The Crisis Leaps Across the Planet

by Stanislav Menshikov

The Russian-language original of this article by Prof. Stanislav Menshikov was published in the Moscow weekly Slovo *of Oct. 17, 2008. The author has over half a century of experience of observing and analyzing the world economy. As Russia's leading senior expert on the U.S. economy, Professor Menshikov here explains to Russian readers how Lyndon LaRouche's forecasts of the current financial breakdown crisis have proved to be uniquely accurate. The article was translated from Russian by Rachel Douglas.*

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Prof. Stanislav Menshikov with Lyndon LaRouche in Moscow on May 16, 2007, before the celebration of Menshikov's 80th birthday. The two have been friends and collaborators for many years.

A crisis of the economy and finance is leaping across the planet—faster at one moment, slower at another, crossing from country to country, from region to region, assuming one form and then another. By now, it is generally recognized as being worldwide, though government officials and economic experts refused to admit as much, even quite recently. And when they did admit it, they pretended that the crisis had burst upon us quite unexpectedly, rather than gradually ripening over years and even decades.

Economists, as a rule, focus on short-term conjunctural fluctuations, often ignoring the medium-term, decades-long cycles, not to mention longer trends or 40- to 50-year Kondratieff cycles. If one pays no attention to such things, it is not difficult—it's even inevitable—to overlook a big crisis, of a type that breaks out with comparative infrequency, and surprises most people.

Among the few economists who look at root causes, and therefore see what others cannot see, is the American scholar Lyndon LaRouche, representing the physical school of economic science, which puts the production of tangible goods first and foremost, rather than superficial speculative processes on the exchanges. Through his systematic investigation of both types of process, he came to the conclusion that the world of fictitious monetary wealth was becoming more and more divorced, over the past 40 years and more, from real, material wealth, and that therefore the world was threatened by a new major financial crisis.

In a commentary for a Moscow radio broadcast on June 15, 2006, for example, when the speculative boom in the world economy was still at its height, Lyndon LaRouche said, "[The current] state of affairs confronts the world as a whole with the prospect of a threatened early, chain-reaction collapse of the present world system, comparable to the collapse of the Lombard banks into the so-called New Dark Age of the Fourteenth Century. Only a principled change in the world's present monetary-financial system could halt this presently ongoing collapse."

Fictitious and Real Wealth

Indeed, the steadily growing gap between the fictitious economy and the real one was becoming more and more dangerous, and the world monetary and financial system more fragile.

At the end of the 1960s, nations gave up the old Bretton Woods system of fixed exchange rates and shifted to a floating-exchange-rate system, without fixed parities. The situation thereby lost stability, while the fluctuating exchange rates enlarged the playing field for currency speculation many times over.

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The next step on this pathway was globalization, particularly the lowering of national barriers to cross-border movements of short-term capital. With their spasmodic and unpredictable speculative nature, these movements destabilized the system even more, giving rise to a new type of crisis that was caused by the sudden outflow of capital from a country or an entire region. The first such crisis appeared in Southeast Asia in the late 1990s, then hit Russia, and brought one of the major New York investment funds, LTCM, to the brink of bankruptcy.

Also in the 1980s, two more innovations promoted growth of the gap between the speculative tumor and the physical economy. One was that new types of speculative securities appeared and began to multiply rapidly. These were the so-called derivatives (various types of swaps and options). After an initial incarnation as tools for insuring against financial risk, these contracts quickly became a preferred object of financial speculation. By 2008, the total nominal value of such deals has reached the incredible figure of hundreds and thousands of trillions of dollars daily. In the U.S.A. alone, the derivatives market has quintupled since 2002, from $106 trillion to $531 trillion. The latter figure is over 35 times the size of the U.S. gross domestic product. LaRouche believes these figures are understated by at least half. The fact that derivatives could trigger an explosion of the financial system was acknowledged in warnings, at various times, by well-known U.S. financiers such as George Soros, Felix Rohatyn, and Warren Buffett. Rohatyn, for example, called them "a potential hydrogen bomb," while Buffett saw them as "a financial weapon of mass destruction."

Secondly, new financial firms called hedge funds emerged and rapidly proliferated in this period. Unlike traditional financial institutions, they were not subject to government regulation. The hedge funds became the center of derivatives trading, although more recently ordinary banks, and brokerage and insurance companies, got into this activity, looking for large and quick profits.

At the end of the 1990s, another event occurred in the United States, to which Lyndon LaRouche has drawn special attention. That was the repeal of the Glass-Steagall Act, dating from the 1930s, which had prohibited commercial banks from engaging in the business of investment banks, namely, placing and trading in securities. Conversely, the law had blocked investment banks from performing the functions of commercial banks, such as accepting deposits and issuing loans. This separation had been found necessary, in order to bar the banks from engaging in speculation, and thus to prevent a repetition of the great financial crisis of 1929-1930. The separation held up for almost 60 years, but finally the Wall Street financial magnates pushed through its repeal, in the name of the free market. Stability was sacrificed to the oligarchical mindset.

