravate the crisis and make government support necessary. When stock prices fall, for example, many banks will call in loans, collateralized by those stocks—especially, loans that were made for re-equipping with new technologies which brought no increase in earnings (although they made the stock indexes rise). And there is no certainty that these loans will be repaid.

Under these circumstances, inflation comes into the picture. Due to acute competition from imports, it has been limited (while the trade deficit and current account deficit have increased by as much as 10% in one month), but the current U.S. leadership’s protectionist policy and the steep increase in the money supply will change this.

## **The Crisis and World Markets**

The current decline of the dollar results from its poor performance in one of its three basic functions—as the national currency of the U.S.A. That means it is connected with the weakness of the U.S. economy.

In the not-too-distant future, this process will be compounded by a weakening of the dollar’s second function—as a world reserve currency. One view, although it is still a somewhat fringe view, is that the introduction of the so-called pink dollar notes in the U.S., planned for this Fall, will be exploited for purposes of a currency reform à la Gerashchenko-93, in order to prevent the penetration of cash and electronic dollars into the United States from abroad. There are plenty of pretexts for doing this, in the course of tracing terrorist financing.

The main blow against the world economy, however, will come not from this, but from the dollar’s inability to perform its third function—as a common unit of account. The world economy rests on global markets—oil, metals, food and gold. The heart of the globalization process was the incorporation of more and more markets onto this list. And the U.S. economy became a service economy, largely because it no longer produced, but rather serviced (as well as controlled) these unified markets.

But the basis for these markets to function, is price forecasting based on futures trading in dollars. A steep and unpredictable fall of the dollar will inexorably destroy this entire mechanism. First of all, because the total volume of futures

traded exceeds the physical volume of goods by orders of magnitude. At the moment, nobody would dream of demanding that these contracts be covered by the delivery of material goods (the difference in prices is compensated by a monetary equivalent). Under conditions of a rapid increase in prices for material assets, however, the situation will change, and the majority of global operators will go bankrupt or disappear.

An example is the gold market, which will play a key role in the near future. The derivatives obligations of just the six largest U.S. banks (not counting the investment giants) would be expressed physically as 28,000 tons of gold. Remember, the total reserves of all the Central Banks in the world are around 31,000 tons, and world gold production is 2,500 tons annually. And while the cost of a ton of gold, sold for U.S. dollars, is almost the same in Australia, South Africa, Latin America or Canada (adjusting for the cost of transport), with the collapse of markets and the dollar's loss of its function as a common unit of account, the cost of that same ton of gold, sold for Australian dollars, rands, pesos or rubles, could vary by 50-80%

Attempts to make the process of the dollar's decline intelligible for forecasting, inevitably encounter skepticism from participants in the market, who have grown accustomed to optimistic propaganda over many years, even though its connection with reality is weak.

A catastrophe will ensue. Major corporations, bureaucratized, with a single global policy, will be unable to maintain the same profit level worldwide. Producers will have to enlarge their marketing services, which will be costly, especially since there are no specialists trained for such a situation. Producer countries will begin to defend their markets, using all the procedures developed under the WTO, even as the WTO practically ceases to exist. Or (we again cite Part I of our analysis), "the interaction of mechanisms for defending national markets, will define world economic development in the first post-crisis years."

## Causes and Tendencies

It is not entirely clear, why the American and the world economy are developing according to this scenario. We are trying to answer this question, since this research will make it possible to forecast the global consequences of the world economic crisis. In our view, the crisis of the model of globalization constructed during the past decade, has three causes.

First, the control mechanisms for the global markets were constructed "top-down." In other words, the system created in the United States for controlling and managing world markets, which brought the U.S.A. a transition to the post-industrial society and a growth of the service sector to 70% of GDP, was guided exclusively from above, and could not react to signals from below. Resources, meanwhile, moved exclusively from bottom to top. In effect, globalization was organized on the model and likeness of the European colonial empires, under which the colonies were denied the right to

have their own resources, either material or intellectual, which were transported to the colonial powers.

The second reason is the crisis of local markets. The lack of adequate support from above, and the removal of resources, led to a crisis in individual local markets, which began to spread to all economic sectors and regions of the world.

We shall cite just two of the many reasons for this. The numerous, and not minor, automobile production markets of Europe have gone into decline over the past 15 years. The auto industry is disappearing in Britain and Sweden, becoming subsidiaries of U.S. and German auto. The Italian market is in crisis. Therefore these markets cannot serve as leaders for these countries' economies, neither technologically nor conceptually. Or, take an example from another sector. During those same 15 years, integration into the international system has destroyed the gem-cutting industry in Russia. As a result, we have lost over half the added value which we could have produced, while the total revenues of the cut gems industry have fallen almost by half.

There are more than a few such examples. The existing system of management in world markets was capable of destroying a local market, but not supporting it. Symptoms of crisis have increased. It should be noted that foreign investors, who withdrew over 60% of their assets from the U.S. stock market in May 2001-May 2002 (a reduction of foreign investment in those markets by a factor of two and a half), are now faced with a situation where there is nowhere to invest these assets. Local markets and producers are unprepared to assimilate such amounts of money rapidly. Thus, the Russian stock market, instead of rising when the U.S. market fell, also fell.

The third reason for the crisis of the globalization model is the absence of fundamentally new products. Looking at consumer goods, the last fundamentally new product was the personal computer. Everything else represents improvements and development of already-existing products. The entire New Economy boom, incidentally, was based on the PC; nothing new has been invented since that time. Under conditions of globalization, it becomes more and more difficult to invent anything, since the financing for such research is reduced. Suffice it to compare the density of "wild" ideas, suitable for use by a significant number of consumers, in science and technology journals in the 1960s, and today.

The pathway out of the crisis lies through the revival of local markets. Every effort should be made to restore them, with all their national and regional peculiarities.

The revival of local markets is inseparable from the question of how they are managed, since the experience of liberalization has shown that they don't prosper on their own. This means that the world may expect a transition to greater control over local markets, with an emphasis on medium- and long-term planning. At the present time, only the state is capable of exercising such control. Those nations, which most effectively carry out the planning function, will have significant advantages in the aftermath of the crisis period.