
The Schiller Institute in Slovakia

Emergency measures can deal with the global financial collapse

by Michael Liebig

Two leading members of the Wiesbaden-based German Schiller Institute, Michael Liebig and Hartmut Cramer, were invited in late January to lead a private seminar and informal discussions with representatives of Slovakia's political and scientific elite in the nation's capital of Bratislava. The invitation was extended by the head of the Slovakian Schiller Foundation, Dr. Jozef Miklůsko, who is also the former vice-prime minister in the first post-communist government of Czechoslovakia.

The following speech by Michael Liebig, prepared for presentation in Bratislava and dated Jan. 19, is titled, "Lecture on the Disintegration of the International Financial System, and Emergency Measures for Dealing with It."

The essential character of the present condition of the global financial system is expressed in the so-called "LaRouche typical collapse function" graph [see p. 24]. Since the 1970s, the global financial system has been characterized by the exponential growth of financial aggregates, while the physical-economic base of the world economy has been stagnating and declining, when measured in terms of the basket of physical production and vital infrastructure services per household. Since the 1970s, we have witnessed an ever-widening "scissors gap" between financial aggregates and the physical-economic production potential.

Of course, this dynamic is not the "natural" result of revolutionary changes in computer-communications technologies leading to an allegedly "new type" of "economy." The so-called "post-industrial" or "information age" or "service" economy is a utopia, a "virtual reality" incompatible with the real lawfulness underlying humanity's economic evolution. The "post-industrial" economy is, in reality, a "financial bubble economy." The ever-widening decoupling of finance and production, is the result of a deliberate, "elite-made" policy shift away from the promotion of physical economic development in industry and infrastructure. During the late 1980s to mid-1990s, we have reached, in the global financial system, a condition where the "scissors" have reached a point of maximum extension. The always fragile "peaceful co-existence" of entrepreneurship in industry, farming, and *Mittelstand*

[small and medium-sized industry] based on scientific-technological progress and State-directed infrastructure buildup on the one side, and purely financial dynamics on the other side, has fallen apart. Financial oligarchies, centered in London, have gained hegemony over "industrial capitalism" and governments promoting economic development.

In the spring of 1992, the economist Lyndon LaRouche coined the term "financial mudslide." This means that, instead of a one-time "big crash," in shorter and shorter intervals, larger and larger chunks of financial aggregates "break off" of the accumulating financial structures. In 1993, LaRouche stated that derivatives were the main driving force of both the ballooning financial bubble—and the ensuing mudslide. He compared derivatives speculation to a "cancer," whose parasitical growth "eats up" more and more of the physical-economic substance of the host, until this "real economic body" ultimately "dies," and, along with it, so does the "cancer."

The etiology of the life-threatening disease

What are derivatives? Well, "derivatives" is the modern, fashionable word for financial speculation, representing the "new type" of financial speculation. Derivatives are futures, options, swaps, and other exotic instruments with which one "bets" on oscillations of currency and interest rates, stocks, bonds, and indices of stocks and bonds. Derivatives are "synthetic" financial instruments, because they are not based on production or transactions of goods. Derivatives are the result of a major shift of the strategic thrust in the West's dominant economic, financial, and monetary policies since the early 1970s:

1. National financial markets were subjected to "deregulation" and "liberalization";
2. "Floating" currency exchange rates were introduced, replacing the fixed gold-reserve-based monetary system of the postwar period;
3. Financial markets were "globalized" through 24-hour electronic data links, which radically changed the character of the basic policy axioms of banking, beginning in the United States and then extending into Europe and Japan;
4. The International Monetary Fund's (IMF) monetarist,

“neo-liberal” [i.e., free trade] axioms were made internationally hegemonic in the form of the IMF’s “structural adjustments” and “conditionalities” policies. On this we shall have more to say in a moment.