One After Another, the Bubbles Pop

This long evolution is what laid the grounds for the current major financial crisis. It began with the popping of a private speculative bubble, the housing construction and mortgage bubble crisis in the United States. This bubble had been pumped up for years by the Federal Reserve System, which supported that boom with no justification except their desire to prolong the economic upswing artificially, in the political interests of the Bush Administration.

As LaRouche has shown, however, the mortgage bubble was also fueled from outside sources, particularly through an influx of cheap yen credits, made available through speculative swap schemes.

When the symptoms of disarray in the mortgage sector began to surface in the Summer of 2007, LaRouche was the first to state the far-reaching conclusion that this was the beginning of a major financial crisis.

"The world monetary financial system is actually now currently in the process of disintegrating," LaRouche stated in his webcast of July 25, 2007. Soon afterwards, he proposed speedy adoption of a Homeowners and Bank Protection Act. Had this law been adopted by the U.S. Congress, the subsequent catastrophic development of the crisis could most likely have been prevented. But, that did not happen.

When the administration did begin to act, it was very late and they did not address the root causes of the crisis. For several months, the Fed kept lowering the discount rate, but that merely helped to support overall statistical performance indicators, without actually improving the situation in the financial sector or protecting it from speculation.

Another of the administration's anti-crisis measures was to return to the population $100 billion of their income tax payments. This move slightly boosted consumer purchasing power, and even lifted GDP growth by 3% in the second quarter of 2008. The downturn of material output was temporarily halted, but the tax refund provided no real help to the banking and financial sector.

The government and the Fed looked on, as one large bank after another had to write off bad loans and securities valued at tens of billions of dollars. It was as if they were counting on the financial crisis to resolve itself. The banks were left on their own for several months.

Just then, one after another speculative bubble started expanding, and then popping. The money that had built up in real estate lending, finding no other use, gushed over into speculation on the stock and commodity exchanges. Oil led the way, of course. The speculative upward push of oil prices was inspired by rumors of a sharp increase of oil consumption in China and India. Enormous phony demand was added to the real demand for oil. The result was that oil prices soared from the $100 per barrel level in early 2008, to $147 at the beginning of July. Then the fictitious demand began to evaporate rather quickly, popping this latest bubble, and prices slid downwards. By the beginning of October, they were below $95 and continuing to drop.

Fleeing the petroleum market, speculative money poured into the currency markets, creating an unexpectedly high demand for dollars. The dollar began to rise rapidly, after several years of decline against the euro and other currencies. From its low of $1.59 to the euro, it quickly rose by 16.9%, reaching the level of $1.36 to the euro. This would seem to be counterintuitive, considering that the United States is still the epicenter of the financial crisis. If its rise represents yet another bubble, then the dollar is threatened with crashing again. Such a turn of events promises to make a new and unpredictable impact on international finance.

Bailout Plans

Back to the American banks, however. Cast upon the mercies of fate by the government, they started failing, one after another. What's more, for the first time in many decades, leading Wall Street institutions took the blows. In March, the investment bank Bear Stearns effectively went bankrupt. Lehman Brothers and Merrill Lynch followed in September. These events were so unexpected, that they touched off a major stock market panic even in Russia, with its fast growing economy, not to mention the other major world financial centers.

A crash such as this had not been experienced in a very long time, and appeared to wake up the Bush Administration. They began to understand that the crisis was not going to sort itself out, after all, and that it could grow into a total catastrophe. This panic gave birth to the Paulson Plan, which proposed for the government to purchase bad securities from banks and other financial institutions, to the tune of $700 billion. The relevant piece of legislation was initially rejected by the House of Representatives, and ultimately passed only under huge pressure from the administration.

Lyndon LaRouche categorically opposed the Paulson Plan. He considers it impermissible to waste huge amounts of taxpayers' money on an attempt to save failed financial magnates.

But the bailout plan is designed to fail, since it cannot eliminate the cancerous tumor of speculation, which is the main cause of the current crisis.

Ultimately, if implemented, the Paulson Plan may have extremely bad effects, not only compounding the current crisis, but leading to ruinous hyperinflation.

Let us look at these arguments in more detail. Begin with the fact that the very announcement of this program represents an official admission that the condition of the U.S. financial system is catastrophic. The administration admits that hundreds of billions of dollars in bad assets have accumulated in the banks and other financial institutions. The real market value of these bad assets is far less than the nominal value, at which they are listed on the balance sheets of these institutions. The government is going to buy them at auction, at a reduced price. This means that the bailout will leave a large hole in the balance sheets of the banks, which will have liabilities significantly in excess of their assets.

