

If a credit crisis comes, will it be manageable?

by David Goldman

By all conventional financial accounting standards, the U.S. credit markets should have broken into a 1929-style crash, centered on the real-estate markets, as of a few months ago. A crash of real-estate markets, savings banks, life insurance companies, and other sectors dependent on negotiable, long-term, fixed-interest debt instruments is by no means to be excluded as a prospect for the next several months, any more than a chain-reaction collapse of the offshore interbank market, or exchange controls against international currencies.

That no such crash is evident is not a reason to abandon conventional accounting standards; they are useful to remind us that the apparent resilience of the financial markets is the result of something extraordinary at work. In fact, senior Treasury and Federal Reserve officials have argued in background discussions with *EIR* that they have in hand some possible solution to whatever potential destabilization of the financial markets might threaten. Somewhat in the fashion of Barnacle Bill the Sailor, they explain that there are contingency plans to contain the worst foreseeable consequences of generalized insolvency among savings banks, developing nations, commercial real-estate operators, and so on.

Nonetheless, as *EIR*'s founder Lyndon H. LaRouche, Jr. argued before an *EIR* seminar in Washington, D.C. June 10, the present policy direction of the Federal Reserve and the Reagan administration will lead to a devastating shakeout of 1929-1931 proportions between now and, roughly speaking, the end of the year. This is not the case because still-rising interest rates will bring the economy to some mathematically determined point

after which debt service can no longer be paid, or fixed assets will have to be liquidated at a loss. Rather, if we examine coolly the means by which the Federal Reserve and the major American financial institutions have avoided a shakeout up to now, it becomes obvious that the medium-term political consequences of their financial methods are producing uncontrollable and unpredictable consequences.

For political reasons that should be obvious to any student of major credit crises, the present situation is inherently unmanageable. A glance at the state of international financial flows makes this clear. During the first five months of 1981, the Bank for International Settlements reports, lending to the developing countries rose to \$12.2 billion, or 59 percent more than during the same period in 1980. The absolute numbers (drawn from published loan figures) probably reflect about half of the real rate of lending, but the BIS is almost certainly accurate about the trend. The rise in lending contradicts international bankers who said last year that they would not lend to countries who manifestly cannot and will not ever pay them back. In its just-published annual report, the BIS itself criticized the imprudence of the banks for keeping up this rate of lending.

The BIS's attack on the banks drew, in turn, a strong response from the London *Economist*—which defended the banks' lending policies—the same London *Economist* that editorialized at the beginning of this year that “the banks have discredited themselves” for getting over their heads into bad lending to the Third World.

Actually, the fight is not about the destination of

the funds lent by banks, but the origin of the banks' own sources of funds. Where is the money coming from to escalate lending to the Third World? Not from OPEC, whose surplus this year is expected to fall from \$115 billion last year to (at best) \$75 billion in 1981, due to the stabilization of oil prices. The Eurodollar market is expanding, instead, at the expense of the depleted central bank reserves of Western Europe.

Origin of funds

The big European nations have burned off several tens of billions of dollars since January defending their currencies on the foreign-exchange markets against the rising U.S. dollar. Higher U.S. interest rates (and other factors) impel European investors to switch into dollars, depressing the value of European currencies, which have fallen by between 20 and 50 percent this year. To slow the fall of their currencies, European central banks buy their own currencies on the market with dollars drawn from their foreign-exchange reserves. These dollars add to the deposit base of the Eurodollar market, in much the same way that Federal Reserve open market operations add to the monetary base in the United States. The difference is that the multiplier of U.S. monetary base is limited by Federal Reserve Board reserve requirements on bank lending, while the reserve-free Eurodollar market operates with a multiplier that is potentially infinite. Much of the added "monetary base" of the Euromarket—about \$15 billion—flowed into the United States during the first quarter of 1981, and a good deal went to the developing countries. Without this financing, the developing countries—who have to pay about \$3 billion in additional debt service for every 1 percent increase in the London dollar rate—would have shut down their central banks for the duration.

For Western Europe, this looting process has engendered consequences which cannot be controlled for long. In West Germany, a federal government loan (for the federal rail system) went unpurchased in the bond market at the end of last month for the first time since World War II. German analysts blamed the bond market disaster on the fact that there is no liquidity in the West German banking system, due to capital outflows, and due to the fact that "German bankers have been returning empty-handed from Saudi Arabia for some months," as the markets daily *Handelsblatt* reported May 28. Whether the apparent stabilization of the West German economy (at industrial production levels on average below last year's level by 6 percent), due to rising foreign orders, can hold is a thoroughly dependent question. If the present credit situation continues through until the end of the year, some of the oldest industrial names in the country will go bankrupt, and the country will be in severe depression.

That leaves aside the situation in Italy and France,

where both national economies are in shambles, and the entire private sector is on the verge of bankruptcy. With effective interest rates in the range of 30 percent, neither economy stands much chance of avoiding a British-style reduction in output during the next six months, i.e., a fall in industrial production of 20 percent.

Wringing out the victims

One sidelight of Europe's financial collapse worth bringing to light is the complementary problem in the United States. When European banks sell dollars to buy their own currencies in the markets, they cash in the U.S. Treasury securities in which they hold most of their foreign-exchange reserves. These Treasury securities then come on to the market in the U.S., adding to the federal borrowing requirement, already \$68 billion as of May.

The principal source of financing for this suddenly expanded supply of Treasury paper has been, ironically, the flow of deposits out of savings and loan institutions. That is, there has been a net transfer of several tens of billions of dollars from the home mortgage market to the government-securities market. The disastrous position of the American savings banks is counterpart to the disastrous position of the European central banks!

