

‘Black Friday’: The financial dam begins to break

by William Engdahl

The largest daily point loss in the history of the Dow Jones Industrials, 618 points, combined with a whopping 9.7% fall in the Nasdaq, bringing that index down 25.3% in a week, and the ensuing drop of stock prices around the world on Friday, April 14, is being touted by Wall Street pundits and financial media as a short, sweet “correction” to overvalued stocks, especially in the Internet-heavy Nasdaq. Such soothing remarks are par for the course, but more sober minds see the events of the past month as the beginning of the greatest financial market upheaval of recent memory.

The April 14 stock meltdown came after intense “confidence building” efforts by the U.S. government, and suspected Federal Reserve market manipulations during the previous week, aimed at stabilizing increasingly volatile markets. Over the April 15 weekend, several Wall Street fund managers again were calling for some form of government or central bank “intervention,” as the only chance to stop the panic from getting completely out of control.

Nothing of substance was publicly released from the International Monetary Fund-Group of Seven gathering in Washington, which also began on April 14. But, reliable sources pointed out that among central bankers and top government officials, two contradictory lines were expressed. One side argued that the inflated stock bubble is simply unsustainable, and that the crash should be allowed to take its course, as long as it does not deteriorate into a breakdown of the global financial system. The other position argued that a stock market crash, even if it were contained, is politically unacceptable, because it would rip the floor out from under American politics.

Indicative of the first position were remarks on April 7 by Swiss National Bank director Bruno Gehrig. Speaking at a financial conference in Zurich, central bank official Gehrig

questioned whether central banks should act “in the event of an asset price crash.” His answer was blunt: “To be realistic, a simple recommendation is all that is in order: Those who buy equities bear the price risk themselves. People who, out of greed and carelessness, buy and sell in such a way that they cannot survive a brutal crash, have only themselves to blame. They must bear the consequences alone, even if it means their economic ruin.”

The other side was typified by U.S. Treasury Secretary Lawrence Summers, who appeared on two U.S. TV programs on April 16, urging investors not to panic, because “the economy of the United States is in better shape than it has been in a long time.”

There could be ‘a huge shift in sentiment’

Hong Kong-based financial investment strategist Marc Faber, echoing an earlier assessment by Lyndon LaRouche, told *EIR* on April 12, two days before Black Friday, “The Democratic Party, Clinton-Gore, and Greenspan have all been riding the bubble economy. The moment the bubble economy breaks, and there is growing pain and disappointment in the United States, there will be a huge shift in sentiment! . . . Already, the popularity of Greenspan is increasingly put in question, among financial analysts who previously praised him. Because of Greenspan, the bubble is much bigger than it was two years ago. Emotions of love and hate are very closely related, and can reverse themselves very quickly. If people in America lose money, negative sentiment will increase rapidly.”

The only intervention Greenspan is able to launch, within the existing financial policy framework, is a further opening of monetary floodgates. However, the inflationary effects of these time-buying “crisis-management” measures—which

the Fed began during the Mexico crisis in 1995, and accelerated after the worldwide Long Term Capital Management (LTCM) crisis in September 1998—can no longer be contained, as the latest consumer price data indicate.

In America's "new economy," inflation had been declared "dead." Now, seemingly out of the blue, official inflation is almost 4%. Any new liquidity-pumping to temporarily stem the crash in stock prices will inevitably show up in the near-term as galloping inflation. Greenspan and the Federal Reserve are faced with the dilemma as early as their Federal Open Market Committee meeting in May. If they again raise short-term interest rates, perhaps by even 0.5%, to convince the world that the Fed is serious about inflation dangers, will that trigger a market panic sell-off? If they do not raise rates, will that also trigger a panic sell-off by foreign holders of U.S. stocks and bonds, who fear that the Fed has lost control over inflation?

Watch the dollar

The sudden vanishing of some \$2.3 trillion in paper values on the U.S. stock market over the past four weeks, however dramatic, is but the beginning of a process of global reverse-leveraging of financial and monetary aggregates. The next phase will likely extend into the foreign exchange markets.

