

EIR Political Economy

Casino Mondiale: A swindle runs the monetary system

This report was prepared by Chris White, Marcia Merry, John Hoefle, Anthony Wikrent, and Laurence Hecht.

The July 7 summit meeting in Munich, Germany of the heads of state, finance ministers, and central bankers of the Group of Seven industrialized nations proved the utter bankruptcy of the political leadership of the so-called developed world. The incompetents produced their verbal platitudes and reassuring noises. The result: The dollar went into free fall.

Similarly, the events culminating in the Sept. 16 collapse of the British pound, demonstrated for all to see that the so-called monetary authorities, the combined central banks of the developed world, are as impotent and incompetent as their political counterparts. That day it became transparently clear that the central bankers, and the system they subserve, has been destroyed, Frankenstein-style, by a monster of their own making.

During the September monetary turmoil, Germany's central bank spent \$65 billion worth of its foreign exchange reserves to defend the parities of currencies within the European Exchange Rate Mechanism. That was about one-third of the central bank's reserve position, as of the beginning of 1992. The French central bank exhausted all but 10% of its reserves in the same effort. Central banks of Italy and Ireland are out of reserves, with the Irish now forced to borrow from international markets to replenish what has been lost. Carlos Solchaga, the Spanish finance minister, now talks of the need for central banks to pool holdings of reserves. As for the British, whose currency took, and is so far taking, the biggest hammering from recent events, they are desperately trying to cover up the exhaustion of their central bank's reserve funds. Comparison of reported disbursements and bor-

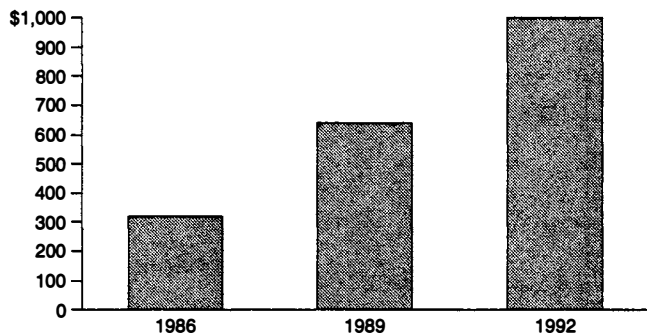
rowings, with reserves available at the beginning of the year, indicates that if the Bank of England is not yet out of reserves, it will not be long before it is.

The exhaustion, or near exhaustion, of central bank reserves reflects the final breakdown of the international system of so-called floating exchange rates, which came into existence in the aftermath of Richard Nixon's momentous Aug. 15, 1971 decision to take the dollar off the gold standard. That was the day that Nixon ended the post-World War II Bretton Woods system. The exhaustion of the central bank reserves also reflects the end of the 1980s' orgy of deregulation and speculation unleashed by the international co-thinkers of Britain's Margaret Thatcher when she became prime minister in 1978. Strange it is indeed that John Major's opponents in Britain's Conservative Party are calling for a return to precisely those of her policies which produced the most appalling of disasters in Britain since the Black Death of the mid-14th century.

The breakdown of the central bankers' international operation is quite simply identified, on the surface at least. The volume of international transactions carried out every day on the world's foreign currency markets was, by early September, twice the available foreign exchange reserve funds of the world's major central banks. The monster that was created during the 1980s destroyed its nominal master.

Thus, the spectacle of officials from a variety of countries, like Britain's Chancellor of the Exchequer Norman Lamont, solemnly affirming before the world, "the pound will never be devalued," only to immediately do that which, he said, would never happen. The failure of his double interest rate increase Sept. 16 says it all. The resources no longer exist to continue the charade.

FIGURE 1
Growth in global currency trading
 (billions \$ per day)



Sources: Bank for International Settlements, U.S. Treasury.

The breakdown also points to the reality that these current political leaders and their companions in the central banks seem to have forgotten, assuming they ever knew, what money is actually supposed to be.

