

# Systemic Crisis Runs Through World Economy

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Financial media, economists, and investors in the Western world are right now shaken by an unusual degree of confusion.

Just a few months ago, late last year, we saw widespread concern over a severe and global economic deterioration, something that was characterized as the first simultaneous trilateral recession in 30 years, hitting the United States, Japan and Western Europe at the same time.

While nothing in substance has changed since that time, we are hearing today, at least from some sources, forecasts of an impressive economic recovery, first in the U.S., then in the rest of the world. They tell us, that inventories in the United States are rapidly shrinking, indicating that the bottom of the inventory cycle has been reached, and therefore the next cyclical upswing is already in the making.

These optimistic forecasts are in particular made by exactly the same economists, bank experts, and analysts who proved to be completely wrong during the extreme stock market hype of the late 1990s and early 2000.

Reality however is different from both views: There will be neither a deepening cyclical recession nor a cyclical recovery in the United States and worldwide, because we are dealing with something quite different: a systemic disruption of the global economy finally being caused by fraudulent economic and financial policies. We are dealing with a systemic crisis which requires a fundamental response.

Within the first 12 months of this crash, the market value of Nasdaq firms dropped from \$6.7 trillion to \$3.3 trillion.

The market capitalization of the 5,000 American companies which make up the Wilshire-5000 index, plunged from \$17.0 trillion to \$11.6 trillion. That is, \$5.3 trillion in paper value was wiped out within one year, much greater than the total debt of all developing countries plus the debt of all countries in Eastern Europe and those that belonged to the Soviet Union.

Already before this crash started, *EIR*, in early 2000, published a special report documenting that the "New Economy" was nothing but a giant fraud, based on three ingredients: corporate accounting fraud, "creative" government statistics, and the most excessive credit generation in a century.

## Corporate Accounting Fraud

Since the collapse of Enron in December 2001, the widespread practice by top American corporations to "massage" their balance sheets—that is, to artificially boost profit numbers and to hide losses, often aided by accounting firms—was finally uncovered.

There had been outright criminal fraud practices, as in the case of Enron, and probably other large corporations that are now the subject of investigations by U.S. authorities. The methods included setting up subsidiaries or "partnerships," often located in Bermuda, the Cayman Islands, or other uncontrolled offshore centers; contracts between the mother company and the subsidiary were specifically designed in order to fake turnover, profit, and debt figures.

Almost every day, new schemes for manipulating corporate data are being revealed. As an example, in early May, U.S. energy trader Reliant admitted that it was part of a huge operation of so-called "round-trip" trade transactions, whereby companies were selling each other electricity on paper at the same price and at the same time, just to boost turnover figures on both sides. About 20% of Reliant's total turnover last year had been artificially inflated by such practices.

The number of U.S. companies that have been forced to restate their financial accounts, due to threats of an investigation by the Securities and Exchange Commission (SEC), has tripled last year compared to the level of four years ago, and this year is going even further. By restating their earlier accounts, the companies admit that they have practiced "false or faulty accounting."

During the Enron hearings in the U.S. Congress, Sen. Byron Dorgan (D-N.D.) spoke of "almost a culture of corporate corruption" in the U.S.

On top of this illegal accounting fraud, there are the absolutely legal accounting tricks, now routinely used by thousands of corporations. An example for this is the reporting of so-called "pro forma" profits, whereby companies calculate and announce fantasy profits, which theoretically would have been generated if all interest payments, taxes, amortizations and so-called extraordinary costs are ignored.

## 'Creative' Government Statistics

While everybody is now aware of the corporate manipulation of results by it has not yet been fully understood that the whole "New Economy" hype would never had been possible, and investors would not have lost trillions of dollars on the stock market, had there not been the deliberate massaging of economic figures by the U.S. government.

Even for the first quarter of this year, when corporate profits and corporate investments were still melting down, and the number of unemployed workers on benefit rolls reached the highest level in 19 years, the U.S. Commerce Department managed to calculate a 5.8% annual growth rate for gross domestic product (GDP).

FIGURE 1

**Capacity Utilization, U.S. Industry**

(Percent)



Source: Federal Reserve.

If you take a closer look at the report, you see that two-thirds of this alleged growth has nothing to do with increased spending by consumers or capital investments by companies, but is rather the result of some inventory algebra: Inventories were reduced sharply in the fourth quarter, were basically stagnating in the first quarter, and therefore the economy is rising compared to the previous quarter.

