EIR Economics

Republicans gamble on 'suckers' rally' of Wall Street

by David Goldman

Republican strategists are gambling their last nickel of political capital on what some frankly call a "suckers' rally" on Wall Street starting after the New Year, lasting long enough to postpone the big economic reckoning until late in 1988. They hope that sufficient use of the Federal Reserve printing presses, with domestic money-supply growth rates reaching 15-25% by spring, and sufficient intervention in support of the dollar by overseas monetary authorities, will give a Republican presidential candidate time to get elected before the full effects of economic depression become obvious.

The $17.63 billion October trade deficit, reflecting higher imports in all categories, and the accompanying collapse of the dollar and stock prices on Dec. 10, should have dispelled the illusion of the coming "suckers' rally." The see-saw of the Dow Jones average, accompanied by a general decline of equity values in general, since the Oct. 19 "Black Monday" crash, reflects a massive change in ownership of U.S. stocks, to the detriment of the near-future solvency of major American financial institutions. It is a virtual repeat of late 1929 and early 1930.

American commercial bank trust departments and pension funds, in consultation with the White House, rally the market at every opportunity, while overseas investors, who have lost an additional 10% of their stake through the dollar's fall since Oct. 19, sell into the rally. Bleeding and in some cases broken, Wall Street brokerage firms are betting the last of their capital, as in 1929, in an effort to prop up the market for a few more months, imitating precisely the blunders of their grandfathers of 1930.

The problem lies in the rate at which reality intervenes into these wishful games. As the Federal Reserve prints money to maintain the apparent rate of consumer sales, imports continue to rise—since there is little domestic production capacity to provide these sales—and are paid with cheaper dollars. Thus the $212 billion annual trade deficit clocked during October, an all-time record, is no surprise, but the inevitable result of the Federal Reserve's deliberate policy. And these shocks of reality spur America's overseas creditors to take their losses early, while there is still something left to recover.

The Reagan administration's economic team is operating on the intellectual and moral plane of a 16-year-old high school football team captain, whose coach has successfully taught him how to cheat. A combination of falling oil prices and European-Japanese reflation will postpone the "second wave" crash after Black Monday long enough for the "Republican team" to win the game. The strategy is not merely venal, but stupid. The first week of December exhausted the credibility of the European "reflation" ploy, at the same time that the supposed center-stage effort to restore credibility—the congressional budget-deficit negotiations—fell apart.

The falling dollar

The apparent motive for the temporary runup of stock prices between Dec. 7 and Dec. 9—the summit euphoria in Washington—argues, on the contrary, for a general withdrawal of overseas support for the dollar and U.S. financial markets. Since the United States closed the gold window in

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1971, the Europeans have paid indirectly, but massively, for America's strategic protection, by accepting low-grade IOUs from the United States in virtually unlimited amounts, i.e., dollars unbacked by gold. Now that the administration has withdrawn the nuclear umbrella, a growing minority of European financial interests argues for circling the wagons around the European Monetary System, and letting the dollar find its own floor.

It appears quite possible that the Saudis, under strong American pressure, may refuse to make the concessions required to avert another free-fall of oil prices, on the scale of the summer of 1986. However, whatever "psychological" value that may have for the markets, will be overrriden by the mayhem it will cause in the crippled financial sector of the southwestern United States, not to mention Third World oil producers.

The 72-point fall in the Dow Jones average Dec. 4 is a case in point. It occurred when several large professional portfolio managers gave the "sell" order for huge blocks of stocks, the moment that European interest rate cuts were announced. "They took the first good news as signal to dump remaining stocks," said one source. "It is a sign of the real underlying mood. It's incredibly bearish. The market insiders are trying the tactic of 'rally, sell . . . rally again, sell,' in order to cut their losses."

