eners, in order to win votes for his own alternative. Any potential was lost for a serious restructuring of the tax code to reverse the speculative and economic overhead categories now getting favorable breaks, in favor of incentives for tangible goods production.

House Speaker O'Neill—who has aided and abetted the strategy of the Socialist International, outlined at their December 1980 conference in Washington, D.C., for radicalizing the nation and destroying Reagan under conditions of economic depression—appeared vindicated in his charges that the administration would not compromise, thereby boosting his factional position within the party. Wright and other moderates, having lost any leverage in their repeated attempts to convince President Reagan that his program could not work unless interest rates were dramatically reduced, were overshadowed by a party position increasingly and intentionally bereft of any policy direction or alternative. O'Neill commented, "When the other side is fighting among themselves, I say don't block the view," as he and other party leaders (notably Democratic National Committee Chairman Chuck Manatt) gleefully awaited economic collapse and, they hope, another liberal Democratic surge in the 1982 elections.

As the administration increasingly defended Volcker and Federal Reserve Board policies, Bill Alexander, a House moderate and Chief Deputy Whip (D-Ark.), introduced H.R. 319 to force the President to consult with the Fed and report back to Congress on how interest rates were going to be reduced. Hoping to get House Democratic Caucus backing, Alexander raised the issue in the Steering and Policy Committee. Here the real policy of the O'Neill wing of the party emerged, as O'Neill's protégé among the younger House leadership, Richard Gephardt (D-Mo.) attacked Alexander for taking emphasis off the "fiscal" solutions to the economy, i.e., more tax increases and budget cuts, and defended the Fed's interest-rate policies. In a subsequent interview with this journal, Gephardt confirmed that he works "closely" with the St. Louis Fed, and demanded cuts in the standard of living, including wage cuts, as a solution to inflation.

As we enter 1982 and the election period, O'Neill Democrats in the House are moving to enforce the Global 2000 blueprint for mass murder by introducing bills for hospices, killing water development and advanced nuclear projects, and ensuring that the euthanasia bill, or "Natural Death Act of 1981" (Act 4-115), becomes law for the District of Columbia, as a model for the states to follow. Whether or not the moderates can find the morality and courage to rally traditional Democrats to regain control of the party remains to be seen. As one member of the moderate leadership told me, "This split between the moderates and the liberals is going to get very deep."

World Finance

The Eurodollar era banking crises out

by David Goldman, Economics Editor

At its moment of greatest apparent triumph, the unregulated world banking system that emerged from the ruins of the Bretton Woods system 10 years ago faces its greatest crisis. For financial history, the subject of 1981 is the unopposed march of the Eurodollar banking system over the fragile defenses of national banking regulation, through the opening phase of a threatened world economic depression. But as the Polish events show in the most lurid light, the further basis of Eurodollar expansion is slim, and the world financial system has entered a crisis of the sort that the 1971 events merely postponed; and whereas the crisis might have been handled smoothly 10 years ago, now it can be confronted only through the most extraordinary and broad-ranging measures.

On Dec. 3 the gates to the citadel of American banking were opened to the besiegers by its supposed defenders, the Federal Reserve Board of Governors, through the much-heralded introduction of International Banking Facilities (IBFs). American banks are now beginning to conduct the same sort of business once exiled to the Cayman Islands, Bermuda, Panama, London, Singapore, and other offshore centers whose volume of deposits, at about $1.6 trillion, was double the size of the broadly defined U.S. money supply and half again larger than the U.S. national debt. Combined with tax breaks for American banks and perhaps with "free-trade zones" and "free enterprise zones," which forthcoming legislation would make into mini-Hong Kongs on American soil, the IBFs have brought the uncontrolled Eurodollar expansion in the offshore markets back into the heart of American banking.