These four factors have led inevitably to ever-larger volatility in currency and interest rates, in stock and bond markets internationally. This global financial volatility is, metaphorically speaking, the “oxygen” which derivatives speculation requires “to breathe.” Apologetically, the vast majority of bankers, the financial media, and government officials have peddled the assertion that derivatives are an “economically useful, responsible hedging against market volatility.” One may note here that even the most prudent form of hedging means exchanging one risk with another risk, but were hedging the true purpose of derivatives, the daily global volume of derivatives transactions could not exceed \$100 billion at most, which is the daily volume of world trade and “regular” international financial transactions. However, the global, daily derivatives turnover was actually \$1,500 billion by late 1994!

Unlike more “traditional” forms of speculation, derivatives represent a radical decoupling from any physical economic base, as they are themselves “based” on other financial instruments. It has become possible to speculate with derivatives, using electronic data devices, “around the clock and around the globe,” from Asia to Europe and on to New York and Chicago. Thus derivatives are the result of financial market volatility, and are simultaneously the key catalyst or “motor” of increasingly wider oscillations on the financial markets. This vicious circle needs to be understood. As to the astronomic volume of derivatives transactions—some \$1,500 billion per day globally—it is being asserted that this refers to the underlying, “notional” sums, while only the net transaction margins (“netting”) ought to be considered. The net margins are usually well below 5% of the notional value, but still vastly surpass the capital base of any, even the very biggest banks internationally. In addition, so-called “decompilers” and “demultipliers” are being used to “scale down” the frightening dimensions of the volume of derivatives contracts. Derivatives are mostly treated “off balance sheet,” and thus left to “in-house” risk-control and accounting procedures.

How the collapse is manifest

In June 1994, LaRouche published an essay, titled “The Coming Disintegration of Financial Markets” [*EIR*, June 24, 1994], in which he pointed to the fact that the financial mudslide had acquired a new quality: The disintegration process has turned into an irreversible, terminal systemic crisis. The “systemic nature” of the financial disintegration results from the fact that the dynamic of parasitical growth of speculative aggregates has reached the equivalent of a “shock front,” in terms of physics. Such shock fronts occur, for example, in the “transsonic” regime—the transition from sub- to supersonic speed—in aerodynamics. Another example is the “firestorm

effect” in mass bombardments of cities. LaRouche elaborated this concept in a May 1995 lecture at Hamburg University’s economics faculty at the invitation of Professor Nöllig, the long-time head of Norddeutsche Landesbank and member of the Bundesbank’s Central Bank Advisory Committee.

Let’s now take a short look at the disintegration of the global financial system during the past 15 months:

- the collapse during 1994 on the world’s bond markets, which wiped out an estimated \$3,000 billion in notional value;
- the \$20 billion bankruptcy of Orange County, California, as a result of derivatives speculation;
- the \$50 billion “rescue package” by the IMF, Bank for International Settlements, and the U.S. government for the collapsing “emerging market” Mexico;
- the de facto bankruptcy of Europe’s largest bank, *Crédit Lyonnais*, bailed out by the French government with some FF 60 billion [roughly \$12 billion];
- the bankruptcy of *Barings Bank*, a central pillar of the City of London;
- the de facto insolvency of London’s *S.G. Warburg*, since taken over by *Schweizer Bankverein*, and that of *Lloyd’s* in London;
- the unprecedented, permanent, and wild currency speculation since early 1995. The oscillations of the dollar rate, repeatedly going up or down 6-8¢ within a 24- to 48-hour period, are unprecedented in financial history;
- in June 1995, the latent financial crisis in Japan erupted into the open. Japanese authorities had to admit some \$500 billion of non-performing, bad loans held by Japan’s major banks. Reliable experts estimate the real figure for such fictitious debt stands at some \$1,200 billion;
- in the United States, especially, a wave of mergers and takeovers of major banks prevented a series of bankruptcies.

