

The BIS Issues a Warning, But It Doesn't Have the Solution

by John Hoefle

The Bank for International Settlements (BIS), in a report issued on June 5, and in a major international press conference accompanying the release of the report at its headquarters in Basel, Switzerland the same day, confirmed what Democratic Presidential candidate Lyndon LaRouche has been warning about for years: that a global financial crash is right around the corner. While that assessment has been given banner headlines throughout Europe, the warning has been blacked out of the U.S. press.

“One point on which virtually everyone would agree is that the current rate of expansion of domestic demand in the United States is unsustainable and potentially inflationary,” the BIS stated in its 70th Annual Report. The report goes on to say that “it could be argued that the sooner the bubble deflates, the better.”

In remarks at the BIS Annual Meeting the same day, BIS President Urban Bäckström threw cold water on the assertions by the U.S. President's Working Group on Financial Markets (a.k.a. the Plunge Protection Group) that the U.S. economy was headed for a “soft landing.”

“We have witnessed too many crises in the last decade not to know that market confidence can shift suddenly,” Bäckström said. “A soft landing is by no means assured.”

He also warned of the rising levels of household and corporate debt in the United States, and the growing dependence of the United States upon foreign goods and money-flows. “Household and corporate balance sheets may look healthy when asset prices are stable or increasing, but what will they look like if prices fall?” he asked.

To underscore the BIS's warnings, the German economic daily *Handelsblatt*, in a commentary by Klaus Engelen on June 6 entitled “Dangerous Dynamic on Financial Markets,” noted that while the International Monetary Fund, the World Bank, and the Organization for Economic Cooperation and Development had proven records of not seeing financial crises in advance, the BIS had warned of instability in the emerging markets before the Mexican and Asian crises erupted. However, Engelen said, “all such earlier warnings from Basel had been ignored by euphoric markets.” Market participants are still not paying sufficient attention to the “emphatic warnings of the BIS concerning ever higher financial asset prices and the unsustainable foreign trade imbalances, in particular the U.S. current account deficit which is running out of control.” Engelen said that the issue was not one of how big the chances

were of a soft landing, but rather whether there is any chance at all to prevent a hard landing.

The blunt warnings reflect the realization by the BIS that the current global financial and monetary system is unsustainable, and that major changes are required to keep the system together. Such warnings, as far as they go, are valid, and represent a better understanding of the state of the world than anything flowing out of official Washington, but they still fall far short of reality.

Hard Landing, or Mid-Air Explosion?

The whole debate about “soft landing” versus “hard landing” is a fraud. The idea behind the soft landing is that the U.S. economy is growing so fast, that the pace of growth is unsustainable and might trigger inflation. Therefore, to slow the pace of growth and head off potential inflation, Federal Reserve Chairman Alan Greenspan has been raising interest rates. By gently putting the brakes on the economy, to use the aircraft metaphor, the Fed hopes to bring the economy down from its lofty heights to a safe and soft landing. The hard-landing crowd likewise assumes that the plane will land, but perhaps with significant damage. What is absent from this controlled discussion is a third possibility, that of a mid-air explosion.

In citing “the record U.S. current account deficit,” the BIS pointed squarely to the fact that the U.S. economy is being subsidized by the rest of the world. The current account balance (**Figure 1**), which hit a record \$100 billion deficit for the fourth quarter of 1999, represents the extent to which the U.S. economy is dependent upon foreign goods and investments. The deficit reflects both the inadequacy of U.S. goods-production to meet the needs of the nation's population, and the extent to which foreign funds have flooded into the country to participate in the U.S. market bubble and purchase other U.S. assets. Were this inflow to be interrupted or reversed, by a stock market crash or a sharp decline in the value of the dollar, the “soaring” U.S. economy would be lucky to make it to the ground in one piece.