Beyond the exhaustion of the reserve position of the central banks, the financial side of what broke down Sept. 16 includes the following elements. Like Humpty Dumpty, it won't be put back together again.

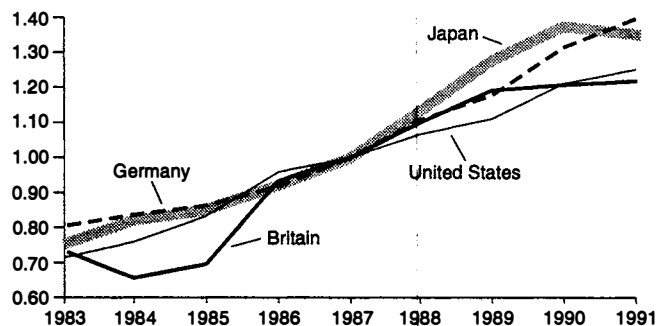
Currency trading: The volume of currency transactions in world markets is running at \$1 trillion per day, according to Nicholas Brady, the bumbling secretary of the U.S. Treasury. That cited daily volume was reached some time earlier this year. Brady's estimates are seconded by various European agencies. It has been reported in German and Austrian newspapers, that of this daily \$1 trillion throughput, more than \$300 billion is handled in the City of London, nearly \$200 billion in New York City, about \$130 billion in Tokyo, and \$57 billion in Frankfurt-am-Main, Germany.

Leaving aside weekends and holidays, when money markets are shut, there are about 250 trading days in the year.

Figure 1 shows the growth of the daily volume of currency speculation since 1986. In these short six years, the volume has doubled, and nearly doubled again. In 1987, there was the "Black Monday" stock market meltdown in the United States and around the world. Note how this form of speculative activity has increased since that stock market collapse. The growth in the international volume of currency transactions can be compared with the growth of central bank reserves, shown in **Figure 2**, and with the magnitude of such reserves, by central bank, up to the end of 1991 (**Table 1**).

Bond dealing: Next in volume, after the currency markets, come the international dealings in the bonded debt of the U.S. government. In this case, it is estimated that about \$300 billion worth of transactions takes place, around the world, each and every day. At that level of activity, the whole of the \$4 trillion U.S. federal debt could be churned through

FIGURE 2
Central bank reserve index
 (index 1987 = 1.00)



Sources: International Monetary Fund, *EIR*.

Relative changes in central bank reserves, indexed to 1987. Lines show relative changes for each country but do not show relative sizes of reserves between countries. Each bank index computed on its own currency.

TABLE 1
Central bank reserves
 (billions of national currency)

Year	Germany	Japan	U.K.	U.S.A.*
1983	DM 160.6	¥26,385	£13.41	\$191.7
1984	166.7	28,627	11.95	203.8
1985	172.2	29,705	12.72	224.0
1986	182.9	32,119	13.97	257.4
1987	199.7	34,920	14.22	269.1
1988	221.1	39,462	15.28	283.9
1989	234.6	37,652	15.18	289.1
1990	239.0	47,900	22.02	325.1
1991	278.8	47,200	22.25	336.7

* Average of last month in period.

Source: IMF, *International Financial Statistics*.

the world's bond markets in just 12 trading days, or 20 times every year (though it doesn't happen that way).

The annual throughput, under these two headings alone, comes to around \$325 trillion per year. For comparison, that is a factor of more than 50 times greater than either the U.S. Gross National Product, or the approximate total dollar value of all goods traded worldwide, in any one of the last few years. It is about \$60,000 worth of transactions for every one of the inhabitants of the globe—nearly three times the per capita income of an American—when two-thirds of the world's population is not assured of even an adequate daily supply of food. Then there is the \$25-30 trillion traded annu-

ally in futures markets, the \$6.5 trillion approximate volume of the futures market in U.S. Treasury Securities, and bringing up the rear, the stock markets.