The IBFs by themselves would not represent so dramatic a shift if not for the accompanying revolution in commercial banking during the past year, including:

- The wholesale purchase of American banking assets by foreign institutions, including Hongkong and Shanghai Bank's 1980 purchase of Marine Midland, Midland Bank's 1981 purchase of Crocker Bank, Standard Chartered's 1980 buyout of Union Bank of California, and Banca Commerciale Italiana's 1981 takeover of Long Island Trust.
- The spectacular two-year growth of the assets of

© 1982 EIR News Service Inc. All Rights Reserved. Reproduction in whole or in part without permission strictly prohibited.

comes to an end:
of control?

money-market funds to $175 billion, largely to the prejudice of the nation's 6,000 savings and loan institutions, which threaten to disappear from the nation's financial life, and at the expense of the commercial banking sector. For the first time since the Glass-Steagal Act of 1934, investment banks now control a significant portion of the deposit market.

- Mergers between Prudential Life Insurance and Bache Halsey Stuart; American Express and Shearson Loeb Rhoades; Bechtel Corporation and Dillon Read; Salomon Brothers and Phillip Brothers; and Goldman Sachs and ACLI Commodities, among others, to create "universal financial services" giants.

Paradoxical credit expansion

The institutional changes in the banking system, set loose in part by the Reuss-Proxmire Monetary Control Act of 1981, in part by legislation, drew their greatest momentum from the monetary policy adopted by the Federal Reserve Board in October 1979 and continued through to the present. The escalation of interest rates to 20 percent at their all-time peak in nominal terms, and to real interest rates comparable only to the months of 1929 immediately prior to the stock-market crash, shattered the foundations of normal deposit banking. Instead of an orderly deposit market between institutions and savers, non-bank intermediaries and then the banks themselves threw aside their customary range of instruments and offered deregulated high-interest, short-term paper that merely eased further escalation of interest rates.

The lack of monetary control at the Federal Reserve became, as a result, a standing joke among central bankers, and the subject of preachments of damnation at the Bank for International Settlements, the arbiter of the world central banking community. Deregulation threw out the distinction between demand deposits, or "bank money" in the standard definition of money supply, and forms of "non-money" deposits or assets held at non-bank institutions, and above all, wiped out the distinction between reserve-backed bank money generated in the regulated domestic banking system and uncontrolled, reserveless Eurodollars. While the Federal Reserve kept the rate of growth of its targeted M-1 in the promised range—it has been growing at less than 5 percent over the past six months—the actual rate of credit expansion reached record levels. Deregulation wiped out the means of correlating the Fed's usual measures and the secondary generation of credit in the economy.

Moreover, the credit expansion, which reached 70 percent per annum in the American short-term credit markets during 1981's third quarter, occurred at the expense of an economy whose aggregate balance sheet sank into the worst condition since the relevant numbers were recorded. By the third quarter of 1981, fully half of all new funds raised by corporations paid interest on pre-existing debt, and corporate America was in the same position as Equity Funding, "salad oil swindler" Tino de Angelis, and other chain-letter game operators immediately before their pyramids collapsed.

Unable to continue borrowing merely to pay old debt service, corporations began, in July, to cut costs by laying off workers and reducing production. Production of consumer durables fell 13 percent between July and November, and overall industrial production by more than 6 percent; it will fall by almost as much again before the economy hits the bottom of this particular leg of a general depression.

On the international level, the extent of the explosion of debt-servicing costs has only begun to come to light. World trade this year will probably be 4 percent lower than the 1980 level in real terms. Among the leading industrial economies, only Japan is still growing, and at historically low levels. West Germany is stagnating and in danger of falling substantially; France and Italy are heading into a deep downturn, and England is mired in the depression levels brought on by three years of Margaret Thatcher economics.

The past 10 years have been a slow-motion version of the clasical debt-bubble, along the lines of the Mississippi Company in France in 1719 or the New York stock market in 1929. Sources of funds have declined sharply while debt-servicing costs have continued to escalate. Only now has the fact become evident that *the world's balance sheet does not add up.* This is as true in the domestic U.S. sphere as in the international markets, and the conclusion is that a liquidity crisis of a sort the world has not seen since the grim summer of 1931 is in the works for the earlier part of 1982.