More important than this inventory mathematics, is the very clever method, by which the U.S. government, since the late 1990s, has been deliberately inflating the GDP total—the so-called “hedonic pricing method”: The price of a new computer has been more or less the same now over many years. So, the inflation rate for computers is close to zero. But, argues the U.S. government, the power of computers, in terms of processor speed and memory, is dramatically rising every year. Therefore, the government says, if—in theory—the old computers were still sold, their prices would be much lower than some years ago. Ergo, we have a dramatic deflation in the computer sector.

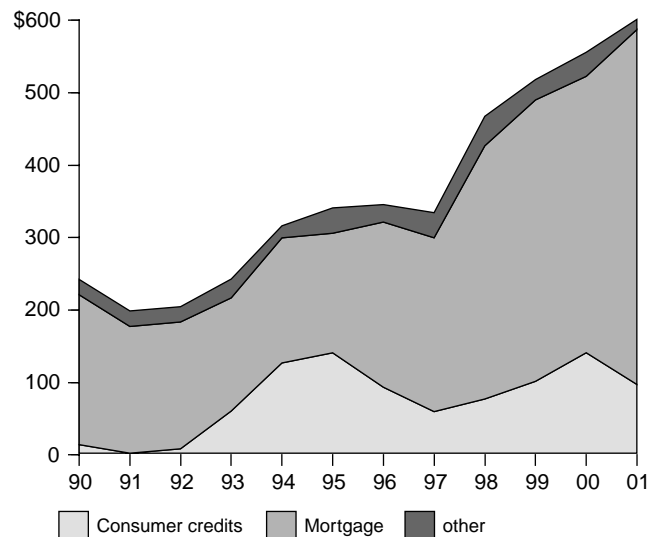
How much? Nobody can tell exactly. There can only be wild guesses. But if you look in the first quarter 2002 GDP report, there actually had been annualized computer purchases of only \$83 billion, but based on the “hedonic” deflation theory, the government adds \$310 billion from computer purchases into its GDP calculation. Similar in the case of software. So, by fictional computers and software purchases alone, the government out of nothing creates an annualized \$396 billion of artificial gross domestic product.

This indeed is very creative. And our German Chancellor,

FIGURE 2

**Growth of Debt of U.S. Households**

(Billion \$ per year)



Source: “Flow of Funds,” Federal Reserve.

in potentially his last weeks of government, just announced that he wants to take over U.S. government statistical methods, in order to be able to present good numbers as well.

Inflating GDP data is very effective, because they immediately inflate productivity data as well, which are calculated as the ratio of GDP to working hours.

Since the beginning of this year, the U.S. government has discovered a widely used statistical trick. Each month, when new figures about employment, industrial orders, or retail sales are being released, the figures for the preceding month are being revised downwards, often without giving any reasoning for the revision. By this clever method, you can, every month, report the very same number, but always claim spectacular growth in comparison to the previous month.

**Excessive Debt Generation**

But even if we take the U.S. government figures as granted, the growth in GDP is ridiculous compared to the growth of debt within the U.S. economy.

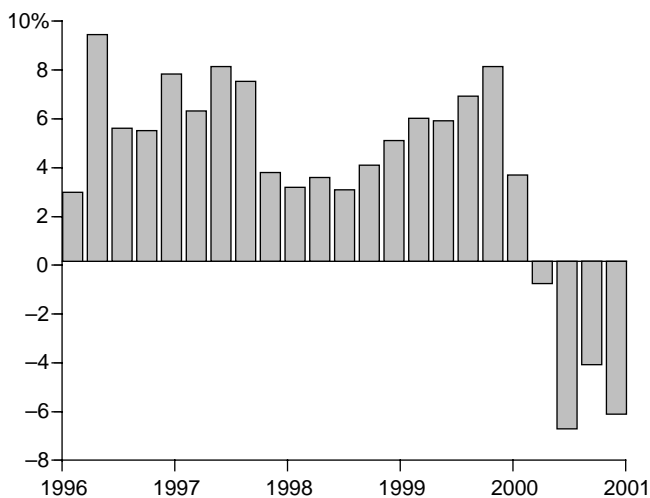
In the year 2001, households added another \$490.7 billion in mortgage debt, about three times as much as the annual average during the 1990-96 period. Total debt by private households and non-financial corporations increased by \$1.109 trillion in 2001. The financial sector increased its debt burden by \$916 billion.

