EIR Feature

October financial crisis happened on schedule

by Lyndon H. LaRouche, Jr.

Introduction: During the spring of 1987, candidate LaRouche forecast that under then-existing economic policies, the U.S. financial markets would slide down over the interval between August and October, and reach the brink of a major financial crash during the month of October. (See Executive Intelligence Review, *June 5, 1987; also an early summer radio interview on New York's WABC-AM "Bob Grant Show.") The candidate is a leading authority in the science of physical economy, and has been one of the most successful economic forecasters over the 1980s to date. He summarizes the most important facts about the Oct. 6-16 crash in the Dow Jones Index. Mr. LaRouche released his statement on Oct. 17.*

George Santayana is often quoted as warning that those who refuse to learn from history are doomed to repeat it. So, as a result of repeating the mistakes of Coolidge and Hoover, since the 91-point Dow Jones plunge of Tuesday, Oct. 6, the published interviews with administration officials and Wall Street financial analysts echo the wishful delusions of Coolidge and Hoover officials under similar circumstances over the period 1927-31.

It is too soon to say that the October panic on Wall Street will be the big financial crash leading European bankers have been forecasting for six months. The governments and central bankers of the International Monetary Fund's G-7 group of leading industrialized nations could conceivably postpone the full-scale panic for a few more weeks or months. If the big crash comes in October and November, it will be because, as leaders in Europe and Japan are saying, the Reagan administration is so committed to the myth of "59 months of recovery," that it refuses to accept and act on the reality of the situation.

The tendency of many people will be to go off half-cocked in one direction or another. Some hysterics will insist that "this is only a correction in the bull market"; others will cry that "the sky has fallen." For the moment, until we see which way the situation turns during the coming two weeks, cooler heads will stick to three facts about the developments of the Oct. 6-16 period.

1) The world came up to the edge of an inevitable financial crash during

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Crowds gather at the New York Stock Exchange on Oct. 20, 1987, the day after "Black Monday."

October trading. What has happened up through Oct. 16, is a financial earthquake about 6.3 on the Richter scale; it is not yet the big financial earthquake, between 8 and 10 on the Richter scale, which we are expecting sometime soon.

2) Whether the expected big crash occurs during late October or November of this year, or later, depends upon how the Reagan administration reacts to the events of the past two weeks.

3) Ignore what the Wall Street financial analysts say to the press. No one has a crystal ball on the situation, including the economist, LaRouche, who called the October crisis on the button six months ago.

How and when the big crash comes, depends upon interaction of four factors:

1) The international and U.S. economic situation, without considering the monetary and financial market statistics and trends.

2) The interaction between the economy and financial markets.

3) Political decisions by governments and the establishment generally.

4) Strategic factors, including breaking developments in the Persian Gulf, South America, the Far East, the U.S. defense budget, and the scheduled Reagan-Gorbachov summit.

Concentrate on the first two points. Most so-called experts, including the stock brokers and the Reagan administration's officials, make very foolish predictions about both the economy and financial markets. The root of their blundering is that they refuse to recognize the differences between real economy and monetary processes; as a result, they confuse these two very distinct factors. As a result of not recognizing the differences, they are unable to understand how these two very different sets of phenomena interact.

As the only presidential candidate who called the shot on these developments, and as an economist, I explain a few of the ABCs.

Twenty years of illusion

Since President Johnson introduced the "post-industrial society" to official U.S. policy, back during 1967, all of the Western economies, excepting Japan's, have suffered a long-term collapse of productivity and tangible investment in agriculture, manufacturing, other industry, and basic economic infrastructure.

The level of development of U.S. basic economic infrastructure peaked in 1970. Since then, earlier investments in infrastructure have been rotted out by lack of maintenance, to the point that we would have to invest more than $3 trillion in repairs today, to bring water-management, production and distribution of energy, general transportation, and basic urban residential and industrial infrastructure back to 1970 levels of quality per capita.

Agriculture has been collapsing since 1977-79, and is now in an accelerating state of collapse worldwide. The percentage of the labor force employed in goods-producing manufacturing and other industries has collapsed to levels of the early 19th century, while real productivity of operatives has fallen as a combined result of lack of tangible investment, lack of growth of energy supplies, and the accelerating spread

of functional illiteracy into even the ranks of high school and college graduates.