U.S. stock markets do \$10-12 billion worth of business each trading day, apparently. So, the global activity in currency and U.S. government debt markets is more than 100 times greater than what goes on in the U.S. stock markets. Despite this, the Dow Jones post-industrial index is still taken to be the best indicator of the state of health of the U.S. financial system and economy.

Money: a political creation

Is any of this actually money? Of course not. Just 10 years ago, hardly any of it existed. Twenty-five years ago it didn't exist at all, except for stock markets and holdings of government debt, then actually long-term instruments, held over years, rather than hours and minutes. It seems that we have been through another transition, in the jargon of financial specialists, from dollars to petrodollars to offshore dollars to narcodollars to non-money dollars and non-money narcodollars.

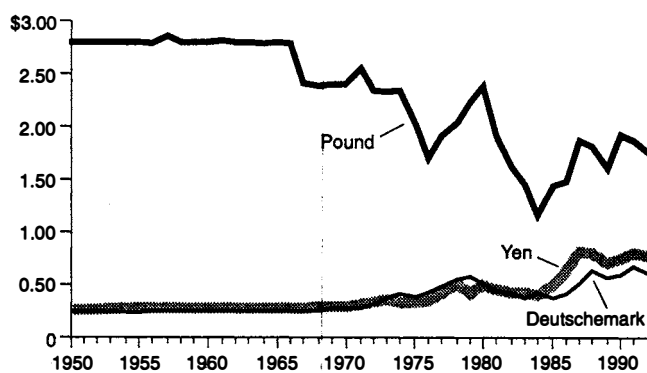
What is a dollar worth? Some point to the fact that among the United States' big foreign exchange earners are the products of the Coca-Cola company, and McDonald's Big Mac, often priced around the world at two to three times their U.S. levels, to argue that the dollar is undervalued. Russians, Mexicans, and Brazilians similarly assert the dollar is way overvalued, and are also right.

But, what if it isn't real money anymore, at least from the standpoint of the rest of the world? What can actually be done with a dollar? What does it buy, except more money, or U.S. government debt, or mob-like political protection from one or another provocation and destabilization, often as not organized by agencies of the U.S. government itself? What do such considerations about how much the currency is worth really mean? Maybe we have to start thinking again about what real money would be, or used to be.

Money, after all, is a political creation. You want money, you can print it. However, it is also a political creation of government. In the old days, a country's currency valuation in international markets used to reflect something of the reality of the productive power of the economy. That was in the days before Aug. 15, 1971, when foreign exchange transactions were primarily for the purpose of balancing and settling trading accounts, actually paying for goods that were being imported and exported.

This is shown in **Figure 3**, which plots the number of dollars and cents needed to buy a British pound sterling, a German mark, or 100 Japanese yen, since 1955. The relative stability, prior to Nixon's 1971 decision, can be compared with what looks like the steady decline of both the dollar and the pound since. Note the three-, almost fourfold collapse of the dollar against the mark and the yen since 1971. The valuation of the pound reflects a financial subsidy from the

FIGURE 3
U.S. dollars per foreign currency unit



Source: International Monetary Fund.

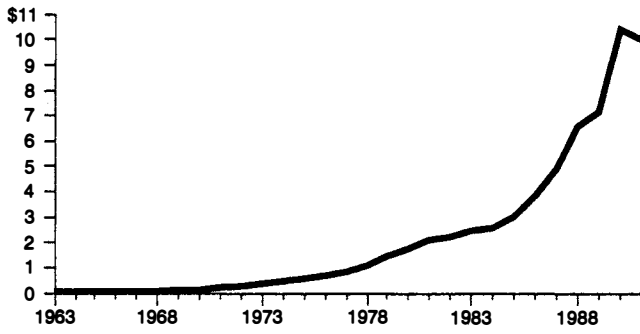
United States in the form of an overvalued exchange rate, a condition which has been allowed to persist over the entirety of the postwar period.