GDP, even including the statistical tricks, only rose by less than \$200 billion last year. That is, in the year 2001, for every single dollar of additional national income, there were

FIGURE 3

### Annualized Changes in U.S. Industrial Production

(Percent)



Source: Federal Reserve.

more than \$10 of additional debt.

During the fourth quarter of 2001, the debt volume of households, companies, and the government even rose 65 times faster than the economy, hardly a “healthy path to recovery.”

### Capital Flows Spell Trouble for Dollar

By looking at the U.S. foreign trade statistics, the question that arises is, not what could become the trigger of such a dollar crash, but rather why it did not already happen? In the year 2001, U.S. exports amounted to \$721 billion, while U.S. imports totalled \$ 1.147 trillion; that is, \$426 billion (59%) more than the export volume. In terms of consumer goods and automobiles alone, the U.S. economy imported \$300 billion more than it exported.

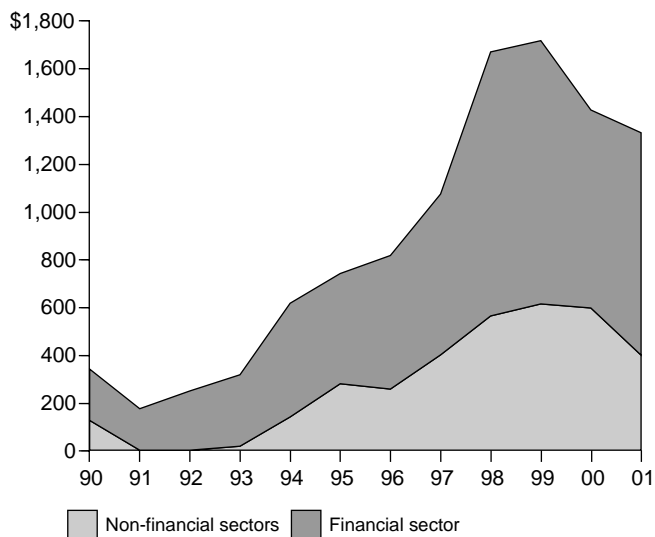
The giant trade gap could be easily financed in recent years by a flood of foreign capital, seeking rescue from numerous financial crises in Russia, Asia, and Latin America, and attracted by the “New Economy” super-hype in the United States. However, already in 2001, the composition of net capital flows into the United States revealed alarming signs of stress.

According to government statistics, U.S.-owned assets abroad increased by \$439.6 billion during 2001, while at the same time foreign-owned assets in the United States increased by \$895.5 billion; that is, by almost \$2.5 billion per day. The combined result was a net inflow of capital of \$455.9 billion into the United States, more or less the same dimension as the

FIGURE 4

### Debt of U.S. Corporate Sector Grows

(Billions \$ per year)



Source: “Flow of Funds,” Federal Reserve.

trade deficit.

But due to the stock market crash and the implosion of the “New Economy” illusion, two main resources of capital inflows—foreign purchases of U.S. stocks and foreign takeovers of U.S. companies—already went down sharply last year. Net foreign purchases of U.S. stocks declined from a record \$192.7 billion in 2000 to \$127.2 billion in 2001. Net financial inflows for foreign direct investments in the United States fell from \$287.7 billion in 2000 to \$157.9 billion last year.

What rescued the U.S. economy, and the dollar, last year, was a further expansion of foreign purchases of U.S. corporate bonds, to \$371.2 billion, surpassing the previous all-time record of \$292.9 billion in the year before. This year, U.S. corporate bonds are again set to break historic records—but this time, not in terms of foreign buying, rather in terms of numbers of defaults.

Following the Enron collapse in December 2001, the corporate bonds of dozens of large telecom, media, and other companies have been downgraded to “junk” level. Total defaults on corporate bonds in the first quarter 2002 amounted to \$34 billion, and rating agencies expect a further rise of defaults throughout 2002.

