The worldwide crisis today

by Maurice Allais

This is part two of a three-part series by French economist Maurice Allais, Nobel Prize winner in Economic Science in 1988, which appeared in the French daily Le Figaro *on Oct. 12, 19, and 26, 1998. (Copyright* Le Figaro, *no. 9812009.) Professor Allais has kindly granted* EIR *permission to reprint his articles. Part one appeared in last week's* EIR.

Maurice Allais

Abstract: The world economy, deprived of any system of regulation, could only run into major difficulties.

Beginning in June 1997, a monetary and financial crisis broke out in Asia that is still ongoing today. The unfolding of this crisis was very complex, but, in its main points, three different phases can be distinguished: from June to December 1997, from January to June 1998, and from June 1998 to October 1998.

The first phase, purely Asian, from June to December 1997, began with heavy speculation against the Thai currency, leading to its being devalued by 18% on July 2, 1997. During this period, Asian currencies and stock exchanges fell: Thailand, Malaysia, Indonesia, the Philippines, Taiwan, Singapore, Hong Kong, South Korea. The average drop of their stock indexes was about 40%. In dollar terms, the currencies of Thailand, Korea, Malaysia, and Indonesia were depreciated, respectively, by 40%, 40%, 50%, and 70%.

During the second phase, from December 1997 to June 1998, after a short price increase in January-February, Asian stock exchanges dropped further. Over the whole period, the average drop in prices was about 20%.

An outstanding feature of this period was the pullout of short-term American and European capital from Asia, leading to asset price rises on their stock exchanges. The rise was especially steep in Paris, where the CAC 40 rose by 40% between December 1997 and July 1998, twice as much as in New York.

The end of this period was marked by a sharp drop in raw materials prices and an approximate 60% collapse of the Moscow stock exchange. During this period, financial intermediaries in Japan met increasing difficulties, and the yen continued to fall. Latin American currencies also came under pressure.

The third phase began in July 1998, when political, economic, and monetary tensions were very high in Russia. The ruble became inconvertible. By Sept. 2, it had lost 70% of its value, and hyperinflation was set off.

In the United States and Europe, stock prices plunged. The CAC 40 went down by a spectacular 30%.

A climate of pessimism, if not of distress, quickly spread throughout the world. No one today really seems able to predict the future with any certainty.

In the Asian countries whose currencies and stock exchanges were severely hit, speculative capital flight caused serious social problems. What is troublesome, to say the least, is that the major international institutions are much more concerned about the losses of speculators (improperly called investors) than the unemployment and misery such speculation causes.

Striking similarities

There are striking similarities between the present world crisis and the Great Depression of 1929-34: creation and destruction of means of payment through the credit system; financing long-term investments with short-term borrowed funds; development of a gigantic debt structure; massive speculation on stocks and currencies; a fundamentally unstable financial and monetary system.

However, there are major differences between the two crises.

In 1929, the world was divided into two distinct zones: on the one side, the West, essentially the United States and Europe, and on the other, Soviet Russia. A large part of what is today the Third World was dominated by colonial empires, essentially the British and French empires.

Since the 1970s, globalization of economies is on the rise, including in countries of former colonial empires, and in Russia and East European countries since the fall of the Berlin wall in 1989. The new division of the world is based on inequality of economic development.

Since the 1970s, a second major difference has appeared with respect to the world in 1929.

Abrupt, excessive globalization has itself created major difficulties. Potential social instability has appeared every-

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Maurice Allais: a profile

Maurice Allais was born in Paris in 1911, and graduated from the Ecole Polytechnique, first in his class, in 1933. He began his professional career as an engineer in the national mining industry, simultaneously working on economics and history.

From April 1948 on, he devoted his time to teaching, research, and writing, working in both physics and history. Although he retired in 1980, he has continued to work actively in all these areas.

Allais is the recipient of many awards, including 14 scientific prizes. As he notes in his essay "My Life Philosophy" (which appeared in *The American Economist,* Vol. 33, No. 2, Fall 1989), "Over the past 50 years, I have never stopped reflecting and working on the problems involved in the elaboration of a unified theory of physics."

For two more of Professor Allais's contributions, see the Spring 1998 issue of *21st Century Science & Technology* magazine.

where, with a very sharp increase in inequalities in the United States and massive unemployment in western Europe.

Russia and the East European countries have also run into major difficulties due to over-hasty liberalization.

Whereas, in 1929, unemployment in Europe only followed the financial and monetary crisis, *already today* there is massive unemployment in the European Union, for very different reasons, but this unemployment can only grow much worse if the financial and monetary crisis develops further.

In fact, we can hardly insist enough on the far-reaching, essential similarities between today's crisis and preceding crises, of which the most significant was certainly that of 1929. What is important is not so much the analysis of the relatively complex *technicalities* of the present crisis, as a profound understanding of the factors leading to it.

Such an understanding is needed to make a correct diagnosis of the present crisis and to elaborate suitable reforms for ending those crises that have constantly been destroying economies over at least the past two centuries, and gaining in force as they progressively spread out to the entire world.