Such an economic function of money implies a relationship between the cost of producing output, and its price, in both internal and external so-called markets. The costs would include materials supplies and utilities, depreciation of plant and equipment, wages of production and administrative workers, plus a fair and reasonable profit to permit investment in upgrading activities. A government could take the whole economy in the same way: working backwards from what is required to reproduce another generation, qualified to work under foreseeable scientific and technological conditions, and also, to produce another successor generation; from this, to the rate of investment, under conditions of technological progress, needed to create and maintain the work places, and infrastructure needed to sustain the required healthy, forward momentum of the country's demographic profile, increased life expectancy, declining infant mortality, a longer time spent in education, upgraded employment, and so on. It is the kind of approach that farmers refer to as "parity pricing." Or, the kind of approach which used to govern electric utility and transportation administration, in the days before deregulation.

Credit generation

Out of such calculations would be produced an estimate of the volume of credit necessary to accomplish the objectives. Of that estimated volume of credit, some portion, related to the combined estimated necessary rate of growth, and the productivity-enhancing, hence labor-cost-reducing and cheapening effects of the investment pathway chosen, would be issued as money. Then, what used to be called "the soundness of money," or "hard money," would reflect the adequacy of a nation's commitment to create the conditions for the

FIGURE 4
Deposit banks' foreign liabilities
 (trillions \$)



Source: International Monetary Fund.

future existence of itself and its population, through increasing the productivity of its labor force.

In this century, we've done it that way in wartime, as under Franklin Roosevelt. It also happens to be the intent of the Preamble and Article 1, Section 8 of the U.S. Constitution. It was the effective method chosen to build the United States, under the First and Second National Banks, and under Lincoln's "greenback" policy, against contemporary advocates of the kind of diseased approach which has now brought the world into disaster. Such is the tradition of the Confederacy.

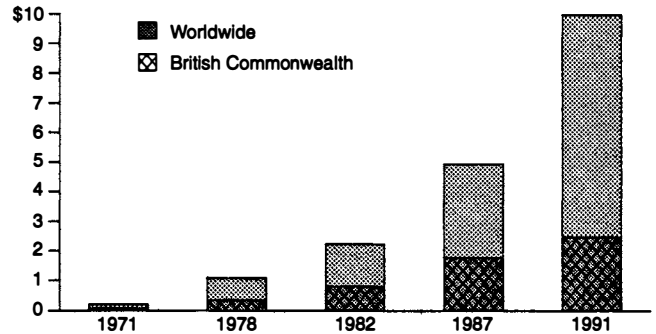
In this approach, government is the source of credit, issued into the banking system in the form of, in the case of the United States, Treasury notes, at low interest rates. Such credit is directed to financing economic functions, for example, capital investment in basic economic infrastructure, such as transportation systems, power generation and grid construction, water management, treatment, and distribution, and sewage systems. Credit issued for such productive purposes generates an economic multiplier effect through the economy as a whole in the form of rising employment, filling order-books for subcontractors on projects and so on.

The debt multiplier, and other swindles

In the alternative version, now imploding, government does not issue credit, but rather finances its activities through issuance of debt, secured against future tax revenues. Absurdly, the government borrows in anticipation of its own future revenue from some private party, secured against its own tax revenue in the form of interest and amortization. The Treasury sells debt into "the market," to raise funds, supposedly to finance that part of the government's budget which is not covered by tax revenues or other receipts. "The market," in this case, is the investment houses and banks.

Since 1985, it has been possible to buy federal debt without providing proof of origin of funds, or documentation that

FIGURE 5
Deposit banks' foreign liabilities in selected key years
 (trillions \$)



Source: International Monetary Fund.