Judging from the Federal Reserve's hard-bitten stance on interest rates, its basic operating perspective is to continue to wring out the same victims for as long as it thinks necessary. The process will not be interrupted until Europe decides to take drastic action, e.g. exchange controls on the movement of funds. As proposed by the French and Italians, such controls are no serious threat to the international movement of funds. Despite the imposition of what at first glance appear to be extremely tough controls in Italy, at least \$10 billion in flight capital has left Italy for the greener grass of the flight-capital havens.

What is interesting about the discussion of exchange controls is not that the obvious crowd of Bank of Italy economists are pressing for a European Currency Zone along the lines of the Club of Rome's perspective for dissolving the nation-state into "interregional" blocs. On the contrary, what is interesting is that West German Chancellor Helmut Schmidt, the last tough nationalist in power in a major European country, is now pressing for the erection of a European monetary zone. Schmidt, the London *Financial Times* reported June 25, urged other European nations—including Great Britain—to contribute to "the further development of the European Monetary System" in order to "face up to the United States" and the policy of "benign neglect" of the currency markets. Speaking before the Foreign Press Association in Bonn, Schmidt urged Europe to join together to exert pressure on the U.S. dollar.

Schmidt's invitation to the British to join the Euro-

pean Monetary System, after years of public acrimony between his government and British Prime Minister Thatcher, is an extraordinary development. Once Europe is pushed to the verge of general insolvency by the actions of the Federal Reserve, the "currency bloc" idea might take a very different form than the Italian and French social democrats have in mind. Rather than a weakling European currency bloc, captive in a world market dominated by dollar-denominated flight capital, the EMS might play some monetary hardball with the Federal Reserve. Suppose the Europeans were to impose exchange controls with real teeth and remonetize gold fully? The EMS could, without much difficulty, provoke a crash of the ultra-overvalued U.S. dollar and a rash of flight capital in the other direction. For the past six months the balance between the European central banks and the Eurodollar flight-capital market has tilted in one direction. Under conditions of duress, the Europeans could pull it right back again.

Leave aside, for a moment, the implications of such a development for the Eurodollar market's ability to refinance half a trillion dollars outstanding of Third World debt. What would the consequences be for the \$3.5 trillion United States real-estate bubble, ultimately more vulnerable than the international bubble?

Peculiarities of the American tax system encourage real-estate speculators to leverage as far as possible. Because mortgage or other interest costs are deducted from taxable income, speculators prefer to pay out virtually all current rental income from commercial properties in interest costs, hoping to make up the difference by selling the property at a higher cost later. Capital gains thus received are then taxed at roughly half the 48 percent corporate income-tax rate.

The whole current operation of the real-estate market depends on capital appreciation of properties, i.e. the availability of a "greater fool" down the road. Should such a fool not present himself, the market will crash, as it has before. This occurred most recently in 1975, when the major banks' Real Estate Investment Trusts went under. Another crash would threaten the integrity of the entire banking system.

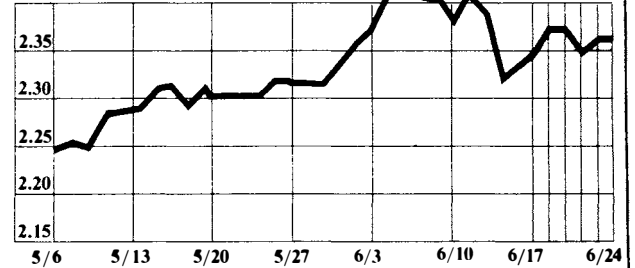
For the past year, Canadian, Swiss, and other well-laundered flight capital, much of it originating in the international narcotics traffic, has played the role of "greater fool." Now the real-estate industry is counting on pension funds to keep the bidding going.

On paper, it is possible to project—as most of the life insurance companies have—that the looting of the world's available savings can keep the speculative bubble going. But the policies which make such financial transfers also threaten the existence of institutions which show surprising resilience when their survival is at stake, and bring to bear political realities which make this type of crisis inherently unmanageable.

Currency Rates

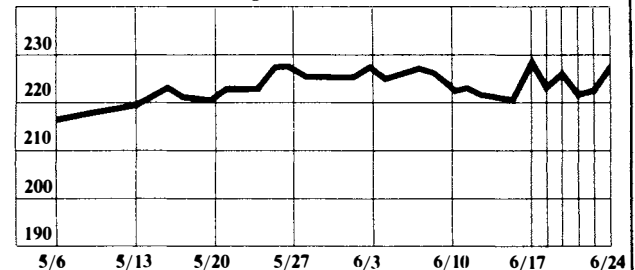
The dollar in deutschemarks

New York late afternoon fixing



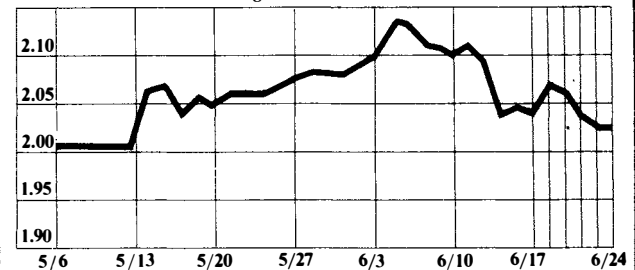
The dollar in yen

New York late afternoon fixing



The dollar in Swiss francs

New York late afternoon fixing



The British pound in dollars

New York late afternoon fixing