If we factor depreciation of basic economic infrastructure as a cost of production, as we should, the real output of the U.S. economy per capita of adult population has been collapsing at an accelerating rate for about 15 years, especially over the recent 10 years.

Worldwide, the situation in Britain is far worse than in the U.S. A. Italy is in a state of collapse. West Germany is falling fast, although it has not yet fallen to U.S. levels. France, the most nationalistic of all Western industrialized nations excepting Japan, has resisted the trend better than the Americas and most of Western Europe, but France is suffering the effects of the same general trends.

Yet, during most of the same 20 years, the official statistics show these collapsing economies to be growing. In part, this is because of inflation, and the natural tendency of politicians in power to order official statistics to be faked in anticipation of the next elections; the rate of inflation has been understated consistently. Even if we assumed that the rate of inflation is no greater than official statistics state, it appears that the gross national product of these economies has been growing.

Since the present Gross National Product system of national income accounting was introduced, during and following World War II, governments and supranational economic and monetary authorities have been using a yardstick which measures the financial growth of economies, but not their economic growth. The yardstick used is "value added," the difference between the price of purchases and the price of sales. The total of the estimated "value added" is then seen as Gross National Product. The result has been that Gross National Product never has better than an accidental relationship to economic growth.

For example, suppose I shut down the physical production by General Motors in all categories. General Motors shifts from producing goods, into a combination of reselling imported products plus investments in real estate and other financial speculation. However, General Motors hires more clerical and sales personnel than earlier, to handle the administration and sales functions of the new lines of business. Under certain conditions of this kind, the "value added" shown on General Motor's books will be even higher than during the time it was still producing useful objects.

This has been the trend in the U.S. economy over the past 20 years. A smaller ration of our workforce is employed in producing wealth, while an increasing ration of the workforce is employed in "overhead burden" occupations of administration, sales, and relatively unskilled services.

On top of this "post-industrial" shift into becoming a "services economy," has been piled a vast bubble of financial speculation in real estate and even outright "junk bonds." The "value added" shown on the books of poor financial speculation has become the key margin of growth in apparent U.S. Gross National Product.

The big bubble

To understand what has happened on Wall Street over the Oct. 6-16 period, the fundamental distinction between economy and financial markets must be recognized.

"Economy" means "physical economy": the production and distribution of useful kinds of physical goods to productive enterprises and households.

We measure this in terms of two factors, the amount of physical production per capita, and the amount of physical production per square mile of land in use. Since human productivity is affected by the level of cultural development of the workforce and managements, as well as the physical well-being of the households from which the workforce is recruited, we include categories such as direct production management, science, and engineering, education, and health care and public health services as part of the direct labor cost of everything produced.

Every other form of employment and income-related activity is part of the "overhead burden" of the physical economy.

Over the past 20 years, especially the past 15 years, the physical economy of the United States has been in decline, but the Gross National Product has been rising during most of these years. The difference is that real growth is measured in terms of physical output and productivity rates in production of physical output; Gross National Product is measured in terms of financial data.

Without understanding the fundamental difference between the two kinds of measurement, it is impossible to understand why the world's biggest financial crash is coming, and what happened to the stock market this month.

A purely financial market is measured in terms of what is commonly termed a "price-earnings ratio": For example, the ratio of the price of a stock to the combined dividends and retained earnings of a corporation. Under normal conditions, "earnings" have a significant connection to real production; the net earnings of farms, industries, and utilities are a large factor in determining the market price of common stocks, and so on. Under normal conditions, a price-earnings ratio of between 10 to 1 and 20 to 1 would be competitive.

Compare such a normal range of price-earnings ratio to the price-earnings ratio on the American financial markets today. By normal standards of the 1950s or early 1960s, the market is floating in the vicinity of 1,000 to 1. The amount of combined dividends and retained earnings from production available to holders of financial paper, is floating near 1,000 to 1.

This has happened because the price-earnings ratio is being determined by financial capital gains on actual or expected resale price of financial paper. Financial analysts describe the result by saying that "financial markets are highly leveraged." Financial paper is sold at prices based on expected financial capital gains, at a time when the ratio of expected capital gains of this sort is many times the amount of real earnings from production.