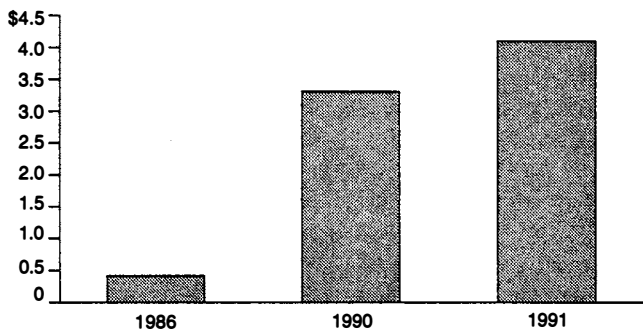
the money employed belongs to whomever it is supposed to. "The market" can then turn around and sell the debt to the Federal Reserve, in exchange for money. And the Federal Reserve can use its holdings of debt to drain money out of the market. This is supposed to regulate the money supply, and perhaps did in the days of real money. Bank and investment house holdings of government debt become the basis for a debt multiplier, spreading outwards from the banks and the Federal Reserve.

Ridiculous, to borrow what will in any case be one's own—future tax revenues—to repay with what is one's own—present tax revenues—to have 20% of the transaction skimmed off the top in the form of debt service claimed by the middlemen in the transaction. Under the Constitution, it is flatly illegal, because it is inimical to republican government. The only function served is a transfer of public revenue into private hands in the name of "sound financing practices." The giveaway swindle is running at \$200 billion per year in debt service.

It has transformed the U.S. Treasury into the house bank of the world currency and bond market casino, and the Federal Reserve into the employee who deals winning hands from a stacked deck to favored clients.

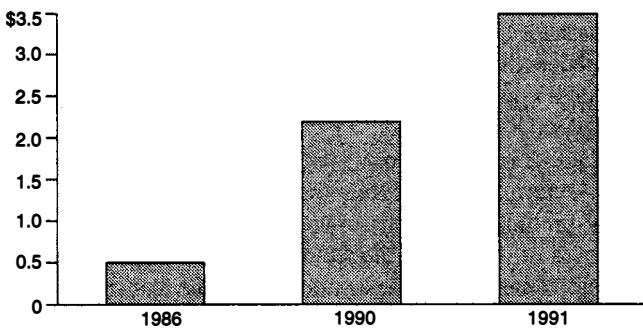
The multiplier effect is aggravated by the existence of offshore funds. **Figure 4** shows the growth of deposit banks' foreign liabilities as an approximation of such offshore funds. This captures the almost \$400 billion socked away in the Cayman Islands by the end of 1991, and the almost \$300 billion stashed in the Bahamas, along with equivalent funds in Hong Kong, Singapore, and other places. This was rightly considered a threat to the entire world system back in 1971, when it was estimated that there were about \$200 billion of such stateless funds in circulation; there were \$10 trillion of such deposits in existence at the end of 1991, a fiftyfold increase in 20 years (**Figure 5**).

FIGURE 6
Growth in over the counter instruments
 (trillions \$ outstanding at year end)



Sources: Futures Industries Association, International Swap Dealers Association, Bank for International Settlements.

FIGURE 7
Growth in exchange rate instruments
 (trillions \$ outstanding at year end)

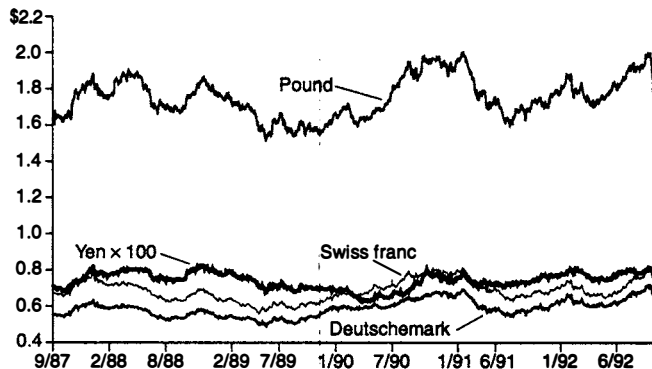


Sources: Futures Industries Association, International Swap Dealers Association, Bank for International Settlements.