The manifold crises in different segments of the financial system, as just listed, can no longer be adequately explained just by concrete, localized situations or abnormalities. The specific causalities of concrete crisis eruptions can only be explained in the context of systemic change. The overall condition of the system is in a phase change. The individual crises are only symptoms of the systemic crisis. Thus, the above-mentioned series of recent financial breakdowns are not an arbitrary accumulation of isolated crises of different, specific origins. What is really important, is not the individual causality of the specific crisis episodes, but the causality for the series of crises. To put it metaphorically, do we see an accumulation of single trees or do we realize that there is a forest.

Stop-gap measures

You may object that all of these financial disasters have not yet produced the total breakdown of the global financial system. Yes, an all-paralyzing, systemic collapse has not yet occurred. Much of the answer can be found at the June 1995 Halifax G-7 [Group of Seven industrialized nations] “world economic summit.” Then, the West’s governments, central

banks—and the private financial oligarchies behind them—decided, that the world’s financial system “could not withstand another Barings disaster.” Were another Barings-style default to occur, a reverse-leverage chain reaction reaching dimensions of systemic collapse would loom. But, do not try to find such a statement in the Halifax G-7 communiqué, which in almost lyrical terms claimed that all was fine. Careful observers noted, however, that in the context of the Halifax summit, President Bill Clinton had said, that the present financial system carried “the seeds of potential disintegration” within it. Leading Japanese government and business representatives had made similar statements. And the newly elected French President Jacques Chirac had even spoken of speculation as “financial AIDS” afflicting the global financial system.

So, since mid-1995, G-7 central banks have quietly begun to pump monetary liquidity into the private banking system, through lowering interest rates, special discount facilities, and other technical means. This reflationary central bank policy has been most visible in Japan, where the discount rate has been lowered to an unheard-of 0.5%, allowing private banks to borrow fresh liquidity at almost no cost. In Europe and the United States, this reflationary policy has been less visible, but you surely will have noted the steady decline of interest rates there since mid-1995. The expansion of monetary liquidity has not yet transpired into rising inflation figures in Europe and the the United States. This is not surprising, because price inflation for physical goods is in fact declining due to slackened demand, low-wage goods imports from Asia and eastern Europe, and productivity gains in domestic G-7 production. The financial oligarchy is also trying to contain the inflationary impact of the present monetary reflation by pushing governments and parliaments to go for harsh fiscal austerity. Expansion of monetary liquidity is to be counterbalanced by shrinking state expenditures for social infrastructure and reductions in state debt levels. These massive austerity programs are presently run under the label of “balancing the budget” and “downsizing government” in the United States. And, if you look at the so-called “Maastricht convergency criteria,” you will recognize the same austerity approach within the European Union.

However, there is a massive inflation in financial asset prices in the G-7 countries: Since mid-1995, stock and bond markets have surged by up to 30%! The Dow Jones is presently above 5,000, the [Frankfurt] DAX is reaching 2,400, the Nikkei is above 20,000. The inflated financial markets reflect the inflow of fresh liquidity into the banking systems since summer 1996, while industrial output and employment decline. This ongoing “boom” in financial markets signifies the exact opposite of what it might appear to be. The “boom” is simply the symptomatic expression of monetary reflation—designed “to buy time” in postponing the financial collapse process. However, the financial asset price inflation is, in reality, accelerating the disintegration process.