Theoretically, such a situation ought to free up a lot of funds as the basis for making new loans. But for that to happen, what must not happen is a run on the depressed banks by panic-stricken depositors, before the banks can get back on their feet. Anticipating this threat, the administration is pushing through an emergency increase in the ceiling on the size of federally insured individual deposits, raising it from $100,000 to $250,000. Whether or not that will save the banks is hard to say. One thing is clear: the system is balancing on the brink of collapse.

Another question is, just what bad paper does the government intend to purchase, and from whom? Officially, the bailout would seem to be mainly for bad mortgage loans, as such. There are a lot of those left, which have not been written off; the crisis in this area remains acute. But the banks want to sell other types of paper, as well, including a lot of unpayable debt obligations, as well as whole pyramids of derivatives, in which the banks have become hopelessly entangled. It will be very difficult for the government to deny them this, but, at the same time, reselling these in the future to pay back the taxpayers, as was promised, will be quite impossible.

Will the government buy paper from the hedge funds? It would appear that they ought not to, since hedge funds are an uncontrolled and irresponsible type of financial firm. It is no secret, however, that the hedge funds themselves, as a rule, are offshoots and appendages of the banks, and they will not find it difficult to circumvent any formal barriers. The best thing to do would be a radical decision to liquidate the hedge funds, as the most destabilizing element of the financial system. Wall Street, of course, will not agree to such a drastic measure, even under threat of destruction.

The stock market's reaction to passage of the bailout package by Congress was typical. In the days that followed, it fell precipitously, rather than rejoicing. That is no surprise. The market sees drawbacks and dangers in the Paulson Plan. At the same time, the market players want to continue playing under any conditions, extracting profit from instability, whether things are up or down.

An Expanding Crisis

Each passing day confirmed that the crisis was only going to broaden. States and municipalities began to ask for federal government assistance, as they became unable to meet their budget requirements with their own means. Even wealthy states like California are in this situation; Governor Arnold Schwarzenegger is urgently seeking Federal financing.

Next, it became known that the Department of the

Treasury was allocating $100 billion, above and beyond the $700 billion, to support non-financial companies in obtaining short-term operating credits. This is something Treasury had not done before. It was a first symptom that the financial crisis was striking major blows against manufacturing and commerce. Bankers are simply afraid to lend to businesses.

Then, on Oct. 8, came an unprecedented event: the Federal Reserve, the European Central Bank, and the central banks of Britain, Switzerland, Canada, and Sweden simultaneously lowered their discount rates by 0.5%. They acted with such haste, that they didn't even wait for a meeting in person, but coordinated their actions by telephone.

The effect of slashing the cost of credit by such a small amount is more psychological, than anything else. It is doubtful that such a measure could do anything, by itself, to buck up the economy and enliven the finance world. Its importance is as evidence of a realization that this crisis is global. It would be difficult to name a single country or region, which has not been affected. This may be seen in the falling stock market indexes of the planet's main financial centers (see **Table 1**).

TABLE 1

Decline of Stock Market Indexes in the Main World Financial Centers, October 2007 to October 2008

(Percent)

Stock Exchange	% Decline
New York	31.1
London	32.4
Paris	37.7
Frankfurt	37.9
Tokyo	39.9
Hong Kong	44.5
Shanghai	60.2

Most recently, Western Europe has moved to the center of attention. In early October, Germany's main mortgage bank, Hypo Real Estate, went bankrupt. Next, one of the leading Benelux banks, Fortis, declared its insolvency. Give the governments of these countries their due: they immediately nationalized the affected banks. The Dutch government even rescued Fortis twice, first laying out a large sum, jointly with Belgium and Luxembourg, to save the bank as a whole, and then spending 17 billion euros to nationalize its Dutch component. The reason for haste was obvious. Not long before its bankruptcy, Fortis had purchased partial control of the largest retail bank in the Netherlands, ABN-AMRO. The government could not allow the latter, with its millions of depositors, to go under.

One week later, the British government bought equity shares in the country's eight largest commercial banks, in a partial nationalization. These are all transnational banks with a large foreign ownership stakes, including American. The sudden flight of foreign funds put them in extremely tight straits. The government's action was an extraordinary preventive strike, unprecedented in British banking history.