Worse, most of the holdings of financial paper are based on credit borrowed at very high prices compared to levels of interest rates during the 1950s and 1960s. This includes so-called "creative" forms of financial assets, including "junk bonds." Raising the Wall Street stock market to above 2,700 points on the Dow Jones Index, has depended upon a massive flow of inflationary credit of this sort into markets, plus heavy inflow of cash dollar assets from Saudi Arabia, Japan, and Western Europe. The higher the price of stocks zoomed, the more inflationary credit, plus Saudi, Japanese, and European cash was needed to cause the market to continue rising.

If this did not occur, if the stock market ever slowed its rise in prices significantly, the source of new capital gains would be dried out. Without new capital gains of that sort, the market would spin into a chain-reaction collapse.

So, the growth in financial markets—in Europe and Tokyo, and well as the United States—has been a classical financial "bubble," like John Law's famous "Mississippi bubble" of the early 1700s, and the South Sea Bubble which popped in Britain during the same period. It is a "bubble" like the "Pyramid Club" fad which victimized many duped U.S. citizens during 1949, or the famous "Ponzi" scheme earlier. It is a "chain-letter" scam, which collapses once the market runs out of an expanding number of suckers to pay into the scam.

Sooner or later, the Wall Street financial bubble, and the giant U.S. real estate bubble had to pop, and carry the already depressed U.S. economy into a deep depression with it. By spring of this year, it was clear that the bubble had been stretched almost to the breaking point.

How the bubble is being burst

The bubble was ready to burst at the end of 1981. My associates and I warned this was coming at the beginning of 1982. During the spring of 1982 I warned the world that a "debt bomb" was about to explode in Central and South America. I forecast the explosion to begin during the period of August and September that year.

At the request of leaders of some nations of Central and South America, in June of that year, I wrote a detailed report, titled *Operation Juárez,* explaining the nature of the crisis, and detailing the measures which both these nations and the U.S. government must take. Copies of this report were delivered to both the Reagan administration and governments of Central and South America during the first week of August 1982. About two weeks after my report had been delivered, the debt bubble popped in Mexico.

During a period of about two hours, the world financial system wobbled on the brink of a "new 1931 collapse." President Reagan telephoned Mexico's President José López Portillo. This telephone call saved the world's financial markets for a moment, but the crisis continued.

President López Portillo acted as my *Operation Juárez* report specified. The world was saved for another month. The governments of Argentina and Brazil promised to support Mexico's policy, but both later broke that promise. The Reagan administration rejected my *Operation Juárez* option, and moved to crush and loot Mexico, and to proceed to loot every nation of Central and South America. Wall Street had demanded this; the Reagan administration capitulated to Wall Street.

By various tricks, since October 1982, the Reagan administration and the IMF have bought five years of continued existence of the sick old financial system. For this five years, we have paid a terrible price. What could have been the easily manageable "debt bomb" crisis of 1982, has been pyramided into the biggest financial crisis in history.

During 1983 and 1984, and on into 1986, defenders of Reagan administration policy told me: We rejected your policy in October 1982, and we have succeeded in delaying the crash for five years; we can delay the crash another five years if we choose to do so.

In April of this year, I shot back: You are near the end of your rope. During the August-October period, you will come right up to the brink of the biggest crash in history; it might just go all the way. Even if you get out of October without a crash, you will not be able to stop the crash, under present policies, for more than a few weeks or months after that. The probability is that the crash will explode this autumn.

They replied: No, it is you who are wrong. Your analysis of the problem is right, but your forecast is wrong. You will see, we will delay the crash until after the 1988 elections, and George Bush will be elected the next President.

I was right; they were wrong. It is still barely possible that the main part of the worldwide financial crash could be put off for a few more weeks or slightly longer. It is not likely that any Republican candidate will be elected President in 1988, or 1992, or 1996. The memory of Herbert Hoover's Great Depression will hang around the neck of the Republican Party for years to come.

Financial forecasting

In physical economy, we are able to predict cause and effect with rather good precision; no one can predict a crash with exactness. The reason for this difference is elementary. Physical economy is essentially a branch of physics; we can not predict with quite as much precision as we can predict in ordinary physics experiments, but the situation is about the same in principle. Developments in financial markets are a mixture of physical realities and psychological-political factors, with enough elasticity that events like financial crashes in markets can come either earlier or much later than conditions are fully ripe for such developments.