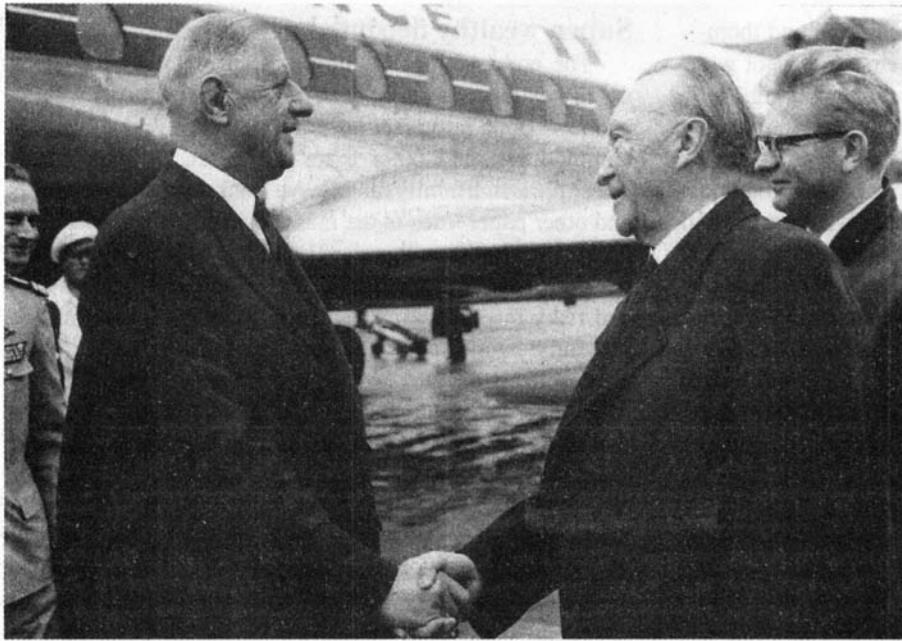
Super-wealthy flee into hard assets

The core sections of the financial oligarchy—centered mainly in London—have been moving out of “paper values,” and have gone into precious metals, strategic minerals, food commodities, and other extra-secure “hard” investments. These ultra-rich family funds leave stocks, bonds, derivatives, and other paper titles to the mass of credulous, mostly small investors who have liquidated their traditional savings and put their money into mutual funds and similar speculative and risky instruments. The steady rise of the price of gold, presently being kept only just below the \$400-per-ounce level, reflects the lack of trust and the profound, underlying *Angst* over the future of the financial system. Gold prices would already have skyrocketed, were they not being artificially kept down through massive sales of gold stocks by central banks.

LaRouche’s central diagnosis is: The global financial and monetary system is de facto bankrupt. In its present phase, the disintegration of the system is moving toward a condition of general, paralyzing breakdown, the prognosis on the exact timing is difficult, beyond stating that it will occur in the near- to medium-term. To situate such a breakdown condition in an historical perspective, LaRouche has repeatedly pointed to the 1922-23 and 1931-32 financial crises in Weimar Germany. A combination of both crises can be seen as an approximation of what we must expect in the near- to medium-term future. LaRouche states, that the present financial system cannot be “repaired” any longer; instead, there must be a bankruptcy reorganization. It is no longer possible to “stabilize” the financial system over any significant time frame by means of so-called “crisis management” policies. Even a policy of administratively containing and cutting-out “speculative excesses,” while otherwise sticking to existing economic and financial policy axioms, will prove futile. In essence, the system reorganization corresponds, on the level of the national economy and in a multilateral economic-financial framework, to the reorganization of an over-indebted, insolvent industrial enterprise whose qualified labor force and technical equipment is still productive and which thus has the potential to survive.

The key to a successful reorganization

The first decisive question concerning system reorganization is: Will it occur before a paralyzing financial breakdown, or will it happen *post festum*? This is fundamentally a question of the political will of the governments concerned. And, that means, first of all, the American government. The second question that LaRouche raises, is, what are the most important emergency measures, which need to be implemented first and foremost by the State in a system reorganization? The fundamental issue before us, therefore, is, *what will life be like after the inevitable financial breakdown?* What emergency measures will have to be adopted to ensure that the financial breakdown will not bury the real economy underneath it?



French President Charles de Gaulle (left) and German Chancellor Konrad Adenauer, in Bonn in 1961. Their dirigist economic policies created strong industrial economies after World War II, and are anathema to the International Monetary Fund today.