In 1999, the United States ran a record current account deficit of some \$338 billion. Yet, the dollar exchange rate has steadily risen since January 1999, especially against the weak euro. The reason the dollar has remained "strong" so far, is quite simple. The excess of U.S. imports over exports of physical goods (clothing, machinery, food, etc.) and other trade deficits, has been more than offset by record inflows of foreign investment into the U.S. stock bubble, mainly from Europeans. In 1999, according to data from the Securities Industry Association, foreign purchases of U.S. stocks, and of corporate and government bonds, reached \$365 billion, a 58% rise over 1998.

This situation cannot continue indefinitely. On April 19, another new all-time record monthly trade deficit of \$29.2 billion was announced. This signifies how dependent the United States economy is on *foreign output* of physical goods for basic consumption, and it shows the increasing size of foreign capital inflow needed to hold the dollar steady.

Yet, under conditions of contracting American stock markets, foreign speculators will be increasingly under pressure to liquidate U.S. stock holdings. That trend will likely extend into bond investments. Then, the financial market crisis in the United States will be transformed into a simultaneous currency crisis with global ramifications—a real "dollar crisis."

At that point, the Federal Reserve's "gradualist" measures of moderate interest hikes will probably be seen as useless by international investors, and radical measures will be demanded. The last major dollar crisis was in 1979, when Paul Volcker was brought in as chairman of the Federal Reserve to

administer monetary shock therapy, which drove U.S. interest rates above 20% and plunged the United States and most of the world into misery.

Even before a full-blown dollar crisis, the 11-nation European euro-zone is facing grim prospects, with the new virtual currency, the euro, falling to record lows. On April 20, the euro hit 93¢ to the U.S. dollar, falling on reports of growing business pessimism in Germany. That has been a drop of more than 20% since Jan. 1, 1999, when the euro came into existence. The continuing weakness of the euro is leading foreign speculators to leave European stocks and bonds, most recently for the booming Japanese stock market, where the Nikkei Dow index was up more than 58% in the fiscal year ended March 31. The euro has fallen most sharply, some 30%, against the Japanese yen, because of the capital flows.

Yet, Japan itself is anything but a picture of economic health. With a banking system still choking on an estimated \$1.5 trillion of bad loans, and a government debt nearing 130% of Gross Domestic Product, foreign investment into the Japanese stock market has been the only major source of liquidity for the depressed economy of the world's second-largest industrial nation.

So alarmed is the Japanese government about prospects of a global stock market meltdown hitting the Nikkei inflows of urgently needed capital, that it announced on April 17, the Monday after New York's Black Friday, that it was proposing creation of an emergency 1 trillion yen (\$9.6 billion) fund at the Ministry of Finance. The fund would artificially prop up the Tokyo stock market to maintain "confidence" of foreign speculators. Japan's stock market capitalization value is approximately that of the entire economy, \$4 trillion.

'Dead tech bounce'

The rapid rebound of the U.S. stock market, especially the Nasdaq, between April 17 and 20, is being referred to by financial market experts in Europe as a "dead tech bounce," a parody of Wall Street's traditional fake rally after a crash (a dead cat bounce), in which the remaining market insiders get out, leaving poor suckers and small investors to suffer the next blowout.

As was the case in October 1987, so today, suspicion is that what Wall Street calls "The Plunge Protection Team," the secretive group set up several years ago under the innocuous name of the President's Working Group on Financial Markets, has been hard at work. This is the government "crisis management" team, which includes the Treasury Secretary, the Fed chairman, the heads of the Securities Exchange Commission and the Commodities Futures Trading Commission, the Comptroller of the Currency, and the president of the New York Federal Reserve, which has intervened in every crisis in recent years, from Mexico to Asia to the LTCM collapse. And also, presumably, into the events of April 14.

Termed "the financial world's equivalent of the war room," by the *Washington Post* article of Feb. 23, 1997, the

Working Group reportedly intervened via Wall Street investment banks Goldman Sachs and Merrill Lynch on April 4, when the Nasdaq fell 13% by midday, then suddenly rallied several hundred points before the day's close. The two giant Wall Street houses started buying huge volumes of stock index derivatives—far cheaper than real stocks. The Nasdaq rebounded, and panic was averted—temporarily.