Creation of money ex nihilo

Fundamentally, the mechanism of credit leads to creating means of payment *ex nihilo,* because the holder of a bank deposit considers it as available cash, while at the same time, the bank has lent out most of this deposit which, whether it be redeposited in a bank or not, is considered as ready cash by the recipient. So for every operation with credit, there is monetary duplication. The mechanism of credit leads to the *ex nihilo* creation of money through simple bookkeeping entries. It is fundamentally unstable, because it is essentially based on fractional covering of deposits.

The volume of bank deposits depends in fact on a twofold decision: The bank agrees to pay on demand, and borrowers agree to go into debt. Because of this, the total amount of the monetary supply is highly sensitive to cyclical fluctuations. It tends to grow when there is optimism, and to decline when there is pessimism, producing destabilizing effects.[1]

It is certain that these fluctuations result, for the most part, from the mechanism of credit, and that, without the amplification of monetary creation (or destruction) by the credit mechanism, cyclical fluctuations would be greatly reduced, if not totally suppressed.

From time immemorial, there has been talk of *credit miracles*. For the receivers of credit, there is in fact something miraculous in the mechanism of credit, because it creates *ex nihilo* a purchasing power that is actually used on the market, even though it cannot be considered as remuneration for a service rendered.

Although it is fundamentally useful for banks to mobilize *real savings* in order to finance productive investments, it is just as fundamentally harmful to create *false rights* by monetary creation, harmful both to economic efficiency which is jeopardized by price distortions, and to income distribution, which is changed and becomes unfair.

Financing long-term investments with short-term borrowed funds

The bank uses short-term demand deposits of clients to finance medium- or long-term investments corresponding to loans made to clients. This activity is based on the exchange of the bank's promise to pay at a given time, against the client's promise to pay at a later date, conditional on paying interest.

The total amounts of assets and liabilities on a bank's balance sheet are of course equal, but this equality is purely on paper, since it results from comparing elements of a different nature: Liabilities include demand and short-term obligations of the bank, and assets include longer-term credits corresponding to loans made by the bank.

This means that the whole banking system is in a state of *permanent potential instability,* since at any and all times, banks are absolutely unable to respond to massive pullouts of demand deposits or of short-term deposits coming to maturity, as their assets are only available at later dates.

If all investments in underdeveloped countries had been

1. Because variations of overall spending depend on both the excess of the money supply over the total volume of desired cash balances, and the variations of the money supply, the credit mechanism has an overall destabilizing effect, because in times of expanding global expenditure, the money supply increases while the desired cash balances decrease, whereas, in times of recession, the money supply decreases while the desired cash balances increase.

financed through private bank loans of a sufficiently long maturity, and if the deficits of the U.S. balance of current transactions had been financed only with foreign long-term investments in the United States, all these imbalances would be much smaller in scope and no major risk would exist. On the contrary, what is extremely dangerous is the expansion of credit, and the ensuing instability of the entire financial and monetary system, both nationally and internationally. This instability was enhanced by the total liberation of capital flows in most of the world.

Gigantic indebtedness

As of 1974, the universal use of bank credits and the massive inflation they caused lowered real interest rates, for a decade, to very low, if not negative levels, leading to both inefficiency and despoilment. As a substitute for real savings, long-term financing was ensured by *ex nihilo* creation of money. Conditions necessary for efficiency and equity were thus compromised. The workings of this system led to squandering of capital and destruction of savings.

This creation of money is largely responsible for the fact that developing countries were induced to apply over-ambitious, and in fact excessive, development plans and to postpone the adjustments they should have been making, since it is so easy to purchase, when it can be done with promissory notes.

Most debtor countries were led by necessity to take out new loans in order to obtain the resources needed both for financing the discharge and interest on their debt; and for making new investments. But, little by little, this situation became untenable.

At the same time, in the developed countries, the indebtedness of public administrations as compared to the Gross National Product, and the weight of interest as a percentage of public spending, became hardly bearable.

Massive speculation

Since 1974, speculation has exploded worldwide. Two significant illustrations of this are currency and stock-exchange speculation.

When, in March 1973, the system of floating exchange rates replaced the system of fixed but adjustable parities, currency speculation driven on by credit increased accordingly. Combined with floating rates, the credit system as it now functions has greatly contributed to the tremendously unstable exchange rates since 1974.

During this entire period, the relative exchange rates among the main currencies have been subjected to unbridled speculation, be it in the dollar, the mark, or the yen, as each currency can be exchanged on credit against another.

Speculation on stocks and bonds has been no less spectacular. Since 1983, in New York, enormous markets have grown exponentially on stock-index futures, stock-index options, options on stock-index futures, and then on the hedge funds and all those derivatives which are presented as panaceas. These futures markets, where operations cost much less than cash operations, and where positions are essentially set on credit, have allowed for increased speculation and generated highly unstable prices.

Indeed, without the *ex nihilo* creation of money and of the purchasing power it permits, the extraordinary rises in stock prices that are to be observed before great crises would not be possible, because for every expenditure for stock purchases, there would have to be a decrease of an equivalent amount of expenditures somewhere else, and regulating mechanisms would immediately be developed that tend to check any unjustified speculation.