How can productive assets be protected? What needs to be done to prevent and reverse uncontrolled production breakdowns and a further escalation of mass unemployment?

It should be clear, that there exists no magical formula, no “post-collapse reorganization kit,” no illustrated “user’s manual.” But, there are basic principles that need to be followed:

1. Sorting out fictitious capital. Obviously, speculative, fictitious financial paper must be written off by governmental action, if it has not already been wiped out beforehand by the market collapse. Financial paper of an unclear nature must be frozen. State debt must be frozen, so as not to impede the continuation of basic State functions.

2. Financial paper backed by productive, physical economic assets *must be protected*. The financial resources of pension funds, health insurance, and other vital social services or educational institutions *must be protected*. The citizens’ “regular” savings must be protected. Private banking functioning with regard to these real economic and social areas must be preserved.

3. By way of exercising national financial sovereignty, the State must issue low-interest credit which is to be exclusively directed toward re-activating and expanding industrial, *Mittelstand*, and agricultural production and infrastructure on the technological level of the “Third Industrial Revolution.” To that end, the private banking system, with its account management and customer expertise, is to be used.

4. The State provides low-interest credit for large-scale, high-technology infrastructure projects on a national and multilateral scale. These projects will be the key catalyst for overall economic reconstruction and regeneration.

5. A new, stable fixed-exchange-rate, gold-backed world

monetary system must be established by governments. When needed, national currencies must be reorganized on the model of General de Gaulle’s 1958 currency reform in France.

I want to demonstrate now that the basic principles of emergency policies in an economic-financial crisis in the West are, while obviously different, not fundamentally different from the policy principles that need to be applied for economic reconstruction and development in formerly communist transition economies.

Dying IMF: sucking the blood from the living

What have the IMF’s neo-liberal, monetarist “reforms” concretely meant in central-eastern Europe since the collapse of communism in 1989-91? There obviously are significant differences between the various ex-communist countries. But, in essence, the so-called IMF “reforms” feature the following policy points:

- priority is given to servicing foreign debt;
- “fiscal stability” is to be achieved through radical budget cuts for allegedly “excessive” social expenditures, state payments for public infrastructure, and for allegedly non-improvable, non-competitive industries;
- price liberalization, which collapsed the standard of living of the population without generating funds for industrial modernization and expanding production;
- elimination of the population’s “excess” purchasing power through radical currency devaluation wiping out the most of their savings;
- lifting capital controls and introducing currency convertibility leading to further devaluation, capital flight, and speculation;
- liberalizing foreign trade, and eliminating protectionist

tariffs, which wiped out not-yet-modernized and thus non-competitive national industries;

- rapid privatizing of State assets in industry and services, which primarily benefitted the old communist nomenclatura, mafia structures, and often dubious “foreign investors.”

The IMF’s policies are not market, but “free market,” monetarist policies. The “enemy image” for the IMF is any *dirigistic* market economy, typified in the postwar period by Konrad Adenauer’s Germany and Charles de Gaulle’s France, or Franklin Delano Roosevelt’s America. “Statist” economic policies in the tradition of Jean-Baptiste Colbert, Alexander Hamilton, Friedrich List, or, today, Lyndon LaRouche, are an anathema for the IMF. The IMF’s policies ideologically proclaim a financial and monetary “equilibrium” as the economy’s supreme aim. Behind the formulae of monetary-financial equilibrium and “fiscal discipline” lies a very different reality: Not only is the underlying physical-economic reality being abstractly negated, i.e., totally disregarded, by neo-liberal IMF policies, but the productive activity of the physical-economic base of society is actually being suffocated.

In fact, only under conditions in which physical-economic output and productivity levels are both rising:

- can monetary stability be achieved, since inflation always indicates the gap between monetary and financial aggregates and available physical-economic wealth;
- can the state budget be consolidated through rising tax revenues based on increasing industrial (*Mittelstand* and agricultural) output and increasing average incomes;
- can the foreign debt be serviced and reduced, while domestic savings and foreign trade with manufactured goods simultaneously rise;
- can capital controls and trade tariffs be slowly reduced as the international competitiveness based on labor skills and technology improves.