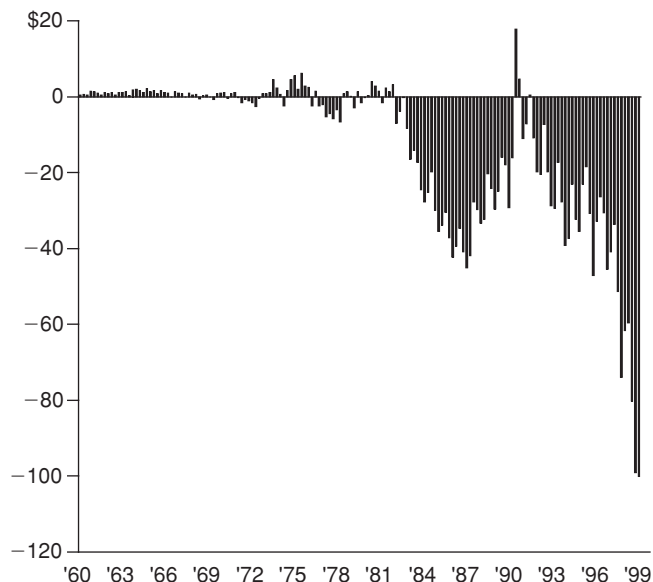
Controlled Burn

One aspect of the effort to bring the U.S. economy in for a soft landing, is the attempt to deflate the overblown U.S. stock market without triggering an investor panic. Make the change gradually enough, and the public will stay in the mar-

FIGURE 1

The United States Is Living Off the Rest of the World: Current Account Balance, 1960-99

(billions \$)



Source: U.S. Department of Commerce.

ket even as it declines, a variation of the frog-in-the-pot theory. (It is said—I’ve certainly never tested it—that one can put a frog in a pot of water on a stove, and that if one heats the water slowly enough, the frog will stay in the pot until it boils.)

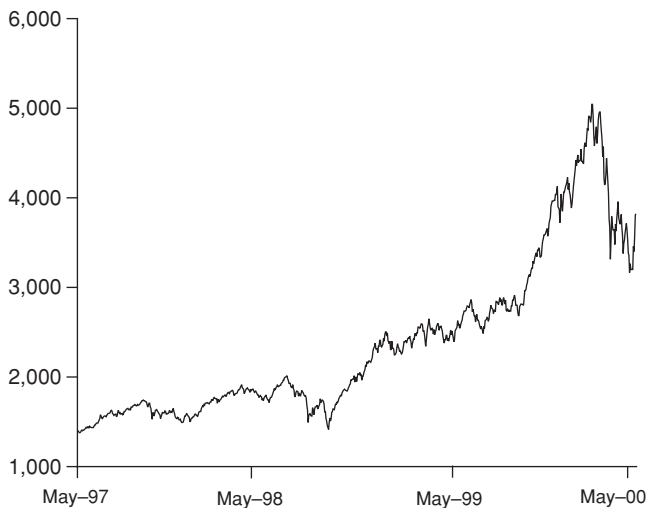
But a controlled and limited deflation of a bubble is a tricky operation, one which can easily get out of hand and trigger the very panic one is trying to prevent.

An analogy for the danger is the fire set by the U.S. National Park Service on May 4 in the Bandelier National Monument in New Mexico. The fire, intentionally set as a “controlled burn” to burn brush and dried timber on 1,000 acres in order to reduce the danger of a wildfire, rapidly went completely out of control, triggering the very wildfire it was designed to prevent. The result was the immolation of some 48,000 acres, the destruction of more than 200 homes and apartment buildings in the nearby town of Los Alamos, and the destruction of parts of the Los Alamos National Laboratory.

The 33% drop in the Nasdaq from mid-March to mid-April, including a 25% drop in just the week of April 10, shows all the hallmarks of a controlled burn (Figure 2). The drop was preceded by an international media propaganda campaign, beginning in Europe and then spreading to the United States, about the unsustainable nature of the “Internet bubble” and the necessity of a “correction.” One key aspect of the propaganda campaign was to prepare the public psycho-

FIGURE 2

Nasdaq Composite Index, 1997-2000



Source: Nasdaq.

logically for the sharp drop, to keep “investors” from panicking and fleeing the market. That aspect of the campaign was successful, as no panic occurred; the market stabilized, at least in the short-term, at a lower level, without an immediate collapse.