Although no details of what happened to trigger the 7% rebound on April 17, and again on April 18, suspicion is that the President's Working Group was not passive. Did they quietly make it known that the authorities would back up any risk by Wall Street on that day?

Regardless of whether such manipulation by the U.S. authorities has been the case, the situation is poised on the razor's edge for the next bit of unexpected bad economic data or bad financial news. With a balance of payments deficit soaring to record levels, a stock market plunging by double digits almost every second week, household and corporate debt levels are in no way prepared to endure even the mildest stock collapse. The April 18 *Wall Street Journal* noted, "American households have 56% of their financial assets tied to the stock market now, compared with 28% in 1989. Mortgage debt now equals 43% of the value of owner-occupied housing, compared with 30% in 1985. But now the hammer: in a balance sheet of more than \$30,000 billion, liquid assets in the form of bank deposits amount to less than \$4,000 billion. In short, the collective balance sheet of the American consumer is extremely illiquid."

Adding into the equation debt-to-equity ratios for U.S. corporations, "up over the last 10 years from 84 to 116," the *Journal* warns, "the stampede of both corporations and private households out of liquidity and into debt in recent years is without precedent."

It's time to begin thinking about a New Bretton Woods global monetary reorganization before the next break in the dam brings on the deluge.

Commentaries

'What, me worry?' some financial observers say

Alan Greenspan, Chairman of the Federal Reserve System, speaking on April 14:

"During a financial crisis, risk aversion rises dramatically, and deliberate trading strategies are replaced by rising fear-induced disengagement from market activity." He added that "fear-induced disengagement" can even refer to sell-off of such "riskless" instruments as Treasury securities.

Guest commentator on Bloomberg financial news radio, Washington, D.C., April 14.

He said that there is no threat of a stock market meltdown, but rather, the markets are seeking to achieve a "selling climax" level.

Treasury Secretary Lawrence Summers, in guest appearance on April 16 Fox News Sunday (Washington, D.C.).

Summers stressed that the U.S. economic "fundamentals are sound. Consumer spending is up." He urged investors not to panic, because "the economy of the United States is in better shape than it has been in a long time."

***Washington Post*, April 16, front page, headlined: "Stock Market's Loss May Be Economy's Gain," by Staff Writer John M. Berry.**

"If it doesn't go too deep, the big stock market correction of last week could turn out to be a boon rather than a disaster for a U.S. economy, the fundamentals of which remain about as sound as they ever have been, according to many analysts."

***New York Post* columnist John Crudele, April 19, headlined, "One Fund Manager's Value Picks."**

"Nobody would blame you if you hated stocks after last week. And there's a good chance that you'll be hating the market again in the weeks ahead as we get closer to the next Federal Reserve meeting.

"But there's usually at least one good strawberry in a bruised bunch." The column then profiles ten investment picks by a partner of Value Holding L.P., and the column concludes, "So, if you are tired of the .com crash, here are some stocks in boring industries that have room—and reason—to move."

***Business Week* ran as its cover feature, sent to press in advance of April 16's Black Friday, the story headlined, "Wall Street—Is the Party Over?"**

Its comforting blurb beneath the headlining read, "High-tech stocks are undergoing a much-needed correction. But relax, the overall market probably won't tank. What we're seeing looks more like a healthy flight to quality." The article looked at the April 4 stock market gyrations (far exceeded on April 14), and ran an analysis titled, "Don't Panic—Investors Are Just Seeking Quality." The article stated, "Even seasoned investors, who were coming to believe that Wall Street had signs pointing in one direction—up—were shaken. Is this just the beginning of a market shake-out? Is the party over?"

"No. April 4 was a day that crystallized the change in leadership of the bull market that began three weeks earlier. It is not so much a change from New Economy stocks to Old Economy stocks; rather, it is a flight to quality across the entire equity spectrum."