Lautenbach’s memorandum

In conclusion, I think it is useful to put LaRouche’s approach for post-crisis economic reconstruction, featuring prominently State credit exclusively for productive investment in infrastructure and advanced technologies, in a historical perspective. Only in 1991 was the protocol of a Sept. 16-17, 1931 conference held by the German central bank, the Reichsbank, published for the first time, when two German academic economists did so. That 1931 conference had been held in secrecy, and its proceedings had remained unpublished for 60 years. The conference, sponsored by the then-influential Friedrich List Society, was chaired by Reichsbank President Dr. Hans Luther. Its participants included around 40 government officials, bankers, and economists. Among the economists were Walter Eucken and William Röpke, the man who would become the leading theoretician of Germany’s “social market economy” during the 1950s. The concep-

tual basis for the secretive conference was a memorandum written by Dr. Wilhelm Lautenbach, a senior official at the German Economics Ministry, who later would be removed from his post by the Nazi regime and would live until 1947.

Lautenbach’s memorandum, over which there were two days of intense discussion, had the title, “Options for an Economic Recovery through Investment and Credit Expansion.” In it, Lautenbach writes: “The natural way for overcoming an economic and financial emergency is not economic contraction, but the expansion of economic activity.” Lautenbach differentiates between two types of emergencies. One is derived out of what he called extraordinary “production tasks” like the war economy, the conversion from war- to peacetime economy, or reconstruction programs following great natural disasters. The other category of emergencies were those in which the financial system breaks down, and the real economy sinks into depression, with mass unemployment and large-scale production standstills. Under economic emergency conditions, there would be a general understanding that, “we should and we wish to produce more. The market, however, the only regulator in a capitalist economy, obviously gives us no directive at all.” The reactivation of the “significant unused production potential” is “the central and most pressing task of economic policy.” The State must generate a “new economic demand.” But, and this is a fundamental condition, this demand must represent a genuine “economic capital investment.” It must be productive, not consumptive! This is the fundamental difference between Lautenbach—and also LaRouche today—on the one hand, and Lord Keynes and his still-numerous neo-Keynesian followers on the other, the latter of whom have no sense of physical-economic productivity and the role of scientific-technological progress. Thus, the overriding necessity for the State is to act in a manner that “public or State-supported [infrastructure] projects and investment programs are realized.” These programs “must result in additional real economic value” being created. Lautenbach thought mostly of public investment programs into transportation infrastructure such as roads, highways, and railway construction, as well as their modernization.

How to finance the needed infrastructure

Naturally, says Lautenbach, the fundamental question is, how to finance these productive investments which expand the nation’s real economic wealth? That question has to take into account that “long-term capital is neither available on the foreign nor on the domestic capital markets,” the latter, because the domestic saving rate is too low. Moreover, the State coffers are empty, because the tax revenue is too low. These are precisely the constraints upon reconstruction today in the transition economies. The great danger is that “in times of the deepest depression perfectly reasonable, necessary public works are being cancelled,” for lack of financial resources. So, how can these State investment programs be

financed? Lautenbach soberly notes that "liquidity, first of all, is a technical-organizational question. The private banks can be made liquid when they have the necessary backup with the central bank." The "actual credit issuance by the central bank," necessary to facilitate a "credit expansion with the private banks," can be rather limited. Lautenbach proposes that the central bank provide the private banks with a *rediscount guarantee* for that category of credit that is, exclusively, to be used for defined "economically reasonable and necessary infrastructure investment programs." Thus, the central bank's new credit generation to facilitate the financing of infrastructure programs by the private banks is just a margin of the total credit volume necessary for these projects.