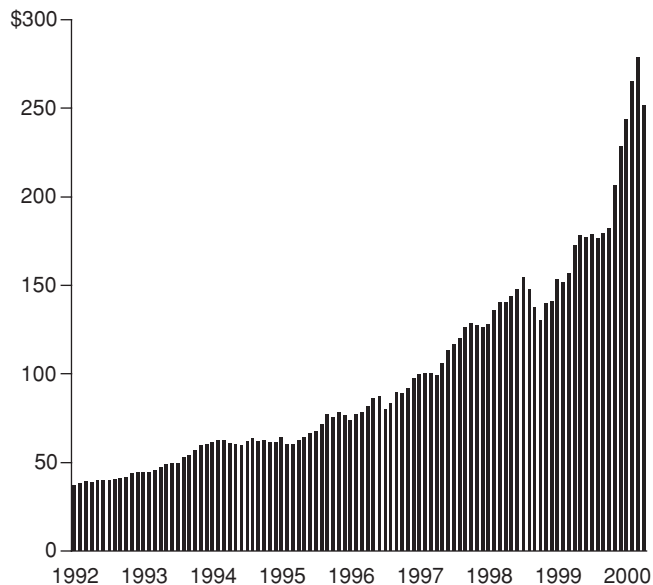
That does not mean, however, that no damage was done. The sharp drop in tech stocks generated serious losses for many investors, those not warned of the central bankers’ plans. Hardest hit were those who had hitched their futures to the Internet, and those playing with borrowed money. Some \$2.2 trillion in value (albeit virtual, rather than real) evaporated between March 10, when the value of all stocks traded on the Nasdaq peaked at \$6.7 trillion, and April 14, when it dropped to \$4.5 trillion. Many of the investors who got wiped out were playing with borrowed money, as indicated by the sharp drop in margin debt outstanding, by clients of the brokers which belong to the New York Stock Exchange. After rising 55% to \$279 billion from September 1999 through March 2000, margin debt fell by \$27 billion—nearly 10%—during April, ending the month at \$252 billion (Figure 3). Most of that reduction was due to investors getting hit with margin calls, and having to sell stock—and their most valuable stock at that—in order to pay their debts.

The impact of such market declines goes well beyond the markets themselves. Many people working in the tech sector have taken stock options in lieu of higher salaries, betting that the money made from rising stock prices will more than offset the lower wages. While this gamble has made many millionaires in a rising market, it will have the reverse effect in a declining one. Many would-be stock-option millionaires are under water, the option prices on their stock higher than the

FIGURE 3

Stock Market Margin Debt, 1992-2000

(billions \$)



Source: New York Stock Exchange.

current market prices, rendering their options worthless. Some of these have borrowed heavily against that planned stock-option money; in California's Santa Clara County, the home of Silicon Valley, for example, the median price of a single-family home was \$577,820 in April, up 45% in one year; nationally, the median price for a single-family home was \$136,700, suggesting hard times ahead for the Silicon Valley real estate market, as well as for other high-tech centers such as Northern Virginia and Austin, Texas. The commercial real estate market will also suffer from the shakeout on the tech sector, since all the new Internet companies required lots of office space, the demand sharply increasing rents in many areas.

The danger is also great in New York City which, according to a study by the New York Fed, is more dependent than ever upon Wall Street. The July 1999 study by the bank's Jason Bram and James Orr, shows that the securities sector generated 19% of the city's earnings in 1998, nearly double its contribution in 1987 and more than four times higher than in 1969. The securities sector itself employed 4.5% of the city's workforce in 1998, and given the U.S. Department of Commerce's estimate that each job on Wall Street generates two additional jobs in other sectors, Wall Street is directly or indirectly responsible for roughly 14% of the total employment in New York City.