I made my first serious forecast at the end of 1956. I forecast a deep recession would begin about March 1957, and that the recession would hit with full force about September 1957. It happened that way. At the end of 1957, I estimated that the financial collapse of 1957-58 would bottom out about the middle of 1958; that happened as the central bankers ambushed major speculators, and taught them a pain-

ful lesson during the spring of 1957.

My second major economic forecast was nearly as successful. I forecast that the first of a series of financial crises would hit the Bretton Woods monetary system during the second half of the 1960s, as early as 1965. I underestimated the Kennedy administration, which stimulated the economy with the combination of its Apollo program and the Kennedy round of investment tax-credit incentives. The monetary crisis did not erupt until the interval between November 1967 and March 1968. The second major monetary crisis hit over the period May-August 1971.

I am not running for President on the banner of the new depression; I am running on the platform of the recovery. Don't flounder there, screaming and drowning about the $4 or $5 trillion doomed to be wiped out by the crash; join me in swimming out of this mess. Let us get back to work, producing real physical wealth once again; with enough working . . . we shall all survive quite well. . . .

I did better in October 1979. I forecast that the Volcker measures instituted that month would set off a major recession beginning February 1980. A few weeks later, my associates' computer-assisted forecast gave what proved to be good estimates of precise dates and depth of the 1980 recession. Our forecast was the only accurate forecast published during the years 1980-84; the leading competitors, such as Wharton, Chase, and Data Resources were way off the wall.

Then, during 1983, the Reagan administration and Federal Reserve System began to fake their published statistics as never before in U.S. history, so that it became impossible to make precise forecasts with available statistics. Nonetheless, even without usable statistics, our general estimates on trends continued to be the most accurate available.

Good forecasting of monetary developments means starting with a sound economic forecast. This defines the situation in which the financial markets and related monetary developments are being shaped. The governments and central bankers have a wide latitude of things they can do to delay a crash when a crash is already overripe. So, to forecast monetary developments, one must imagine oneself inside of the mind of the money managers. One must imagine what they might be able to do to postpone the crash as they wish to do. One must see what they will attempt to do, and then ask oneself if that can be made to work.

By spring 1987, it was clear to me that Treasury Secretary James Baker and Federal Reserve Chairman Paul Volcker were running out of monetary options. First, the dollar was collapsing on world markets; that meant that interest rates were going to begin climbing upward again within two or three quarters. Once the overstretched financial bubble was caught between the Scylla and Charybdis of a falling dollar and rising interest rates, the show was at an end.

As long as Baker and Company were able to inflate the U.S. financial markets, and draw down large cash contributions from the Saudis, Western Europe, and Japan, the financial bubble could be kept intact. So, from the time the crash was set into motion, by the London stock market deregulation of autumn 1986, the biggest worldwide financial crash was being prepared by a temporary expansion of the financial bubble. However, as a falling dollar put pressure on shaky bond markets, which began in the spring of 1987, a self-feeding spiral of collapse was building up in bond markets, behind the other parts of the financial markets.

This meant, that to keep the U.S. financial markets up, Baker and company would have to inflate the markets; however, to defend the bond markets, Baker and company would be pushed into raising interest rates, and would thus force Western Europe and Japan to do the same. Rising interest rates, combined with a continued slide of the dollar would nullify the Louvre monetary agreements on supporting the dollar.

This could not be delayed much beyond early August 1987. If this began to build up during August as it must, after the end of the third quarter, about Oct. 10, the first seismic shock of a new worldwide crash must hit. It could go all the way, to become immediately the big crash the world was expecting; or, it could be just the first shock, with the big shock to come weeks later.

In other words, to forecast major turns in monetary processes, we must first identify critical boundary conditions, at which the psychological-political factors break down. A vise of combined falling dollar and rising interest rates is that sort of boundary condition. The governments and money managers can not resort to inflationary tricks on the scale needed to stimulate financial capital gains at the rates needed to hold up the markets; that would blow up the markets. The alternative to inflation, rising interest rates under conditions of declining dollar values, sets up the conditions for a deflationary blowout.

The only alternative to this, under existing monetary policy, is imposing a very savage sort of austerity, of the kind governments would rarely risk during an election year. The only other alternative, is to scrap existing monetary policy, and to reinstitute the strict regulations needed to stabilize currencies, government bonds, and keep open the doors of banking institutions. That would work, but it would mean

scrapping every economic and monetary policy of both the Carter and Reagan administrations.