European governments' too-little, too-late response to American pressure for looser money policies prompted European portfolio managers to take the opportunity to sell off. Banking authorities in London warn that the "endgame" of the European reflation gambit has arrived; most believe that by March at the latest, the Fed will have to sharply raise interest rates, or face a drastic collapse of the dollar. Federal Reserve chairman Alan Greenspan's "only option at present is to devalue the dollar abroad and to depreciate the internal debt by printing liquidity like mad, to keep the credit system from breaking down given his interest in avoiding recession until 1989," one banker warned. "This is one reason Reagan so desperately wants to play the arms game with the Russians, though he can't admit it is to open the way to huge budget cuts in defense."

Oil prices to collapse?

Leading Rotterdam oil sources give the Vienna OPEC talks which began Dec. 10 "only slightly better than a 50% chance to hold the line on prices." If no accord to cut the present excess output above the 16.6 million barrel/day quota results, "within a week, the world oil price could collapse again as it did in 1986, with no bottom in sight."

To eliminate the 2 million barrel/day overhang on the world market, Saudi Arabia would have to accept a much greater subsidy for Iraq's position in the Gulf War; the excess derives in large part from forced Iraqi sales above its quota, due to the war's financing requirements. Mixed reports from the Dec. 10 meeting led to a sharp rise in oil prices on the New York Mercantile Exchange, in contrast to a sharp fall on the European spot market, where the key OPEC crude fell to $16.15 a barrel.

"It is a difficult situation, especially if some members insist on irrational behavior," said a senior Arab official who asked not to be identified. Kuwait's oil minister, Sheik Ali Khalifa al-Sabah, warned in a recent published interview that he does not exclude the possibility of a collapse similar to the one that saw prices fall to $7 a barrel last year.

Analysts will no doubt revive the old nonsense about the benefits of cheaper oil. Lower oil prices will benefit nothing but battered consumer spending, lower now than it was at the same time in 1986, even before taking inflation into account. But any further decline in oil prices would smash the props which have prevented a wholesale breakdown of Texas and Louisiana banking.

The next victim, bank analysts predict, will be the First Republic Bank of Dallas, whose fourth-quarter losses are estimated at $325-350 million, with total 1987 losses at $659 million. It will join the other six major Texas bank holding companies in suspending dividend payments. About 12.4 % of its assets, around $3.13 billion, are non-performing. About 40% of its loan portfolio is in Texas real estate.

The carnage continues among smaller banks. On Dec. 4, the Federal Deposit Insurance Corp set a new one-day record in bank closures, by closing nine banks and bailing out a tenth. This brings the total of banks closed so far this year to 173. Four of the banks were in Nebraska, two in Lousiana, one in Oklahoma, one in Texas, one in Kentucky, and one in Iowa.

The banking system as a whole, including the savings and loans, appears to have tipped into overall negative net profitability, despite the postponement of $25 billion of Brazilian loan-loss writedowns, among other bad paper left on bankers' books. Overall numbers suggest that the snowball has just begun to roll. During the third quarter, savings and loans lost $1.6 billion. About 39 failing S&Ls in Texas accounted for $1.3 billion of the loss. The S&L industry's loss exceeds $3 billion for the first nine months of the year; depending on fourth-quarter results, the industry's yearly loss could rival the record $4.6 billion loss of 1981.

Meanwhile, the commercial banks' $5.8 billion third-quarter profit looked pale against the second quarter's $10 billion loss. Federal regulators are frightened. "Clearly the economy in the Southwest is not improving," Federal Deposit Insurance Corporation chairman L. William Seidman said recently. "Right now we do not see any recovery in the figures."

The massive third-quarter write-offs for Third World debt problems do not reflect Southwestern loan losses, which will hit fourth-quarter bank earnings; Seidman estimates that the nation's federally insured banks will earn $4 billion in 1987 on assets of $3 trillion, a return on assets of 0.02%. That would be the industry's lowest return on assets since 1934.

Including the savings and loan numbers, the overall return on combined banking operations will actually be negative.

Much worse results—chain-reaction runs against weaker institutions, were averted by the sharp reduction in interest rates of the past several months. As noted, the leeway for such a reduction, financed by the corresponding declines in European interest rates and the devaluation of the dollar, reached the zero-point on Dec. 4. The best guess is that chain-reaction runs will start in earnest during 1988's second quarter.