In fact, according to economist James Parrott, Wall Street workers accounted for an astonishing 97% of the increase in the city's payrolls between 1990 and 1997.

There is an unexpected bright spot in the city's economy, according to the Fed study, and that is manufacturing, or rather the lack thereof. The manufacturing sector accounted for nearly half of the city's job losses and more than two-thirds of the decline in real earnings during the city's slump in the early 1970s, and was "a severe drag" on the local economy during the 1989-92 recession, as well. Today, manufacturing accounts for just 6% of local earnings, compared to 20% in 1969. "Because its importance to the city's economy has diminished significantly, another decline in the manufacturing sector would likely put far less pressure on the local economy than was true in previous downturns," bubbleheads Bram and Orr concluded, showing that the Fed doesn't have a clue when it comes to physical economy.

Reorganization and Manipulation

Coincident with the newly emerging bear market is a reorganization of certain financial warfare operations, particularly the large hedge funds. Julian Robertson's Tiger Management group of hedge funds, which once had \$23 billion under management and controlled many times that through leverage, has closed down, said to be a victim of Robertson's bet that the Old Economy would prevail over the New. The impression is given that Robertson was an old-style investor who just didn't understand the new era, when in fact Robertson was one of the bloodiest speculators on the planet. Stanley Shopkorn, the man who, as head trader at Salomon Brothers, is credited with doing much to prevent the Black Monday Crash of 1987 from melting down the financial system, and is now an investment guru with the \$10 billion Moore Capital hedge fund group, is taking a sabbatical this summer to cruise the Mediterranean.

Then there's the case of drug-legalizer George Soros and his Soros Fund Management, at one time worth \$22 billion. After the March-April slide of the Nasdaq, Soros announced he was downsizing his operation into a more conservative style of investing. With the change came the resignations of his two top fund managers, Stanley Druckenmiller and Nicholas Roditi, and the departures of chief financial officer Peter Streinger and chief executive Duncan Hennes.

Nominally, the reorganization at Soros Fund Management comes as a result of sharp losses on the tech stocks in the wake of the April-May Nasdaq slide, but there are indications that the truth runs deeper. Last autumn, with his funds down slightly for the year, Soros made a sharp push into technology stocks, buying enough to end the year up 35%. Between mid-October and mid-March the Nasdaq Composite Index nearly doubled, rising an unprecedented 88%. Some Wall Street observers have attributed a significant portion of that rise to Soros's heavy buying.

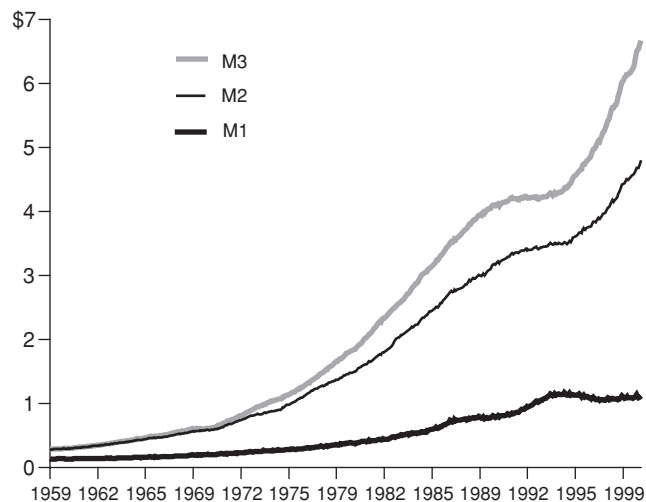
The timing between the controlled burn of the Nasdaq and the announcement of the reorganization of the Soros funds, suggests the possibility that Soros also played a role in setting that particular fire.