On the initiative of the President of France, there were two European Union meetings to develop a joint crisis strategy. The EU leaders did not arrive at a coordinated strategy, but they adopted separate preventive measures. It was decided to raise the insurance ceiling on personal bank accounts to 50,000 euros in most EU countries, though this has not been set as a ceiling in Germany or Austria. Thus, a barrier against massive runs on the banks by depositors would seem to have been erected. How it will hold up is hard to say, since these techniques have never been tested anywhere in practice. If it happens, there will have to be such huge infusions of government funds into the economy, that the threat of hyperinflation will no longer seem improbable.

Still, the sought-after calm did not descend on the financial markets. Italian Prime Minister Silvio Berlusconi called for temporarily shutting down all world stock exchanges, in view of their continuing fall. The Group of Seven finance ministers gathered in Washington and adopted a common declaration of intent, but failed to arrive at a specific strategy.

At the same time, the crisis raised its head in Japan, where things had been relatively calm. The country was shaken by news of the bankruptcy of two major entities—an insurance company and a real estate firm. In tandem with other Asian banks, the Bank of Japan lowered its discount rate by one percent in October, but Asian markets continue to slide.

Finally, in despair, the Western countries decided on unprecedented drastic measures. On Oct. 13, the EU governments announced they would pump on the order of two trillion euros into the banking system, a large part of the money being earmarked for the acquisition of shares in major private banks, i.e., partial nationalization. Washington simultaneously announced the allocation of $250 billion for a similar partial nationalization of the largest U.S. banks, including J.P. Morgan Chase, Citigroup, and Bank of America. This immediately prompted a sharp jump in share prices on all important stock exchanges. But, does it mean that the financial system has been saved, and the financial crisis is ending?

By no means. There are many open questions here. The chief one is how these countries plan to finance such colossal infusions. In Western Europe, for example, the sums involved are equivalent to over 10% of GDP. Government budgets do not possess such reserves. There's effectively nobody from whom to borrow such sums of money. Yet, a steep increase of the money supply threatens to bring about exactly what LaRouche forecast: hyperinflation.

Will There Be a New Great Depression?

Many people are now comparing what is happening with the great crash of 1929-1933. Certainly the current financial earthquakes are as acute as anything that happened then. Back then, things also began with the banks and the stock markets, and the steep collapse of production did not occur immediately. But it did come. What will happen this time?

The capitalism of 80 years ago was quite different from today's. The share of government spending in the economy was small, and could not serve to dampen the effects of a sudden contraction of aggregate demand. Today government spending represents as much as 30-50% of GDP, and its role as a shock-absorber is well-known.

As the Great Depression arrived, there were not even the rudiments of anti-crisis regulation. The Herbert Hoover Administration, which was in power in the U.S.A. for four years after the stock market crash of 1929, did absolutely nothing to combat the crisis. On the contrary, its actions served to aggravate the situation. As a result, the decline of GDP was prolonged and very steep, totalling over 40%.

In the current crisis, a full range of anti-crisis measures was launched in the U.S.A., albeit late in the game. Those did not stop the crisis, but, so far, they have blocked a drastic collapse of output. Sooner or later, that will come. It is already unfolding in Germany and France. As of now, many people concur in a belief that what lies ahead may be not so much a great crash, as a years-long depression. But any prolonged halt in economic growth in the industrialized nations will cause higher unemployment and a drop in the living standard. Thus, its social effects will be just as bad as those of a great crash.

What LaRouche Proposes

To prevent that from happening, LaRouche says, requires immediate radical reforms:

- Measures taken must be coordinated at the level of all the leading countries. Above all, there must be decisive measures to clean up the banking system, up to and including putting its most rotten segments through bankruptcy. The activity of the hedge funds and all other derivatives trading must be put under government control or banned altogether. Without the surgical removal of this cancer of speculation, it will be impossible to end the financial crisis.
- Coordinated action by leading world powers—the U.S.A., Russia, China, India, Japan, Germany, and France—for a fundamental transformation of the international financial and monetary system into a New Bretton Woods. This means the elimination of the existing floating-exchange-rate system and the introduction, in its place, of a fixed exchange-rate system. Doing this would significantly restrict the possibilities for speculative activity, which is one of the root causes of the current instability and the financial crisis.
- These same nations shall agree to develop a coordinated program of long-term capital investment in the development of the power industry and transport infrastructure worldwide, for the next 20-50 years. Such a program would provide a firm base for the sustained development of the world economy, with an emphasis on tangible production, and the greatest possible reduction of the amount of resources spent on non-productive, speculative activity.

Some may find such proposals utopian, or incompatible with the principles of the market economy. If, however, that market economy inevitably leads to destructive crises, then doesn't it require thoroughgoing curative treatment, and reconsideration of its principles?

For EIR*'s report on Professor Menshikov's 80th birthday celebration, which Lyndon LaRouche attended, see* EIR, *May 25, 2007, www.larouchepub.com/other/2007/3421menshikov_80th.html.*