Past and future debt finance

Manufacturers Hanover Trust recently published a brief study of the ratio of net savings to net federal financing requirements, noting that in 1960, federal borrowings as a percentage of private savings were 19.3 percent; in 1970, 25 percent; in 1975, 58.7 percent; and in 1980, 78.8 percent. A linear projection of savings and

Herstatt bank director and customers in 1974 following near-collapse of Euromarkets.

federal borrowing trends would indicate that the latter will exceed the former during fiscal year 1982, implying that credit demands of the public and private sector, both at record levels, could only be met by widespread creation of new Federal Reserve money, or by importation of foreign savings. Indeed, substantial crowding out took place in the bond markets during the second half of 1981, when the rate of corporate debt issues slowed to virtually nothing before taking off in the fourth. Worse was avoided only by the administration's ability to persuade Saudi Arabia and other OPEC countries to purchase more than $20 billion worth of U.S. Treasury securities. But now OPEC savings have fallen as sharply as have American domestic savings, from a net investable surplus of over $80 billion in 1981 to an estimated $30 to $40 billion in 1982.

The spectacular rise and fall of the bond market during the fourth quarter of 1981, including a 17-point rise in the price of long Treasury bonds in the six weeks to Nov. 25, followed by an 8-point fall in the subsequent two weeks, is not surprising. Nor is the "unexpected" stickiness of interest rates on the downside. At this writing, interest rates have actually turned up slightly, an extraordinary development in an economy which has probably lost 8 percent of its current industrial output in the preceding five months. The last time such a thing happened, during the second quarter of 1980, the prime rate had been cut in half within four months.

Other governments' problems in financing their deficits are substantially worse than those of the United States. Starting with Italy, whose government deficit is 11 percent of GNP (against 6 percent in the United States), the rest of the major industrial countries are running government deficits that are proportionally worse, except that in Germany and Japan, traditionally high rates of savings provide a buffer that more than compensates for the additional financing burden. France and Italy are two sectors where a major internal liquidity squeeze is widely forecast for 1982 of a magnitude worse than anything yet imagined for the United States. Reports from Paris say that the French credit system may go through a shock unlike anything in the postwar period when the following year's budget is announced, with double the previous year's deficit, next September.

Most vulnerable in the entire process is the major debtor of the Eurodollar banks, the Third World, whose aggregate foreign debts now exceed $600 billion and whose annual debt service, according to the International Monetary Fund, exceeds $100 billion, or about 30 percent of its total exports. Last October's meeting of the IMF pronounced the current-account deficit of the developing countries, at over $100 billion (two-thirds of which is interest, which is counted into current account), to be "unsustainable." But the same commercial banks that earlier had argued for tough "conditionalities," i.e., austerity preconditions in return for loans, dropped that demand like a hot potato after the IMF meeting, when it was realized that any austerity measures would instantly cut into these countries' ability to manufacture goods for export!

Twenty-one countries have already had to reschedule their foreign debts, nine in the past year and a half alone. Even the largest debtors, such as Brazil, will require rescheduling. But the collapse of advanced-sector economies, particularly that of the United States, which absorbs 40 percent of the non-oil exports of developing countries, means both fewer exports and lower prices for commodities exports, and hence a far worse deficit than in the previous year. Commercial banks remain in the same trap of lending increasing amounts to borrowers whose chances of repaying them grow proportionately smaller.

Central banks and crisis potential

That was the background to the pronouncement of the Bank for International Settlements in its June 1981 annual report that the present deficits of governments precursed a depression "comparable to the interwar years," i.e., the 1930s. To the extent that the BIS suggested that reduction of government deficits was the solution to the threat of monetary crisis, a viewpoint echoed in frequent congressional appearances by Federal Reserve Chairman Paul Volcker, it was belied by the central bank's simultaneous defense of the high-interest policy that had produced the gaping deficits in

the first place. Certainly, a policy of reducing social services could reduce the financial burden on government by permitting defenseless sections of advanced nations' populations to perish. As Milton Friedman argued favorably in 1956, the Nazis "contained" the stupendous monetary expansion of their regime by conquering populations around them, and the money supply, adjusted on a per capita basis, remained under control. But such brutalities were not in the reach of existing democratic institutions, and President Reagan has not been persuaded to shatter those institutions.