These funds are not only not real money, since they are stateless; they are also more or less criminal, the proceeds of capital flight, tax evasion, and of drug and weapons dealings, and so on. Since the difficulties of First National Bank of Boston in the winter of 1991, offshore liabilities, in the form of deposits in foreign operations of U.S. banks, have been covered by the Federal Deposit Insurance Corp. (FDIC).

The internal multiplier and the offshore black funds combined to become a kind of monetary sorcerer's apprentice during the 1980s. Foreign exchange and bond trading (Figures 6 and 7), in significant portions, are organized through so-called off-balance-sheet liabilities. These really did not exist before the middle of the 1980s. Now, there are about \$4 trillion of such transactions held off the balance sheets of U.S. banks: The explosive growth of these off-balance-sheet liabilities is similar to that of foreign currency trading. In

FIGURE 8
U.S. dollars per foreign currency unit



Source: EIR.

1984, U.S. banks had \$1.4 trillion in off-balance-sheet liabilities; by 1985, that figure had risen to \$1.8 billion. By September 1991, the 20 largest U.S. banks had \$6.1 trillion in off-balance-sheet liabilities, or 697% of their \$899 billion in reported on-balance-sheet assets. Citibank alone had slightly more in off-balance-sheet liabilities in 1991 than the entire banking system had in 1984.

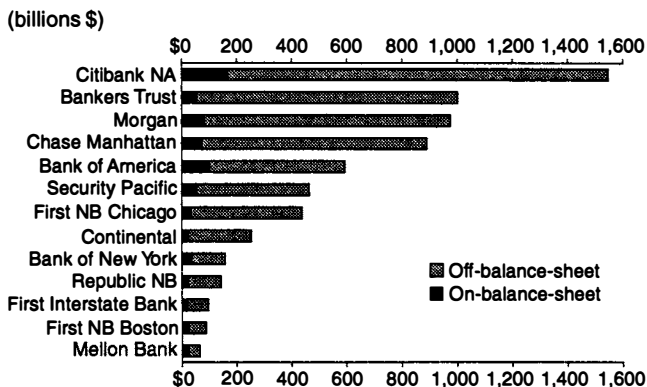
The transactions take the form of "hedges." Movements, or volatility, of one currency are compensated by trading in the contrary direction in another currency or group of currencies, or in futures markets. Interest rate swings in bond markets offset movements in currency markets.

Figure 8 shows the pattern of increasing volatility which has been introduced into currency markets as the daily volume of trading reached toward \$1 trillion, from its level of 1986-87. Note how over the succession of intervals indicated in the time line, there are increasingly wilder swings from peak to trough. The standard 15-20% fluctuations, in almost any six-month period, are sufficient to wipe out the profits of any company that is engaged in trading goods, unless that company joins in the speculative binge to "protect" itself. Hedges, between and among currencies, and between currencies and interest bearing instruments, are supposed to tame and conquer such volatility.

Through such means, it is claimed by some that 77% of the after-tax profits of the 10 largest U.S. banks were, in 1991, the result of those banks' currency-trading activities. Federal Reserve-supervised Citibank will confirm this trend in the next days, when it announces its third quarter 1992 results. Currency trading gains in August and September are expected to help rebuild Citibank's balance sheets. Figures 9 and 10 show the volume of "off-balance-sheet liabilities" of the 13 largest U.S. banks, and their "off-balance-sheet" exposure compared to their paid-in capital.

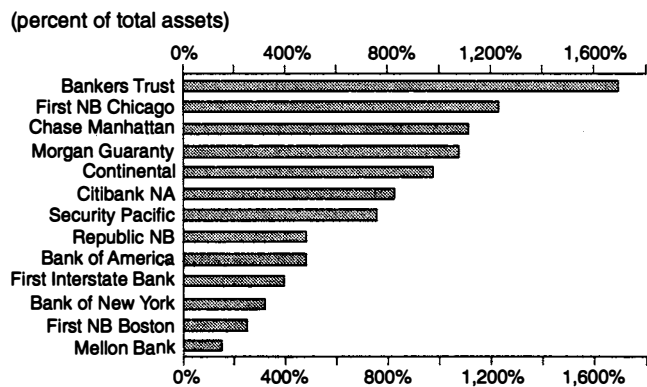
Investment in the stock market, as Nicholas Brady never tires of saying, represents more of a commitment than most

FIGURE 9
Off-balance-sheet activities of the largest U.S. banks



Source: Weiss Research.