The idea of an orchestrated run-up and take-down in this

FIGURE 4

Monetary Inflation Feeds the Bubble: U.S. Money Supply Grows, 1959-99

(trillions \$)



Source: Federal Reserve.

highly manipulated environment is nothing new. By running up the Nasdaq at the end of the year, large profits could be gained to offset losses — particularly hidden losses — from the spring and summer turmoil. Once in the new year, the insiders could sell off into a rising market, taking one last profit fling while sticking the suckers with the looming losses. Even investors in the Soros funds, which were down 22% for the year as of the end of April, could have covered their losses with offsetting bets.

Hyperinflation

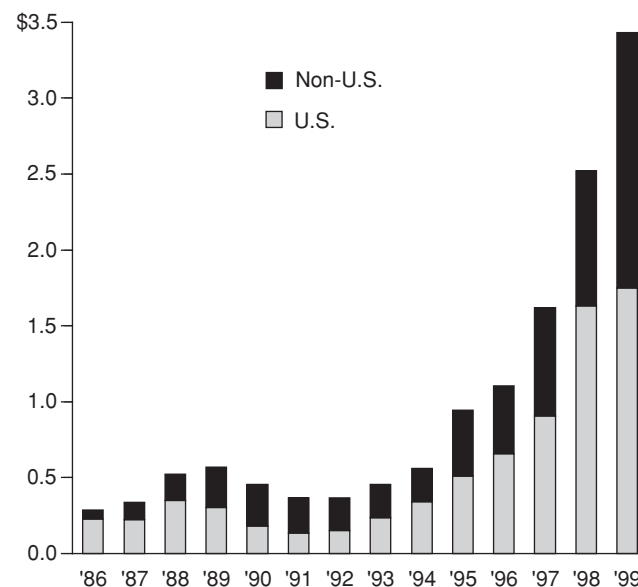
Beginning with the global financial crisis which broke out in Asia in the summer of 1997, and continuing through the subsequent “Russian,” “Long Term Capital Management,” “Brazilian,” “Tiger,” and other, better-hidden events, the central bankers have responded to each crisis with what Soros himself called “a wall of money.” Throwing money at problems is nothing new for the bankers, as the sharp growth in the U.S. money supply since 1992 indicates (Figure 4). But as the money flows in, the instability grows and the crises come ever faster and larger. That is because the increased money for the bubble comes by further cannibalizing the physical economy, heaping ever more financial claims on an economy whose ability to pay those claims is shrinking.

The result is a self-accelerating, leveraged turbulence which, according to LaRouche, has reached the point where the monetary aggregates are now growing faster than the financial aggregates. In such a period, the money will begin to lose value faster than it can plug the holes, leading to a Wei-

FIGURE 5

Global Cartelization Escalates: The Value of Announced Mergers, 1986-99

(trillions \$)



Source: Thomson Financial Securities Data.

mar-style hyperinflation, where the value of money itself goes into a free-fall.

Another aspect of this nascent hyperinflation is the surge in commodity prices in the recent period, typified by the rise in the price of oil. One of the factors in this is the accelerating level of mergers in the economy (Figure 5). Due to the extraordinary levels of debt taken on in these mergers, the companies are forced to raise prices in order to show a profit. Thus, the attempt to outpace the collapse via consolidation, actually brings closer the demise.

While the warnings issued by the BIS have some validity, the solutions it puts forward do not. The BIS does not wish to kill this global financial parasite—which would be tantamount to suicide—but merely to exert tighter control over its growth, to avoid killing its host. The BIS is, as its report shows, in favor of the continued deregulation and globalization of financial markets, taking ever more control out of the hands of nation-states and giving it to the oligarchic forces which control the financial system and the BIS itself. It is not the process, but the perceived excess, which the BIS deplors.

Thus, the BIS, like the speculators it is trying to curb, is doomed by its inability to break free of its own failed axioms. They are all actors on a stage, not controlling the action, but being controlled by it, in a tragedy of historic proportion. Only by stepping out of their roles and joining LaRouche, can they survive.