The Wall Street minority which wants the Federal Reserve to tighten money now, and take the losses up front, made itself ridiculous the week of Dec. 7, when the *Wall Street Journal* proclaimed in a front-page article that the Federal Reserve had decided to tighten credit to support the dollar. By Dec. 9, the Federal Reserve had erased the small increase in interest rates which derived from such speculation. In fact, the Greenspan Fed has no choice in the matter. It must let the dollar fall, leaving it to European monetary authorities to buy as many unwanted dollars as they might, or trigger massive problems in the domestic financial system.

What happened to the budget summit?

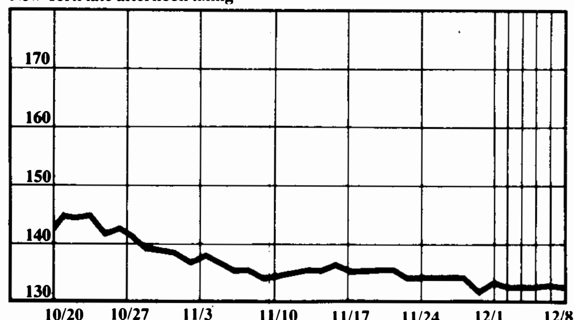
Newspaper editorialists around the world argued that the market's attention after Oct. 19 would center on efforts to cut the U.S. budget deficit. Contrary to the then-universal acceptance of such nonsense, the budgetary issue has disappeared from public view after weeks of boring and useless negotiations between the administration and Congress, and the market chose to ignore the issue entirely. Cooler heads began warning in mid-November that drastic deflationary measures in the United States would not merely guarantee a new world depression, but would be taken at the immediate expense of such budget items as the U.S. troop presence in Western Europe.

That has left the post-Black Monday financial system with no policy perspective whatever for a remedy of the factors which produced the world's worst stock-market crash. All that remains is what Prof. Robert Mundell of Columbia University likes to call the suicide argument: As in the case of suicide, there is always a good reason for postponing a financial crash.

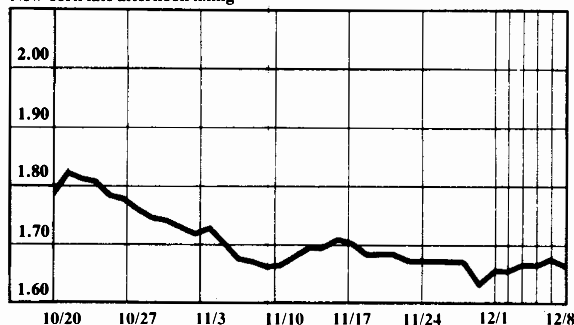
The private portfolio managers of Western Europe have no reason to continue to hold American corporate or government paper, except to sell off their holdings in an orderly fashion. To some extent, their own central banks are, in effect, buying this paper from them, by purchasing dollars no one else wants on the markets, and reinvesting them in U.S. Treasury securities. They will not oppose the efforts of the U.S. administration to float the market for a few more months; on the contrary, it is in their interest to sell at the maximum price. Neither will they forget Nathan Rothschild's legendary advice: "I became rich because I always sold too soon."

Currency Rates

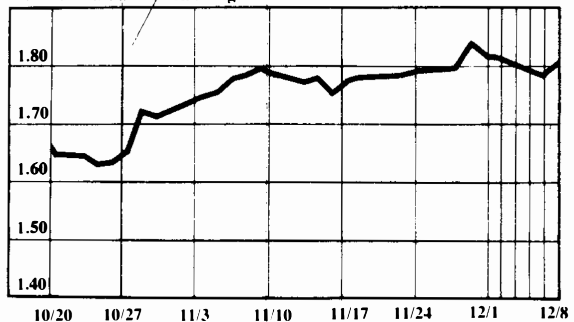
The dollar in yen
New York late afternoon fixing



The dollar in deutschemarks
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