FIGURE 10
Off-balance-sheet activities of the largest U.S. banks

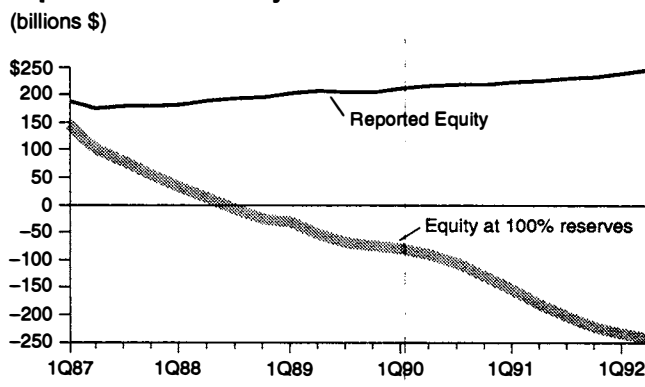


Source: Weiss Research.

other types of investment. You have to use money. One dollar buys \$1 worth of stock, whether the market is up or down on that particular day, whether the money is yours or borrowed.

The currency and bond markets don't work that way. For a little over \$2,000, the bond market player leverages \$100,000 worth of U.S. government debt. In that market, 2¢ buys one dollar's worth of action. So the \$300 billion traded every day is the dollar volume leveraged by a mere \$6 billion or so. In the currency markets, it is different again. There, margins can be as thin as 0.5-1%. So, half a cent to a cent buys \$1 worth of action, and the whole \$1 trillion of daily transactions is backed by a mere \$5 to 10 billion each day. And thus, central banks are hemorrhaging away their reserves, by the tens of billions, to fend off flows leveraged by mere billions of dollars. Insane, isn't it? And considering the

FIGURE 11
Equity capital at U.S. commercial banks, reported versus adjusted for 100% reserves



Sources: Federal Deposit Insurance Corp., EIR.

real economic crisis ravaging the world, it's criminal.

Wait a minute. Wasn't that supposed to be one of the lessons of the 1929 stock market crash? Weren't margin calls against uncovered positions supposed to be one of the causes of the crash? Weren't trades on margins banned in the aftermath? The leverage, you see, works both ways. Yes, the \$2,000 margin leverages \$100,000, but a swing of 2% and more which wipes out the margin, and produces a call for cash settlement, can also bring down the 98% of the transaction which is unsecured.

Then look again at what happened on Sept. 16, and in subsequent days. Behind the daily convulsions of the currency markets, what happens to the hedging positions of the currency traders when a currency is removed from trading, as was the Italian lira, or when exchange controls are imposed, as they have been in Spain and Ireland, and interest-free deposits have to be placed before certain currency trades can be made, or when overnight interest rates go to 500%, and then down to 40%, as was done in Sweden?

The hedging positions get knocked out. And, as that happens, the off-balance-sheet liabilities, which are the core of the \$1 trillion per day currency markets, come unglued, and the currency trading earnings of the banks disappears. **Figure 11** shows the equity capital position of the U.S. banks adjusted to write off losses sustained in all areas of their activities, and what the FDIC claims to be their equity capital. The difference between the two at the end of the first quarter of 1992 was \$500 billion of unaccounted losses, from dead real estate loans, etc. Even without the collapse of the international speculative pyramid, the whole U.S. banking system is dead. Such a chain reaction collapse is now under way. It is the proverbial Belshazzar's Feast for the \$320 billion daily currency volume of the City of London, sure not to survive in its present form. And also, for the bankrupt core of the U.S. financial system.