Whether the speculation be on currencies or stocks, the world has become a vast casino, with gaming tables set up at all longitudes and latitudes. The game and the bidding, which involve millions of players, never stop. American quotations are followed by quotations in Tokyo and Hong Kong, then in London, Frankfurt, and Paris. Everywhere, speculation is encouraged by credit, since one can buy without paying and sell without owning. A decoupling between the parameters of the real economy and nominal prices determined by speculation is usually to be observed.

Everywhere, this feverish, wild speculation is made possible, nourished and expanded by credit. Never before has it reached such a scale.

A fundamental instability

The entire world economy today is based on gigantic debt pyramids, supporting one another in a very fragile balance. Never before has there been such an accumulation of promises to pay. Probably never before has it been more difficult to meet them. Probably never before has such a potential instability appeared, coupled with such a threat of a general collapse.

All these difficulties are the result of the misreading of a fundamental fact, which is that no decentralized system of free economy can function correctly if the uncontrolled *ex nihilo* creation of new means of payment serves to avoid making the necessary adjustments, at least temporarily. This is what always happens when expenses or debts can be covered with simple promises to pay, with no effective, direct or indirect, real compensation.

In this situation, the experts are all looking for means, sometimes expedients, to overcome the difficulties, but no real agreement on defined, efficient solutions can be reached. For the moment, almost all experts see no other solution than creating new means of payment, if need be by pressuring commercial banks, central banks, and the International Monetary Fund, in order to allow debtors and speculators to pay off their debts or meet their interest payments, although this will increase the burden for the future.

You will always find at the center of these difficulties, in one form or another, the negative role played by the present credit system and the massive speculation it allows. *As long as the institutional framework in which it operates is not pro-*

foundly reformed, the same major difficulties will always appear, but with different technicalities according to circumstances. All the major crises of the 19th and 20th centuries were the result of excessive growth of promises to pay and their monetization.

Particularly significant is the complete absence of any challenging of the very basis of the credit system as it presently works, that is, with *ex nihilo* creation of money by the banking system and the generalized practice of long-term financing with short-term borrowings.

In fact, it is no exaggeration to say that the present mechanism of creating money through credit is certainly the cancer which is irremediably eating up private property market economies.

The collapse of the world laissez-faire doctrine

Over two decades, a new doctrine was little by little imposed: the world free trade doctrine, which involves eliminating any and all obstacles to the free flow of goods, services, and capital.

This doctrine states that the disappearance of all obstacles to such flows is both a necessary and a sufficient condition for bringing about an optimal allocation of resources worldwide. All countries, and within each country, all social groups, would experience an improved situation.

Defenders of this doctrine became just as dogmatic as the defenders of communism before it definitively collapsed with the Berlin Wall in 1989. In their view, this world free trade doctrine had to be implemented in all countries and, if difficulties arose during implementation, they could only be temporary and transitory.

In developing countries, a total opening up of their economies was given as a necessary precondition, and the proof of this was to be found in the extremely rapid progress of emerging countries in Southeast Asia. This was a major growth pole for all Western countries.

In developed countries, eliminating all tariff and other barriers was given as a precondition for their growth, as the undeniable success of the Asian tigers could decisively demonstrate, and it was continually repeated that the West should just follow their example in order to achieve unprecedented growth and high employment levels.

Especially Russia, the ex-communist eastern European countries, the Asian countries, and China were presented as major growth poles, offering the West unprecedented possibilities for development and wealth.

Fundamentally, this was the doctrine of universal scope that was little by little imposed on the world, and was supposed to open up a *new Golden Age at the dawn of the 21st century*. This doctrine has been the unquestioned credo of all major international organizations over the last two decades, be they the World Bank, the International Monetary Fund, the World Trade Organization, the Organization for Economic Cooperation and Development, or the Organization of Brussels.

All these certainties were swept away by the deep crisis that developed starting in 1997 in Southeast Asia, then in Latin America, to culminate in Russia last August, and hit American and European banking houses and stock exchanges in September 1998.

Two major factors played a decisive role in this world crisis of unprecedented scope since the 1929 crisis: *the potential instability of the world financial and monetary system, and world globalization of the economy in both monetary and real terms*.[2]

In fact, what had to happen, did happen. The world economy, with no real system of regulation and which had developed in an anarchistic framework, could only, sooner or later, run into major difficulties.

The prevailing doctrine had ignored one essential fact: Total liberalization of trade and capital flows is only possible, is only desirable, within the framework of regional organizations bringing together countries that are economically and politically associated, and whose economic and social development is comparable.

In fact, the new world order, or the so-called world order, has collapsed, and it could not help but collapse. The obvious facts finally won out over doctrinal incantations.

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2. Cf. M. Allais, *Combats pour l'Europe* (Paris: Editions Clément Juglar, 1994). The publisher can be reached at 62 avenue de Suffren, 75015 Paris, France.

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