The credit financing through central bank-discountable and renewable letters of credit for such investment programs has both immediate and indirect effects in activating the economy: to immediately expand production through the productive utilization of idle workers, machinery, and raw materials. With the improvement of the financial condition of firms involved in the projects, the financial condition of their banks improves as well. Thus, the demand for capital goods rises and wage payments for newly employed workers lead to an expansion of the demand for consumer goods. Lautenbach says that the "trigger effect of the primary [State] credit expansion" for infrastructure projects has an "effect to stimulate production as a whole." This, in turn, will lead to an increase of the State's tax revenue, which allows the State to, in turn, make payments to the central bank for the long-term consolidation of the original credit emission.

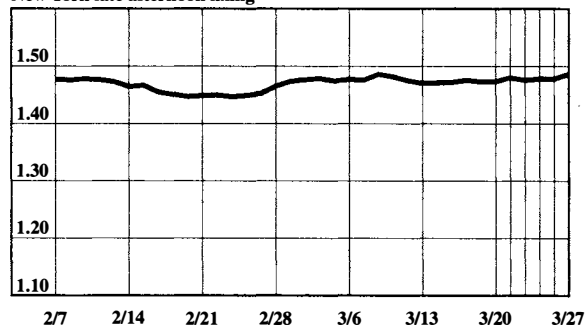
The improvement of infrastructure and an upgrade of the technological quality in industrial production leads to a rise in physical output and of the average productivity of the economy as a whole. Thus, the economy can be stimulated without creating inflation. Lautenbach categorically denies that credit-financed infrastructure and technology projects would lead to inflation. He says such projects are not consumptive; rather, they represent "in a material sense, genuine economic capital formation." But, says Lautenbach, he would not oppose, as a re-insurance against inflationary anxieties, that the wage level be reduced by a certain degree, if the "economic saving thus achieved" would be exclusively used for the creation of new productive workplaces. "That saving and the productive use of what is saved" must be combined. "Positive action, the making available of credits for investment, are in every respect primary. . . . Do we refrain from adopting such a policy, we will inevitably suffer further economic collapse and the ultimate and total ruin of state finances and the economy as a whole."

What Lautenbach said 65 years ago holds true today, and is being said by LaRouche in nearly the same words: "Today, we can still decide that through the employment of this [State] credit policy for productive purposes, both our economy and our public finances can be brought back to stability and growth."

Currency Rates

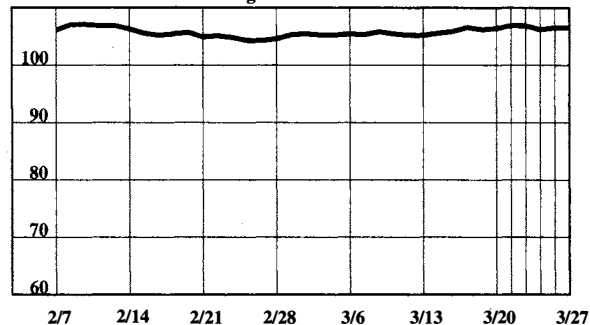
The dollar in deutschemarks

New York late afternoon fixing



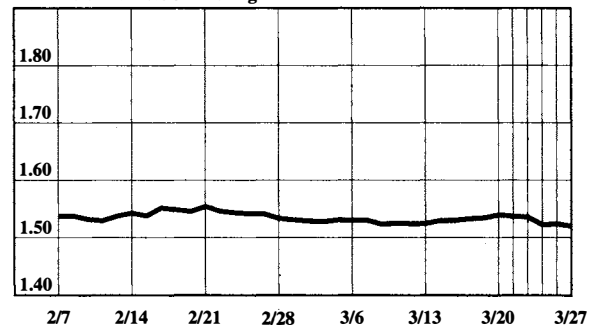
The dollar in yen

New York late afternoon fixing



The British pound in dollars

New York late afternoon fixing



The dollar in Swiss francs

New York late afternoon fixing