As a consequence, foreign purchases of U.S. securities—including stocks and bonds—have collapsed. In January and February, they crashed by 75% compared to one year ago and hit the lowest level since Autumn 1998. Following the bursting of the stock market-, takeover-, and corporate-bond

bubbles, there is nothing in sight that could induce foreign investors to maintain net flows into U.S. markets of \$400 to \$500 billion—besides perhaps the issuance of giant amounts of high-yield, government-guaranteed “war bonds.”

Once the dollar crashes, the well-known horror scenario might take place. The Fed will have to raise interest rates to defend the dollar, thereby shutting off the engine for the real estate bubble. In the recent few years, rising home prices have played a key role in keeping the United States going, in particular since stock markets were crashing. Sales of both new and used homes hit records in 2001, with year-over-year price gains of 8% in February. Over the past two years, home-price growth alone has added nearly \$2 trillion in wealth to U.S. household balance sheets, partially offsetting a \$4 trillion decline in household stock-market investments over the same period. Rising interest rates would finally burst the real estate bubble, with far-reaching implications for U.S. consumer spending and therefore the U.S. economy, and also for the already very fragile financial system worldwide.

## Telecom and Corporate Defaults

The fear factor in the financial system is further heightened by an unprecedented wave of mega-bankruptcies. Almost every day, another large corporation, most often in the telecom sector, defaults on corporate bond obligations or files for bankruptcy.

Already in the first quarter of this year, we saw the bankruptcy of U.S. fiber optic operator Global Crossing, the biggest telecom bankruptcy ever worldwide. The company defaulted on a total debt of \$11 billion after laying 160,000 kilometers of mostly idle fiber optics nets, in 27 countries. Other telecom companies, each with debt of more than \$1 billion, followed.

In the meantime, there is a related bankruptcy wave among the leading European cable television providers. The British cable-TV provider NTL, a few weeks ago, defaulted on \$17 billion of corporate bonds, the largest such default ever, worldwide. Much more is to come. According to rating agencies, the number of defaults on corporate bonds is about to reach historic records this year.

Many chief executives of technology companies no longer worry about any recovery in sales this year or later. They are struggling to prevent their companies from defaulting tomorrow or next week. The list of troubled companies with debt volumes in the range of \$5 to \$30 billion is rising by the day, in particular among the large telecoms:

- WorldCom, the second-largest U.S. long-distance phone company, on May 15 broke the historic record of daily traded stocks, set by Enron last year, as the \$30 billion debt of the company has been downgraded to “junk” by Standard & Poor’s. If WorldCom doesn’t receive new cash from its creditors, it might have to file for Chapter 11 in June. On May 15, the company announced that it would tap its last existing bank credit line worth \$2.65 billion. WorldCom stocks have

fallen more than 90% since the beginning of this year alone.

- Adelphia Communications, the sixth-largest U.S. cable-TV operator, on May 15 defaulted on some of its \$19 billion outstanding corporate bonds. The same day, Moody’s warned that a bankruptcy filing by Adelphia may be “unavoidable,” and the chairman and chief executive of the company, who founded it 50 years ago, resigned. In late March this year, Adelphia admitted that it had built up off-balance-sheet transactions to hide parts of its debt. Since then its stocks crashed by more than 80%.

- KPN QWest, the Dutch-American cable-TV operator, saw its stock price plunging 57% on a single day on May 15, after banks, stockholders, and other creditors refused to bail out the company with new capital. A bankruptcy filing is expected in coming weeks.

- On May 16, Britain’s leading telecom equipment producer Marconi confirmed that it is asking creditors to exchange debt for equity, as probably the last option to prevent bankruptcy. Marconi is right now in emergency talks with creditors to restructure \$6 billion of debt. Its stock prices on that day alone fell by 15%. First quarter new orders fell by 54%.

Other telecoms are still reporting huge losses and are preparing large job cuts. Telecom suppliers such as Ericsson and Lucent were reporting a further 40% crash of new orders during the first quarter. Ericsson will cut 17,000 jobs; Lucent, 6,000; Siemens, 6,500. Cable & Wireless in Britain announced a \$7.4 billion annual loss and its chief executive Graham Wallace warned, “The market we operate in won’t stabilize probably for another 12 months.” Both the chairman and the finance director of the company resigned. Nippon Telephone and Telegraph (NTT), the world’s largest phone company, posted the biggest full-year loss ever by any non-financial Japanese company—\$6.4 billion. Deutsche Telekom in Germany is expected to cut about 30,000 jobs within the next three years.