As so many times in the past, the last resort of the central bankers is to punish offending governments by letting a financial crisis be unleashed. That was the policy of the Federal Reserve and Bank of England in 1921, again in 1929, and most emphatically in 1931, when the central banks softened up Germany through a shutoff of international credits and a collapse of its currency and some of its major banks, relenting only in return for the placement of Hitler's soon-to-be financial czar, Hjalmar Schacht, at the helm of the Reichsbank.

What the Bank for International Settlements, the arbiter of the 1931 crisis, has in mind, and what its outgoing President, Dutch central bank chairman Jelle Zijlstra, told the IMF meeting last October, comes down to a world directorate of central bankers. Rather than the mere use of interest rates, which have promoted rather than dampened credit expansion, the Federal Reserve must adopt direct credit controls. That such a view filtered into the Bank of England became evident only at the end of December, when the London *Financial Times* editorially demanded tougher action to stop credit expansion. Writing Dec. 17, the premiere British financial paper's editors argued, "Such is America's economic and monetary influence that every other country has an interest not only in the new financial phenomenon emerging there, but also in the controls being devised to rein it in."

The Bank of England had earlier indicated its sensitivity to the crisis potential built up in the financial system, in a September study of the potential for a chain-reaction banking collapse on the Eurodollar market. On Dec. 16, Bank of England Chairman Gordon Richardson summarized the dangers to the world banking system and noted that the Polish events, if they caused banks to act defensively and abandon the process of orderly restructuring of bad loans, could make the entire process unmanageable (see article, page 26).

That the world monetary system is on the verge of a major crisis reaching, through the Eurodollar market, into every national subsector is no longer a matter of hushed discussions in central bank corridors, but of open declarations by the oldest of the world's central banks. What will follow is much less clear. Whether the Polish events will provoke a break-up of loan consortia, a shut-off of lending to major international debtors, and subsequent defaults by major national debtors and commercial bank failures, is impossible to tell at the moment; West Germany, which has less interest in a Polish debt failure than anyone, may yet persuade the Russians to underwrite the Polish debt, for example.

But Poland, for all its attention in the headlines, is far from the most dangerous trouble spot in the world monetary system; the real-estate markets of various major cities are potentially far more vulnerable, and capable of compromising a far greater volume of risky loans. No one can predict the time and place of the outbreak of such a crisis; the opportunities for it to occur are too widespread for even the Bank for International Settlements staff to grasp in totality.

Two kinds of gold options

The first serious public discussions of gold in 10 years are both an indication of the recognition of crisis and a direction-finder out of it. As BIS President Jelle Zijlstra emphasized, "Gold is no longer a dirty word," although Zijlstra's own version of remonetization is for gold to be a chip circulating among central banks who would simultaneously force back the credit volume available to industry at whatever cost to national economies. Gold will return either to prevent a crisis, or as a result of it; the dollar will not survive major bank failures as a free-floating, still acceptable, but universally distrusted international asset. Gold may become the "only acceptable international means of payment," as Princeton professor Peter Kenen warned the President's Gold Commission in testimony Nov. 18.

However, as *EIR* founder Lyndon H. LaRouche Jr. proposed in these pages in October, gold can be a solution, not merely the bedrock to which the paper monetary system crashes. Backing the dollar by gold, i.e., paying the U.S. current account balance in gold revalued to $500 an ounce or market price if higher, would immediately restabilize the world monetary system, on one condition. That condition is that the pledge to meet U.S. deficits with gold were backed up by a national effort to rebuild the technological edge of American industry, and wipe out the present $40 billion per year trade deficit through the high-technology exports America excels in. At home such a policy would require low-interest loans on a priority basis to goods-producing industry; such loans would be non-inflationary as a matter of definition, being applied to new goods production and productivity-improving investments.

That is the course that economists like France's Jacques Rueff and Lyndon LaRouche urged in 1971, as an alternative to the Nixon debacle; it is still not too late to adopt it, in the face of the terrible consequences of wrong decisions.