In 1787-89, the United States was at the edge of national bankruptcy. Benjamin Franklin, George Washington, Alexander Hamilton, and others recognized the nature of the problem, and organized a constitutional convention for the purpose of creating the kind of strong federal government needed to reorganize the economy.

The combination of the strong presidential system, under the new Constitution, and Washington's and Hamilton's organization of what was called "the American System of political economy" rapidly transformed the economic situation. In that sort of economy, described in Hamilton's reports to Congress on the subjects of public credit, a national bank, and manufactures, was established a different sort of economy than the chaotically deregulated mess we have today. In such a national economy, accurate economic forecasting is much easier to accomplish than under the present sort of chaotic, deregulated, and bankrupted "free trade" system.

Under the American System of Washington and Hamilton, financial flows are tied very closely to both tangible investment and production rates. In that system, earnings on production and financial earnings of enterprises are very nearly in correspondence. So, in that case, an economic forecast is also a very good estimate of financial trends, as it is not under the monetary order of the past 20 years.

For that reason, if we respond to the present crash by returning to the principles of the American System—as we must if we are to get out of this depression—we can forecast the results with much better precision than has been the case over the past 20-odd years. In other words, we can promise what will work, and how well it will work, with rather accurate estimation.

What I will do as President

The first thing I must do as the next President, is to declare a national economic emergency. This permits the federal Executive and the Congress to take a series of measures to bring the financial situation under control, and to launch a general economic recovery.

The emergency powers of government must be used to reorganize the Federal Reserve System, to the effect of establishing a national bank along the lines of Washington's Bank of the United States.

The Federal Reserve System ceases to issue Federal Reserve Notes. Instead, the President sends an emergency bill to the Congress, under the authority of Article I of our federal Constitution. This bill authorizes the Treasury to issue at least $500 billion of Treasury currency-notes. These notes are loaned through member-banks of the Federal Reserve System at federal interest rates of between 1% and 2% for an approved list of applications of such loans.

These loans, which will total several trillions of dollars during the four years of the next administration, will get the economy moving again.

The President must act under emergency powers to impose those measures of federal regulation of foreign and interstate commerce, and foreign exchange, provided under Article I of the Constitution. These measures stabilize the dollar, and foster a revival of general transportation, energy production, and hard-commodity trade.

The President must not only mobilize a strict and effective defense of the U.S. dollar and government bonds; the doors of essential local banks must be kept open for business, and the savings of depositors defended at par value. Other financial paper, except new loan issues, will be allowed to float down to stable levels in an open market.

Foreign trade balances must be defended by help of both exchange controls and export-import licensing. A gold-reserve system, somewhat like the pre-1968 arrangements, must be reestablished, with monetary gold at a fixed price corresponding to the fair market price of newly produced gold; this is needed as part of the measures to defend both the U.S. dollar and the value of government bonds.

Loans at low interest rates must be channeled into investments in capital goods and other operating capital for production, in agriculture, industry, basic economic infrastructure loans to federal, state, and local agencies and utilities, and for export production loans.

The tax laws must be immediately revised to provide investment tax-credit incentives to investors, banks, and private savers. All available credit and savings must be mobilized to build up employment in production and marketing of useful physical output, with an included target of 5 million more manufacturing jobs for operatives added during the next four years.

Let us sum up the situation facing us.

"Yes, John, we are plunging into the Second Great Depression of this century, potentially a depression much worse than that of the 1930s. What's the point of yelling at a man who has fallen overboard, over and over again, 'Hey, guy, you are drowning!' The thing to do, is to concentrate on helping the man to learn to swim, and that very quickly."

The first shock of the biggest financial crash in history has happened. The next, bigger shock, is about to hit, either immediately, or soon enough. No need to dwell much longer on that fact. The point is to start swimming to safety; we ought to concentrate our attention on that. We are going to pay for the mistakes of the past 20 years, but why think about that any more than we must? The place to concentrate our energies is on the recovery.

I am not running for President on the banner of the new depression; I am running on the platform of the recovery. Don't flounder there, screaming and drowning about the $4 or $5 trillion doomed to be wiped out by the crash; join me in swimming out of this mess. Let us get back to work, producing real physical wealth once again; with enough working, producing the physical things we need, we shall all survive quite well, and find ourselves able to bring our financial affairs back into order once again.