

Debt-Choked System at Hyperinflation 'Boundary'

by John Hoefle

When the international bankers adopted their “wall of money” approach to save the global financial system from collapsing in September 1998, Lyndon LaRouche told them they would be better off putting the system through bankruptcy. If you go ahead with this bailout, he warned, it will only make matters worse, leading to hyperinflation and, ultimately, a much bigger explosion. As usual, the bankers chose to postpone their rendezvous with reality, and set into motion a vast market-manipulation bailout, combining low interest rates, sharp run-ups in real estate and stock values, huge increases in corporate and household debt, and more than a doubling of size of the global derivatives market.

The years since that 1998 decision have seen one disaster after another, from the stock-market blowout of 2000, to the apparent blowup of J.P. Morgan Chase and the meltdown of the energy pirates and telecommunications companies, led by the bankruptcies of Enron, Global Crossing, and WorldCom. Waves of scandals have hit both Wall Street and Main Street, resulting in significant changes in the regulatory apparatus, many for the worse. Federal Reserve Chairman Sir Alan Greenspan has publicly promised to bail out the derivatives banks as needed, and Fed Governor Ben Bernanke has promised to print all the money required to keep the system going.

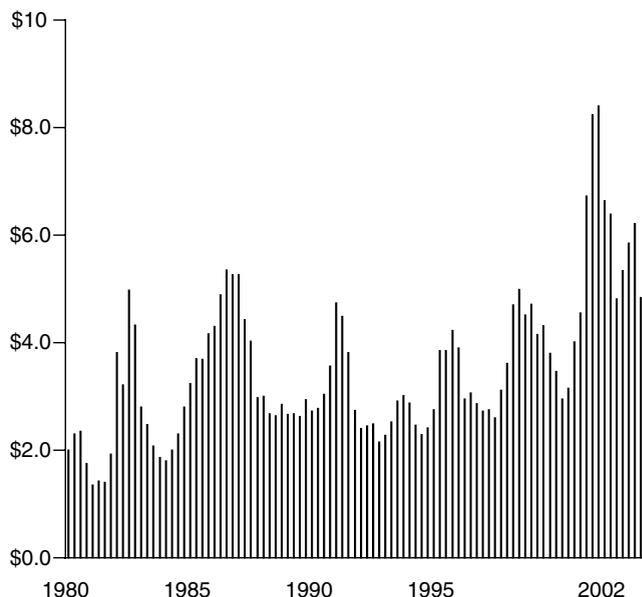
Today, the system is more unstable than ever, with widespread concern about the growing Federal budget deficit, the staggering current account deficit, a dollar crisis, and sharp inflation in commodities price. The measures which have been, and are being, taken to stop the deflationary blowout of the bubble have led to an explosion of debt and other financial claims (**Figure 1**), and nascent hyperinflation in the commodity markets and other sectors (**Figure 2**). The pyramid scheme is unravelling, and the system is ready to blow.

The so-called “solvency” of the global financial system today is an accounting fiction, in which unpayable claims on the liabilities side of the balance sheet are offset by worthless IOUs on the asset side. As long as the IOUs are treated as valuable, the system is solvent, but the moment there is any large-scale attempt to cash them in, the fiction fails, and the system fails with it. To keep this game going requires an ever-expanding pool of fictitious values, which is where the global derivatives market comes in.

According to the Bank for International Settlements (BIS), the global derivatives market stood at \$86 trillion, in the “notional value” of derivatives outstanding, at mid-1998,

FIGURE 1
Increase in Debt Per Dollar of Increase in GDP Annualized, by Quarter

(Dollars of New Debt)



Sources: Federal Reserve; U.S. Department of Commerce; Bureau of Economic Analysis.

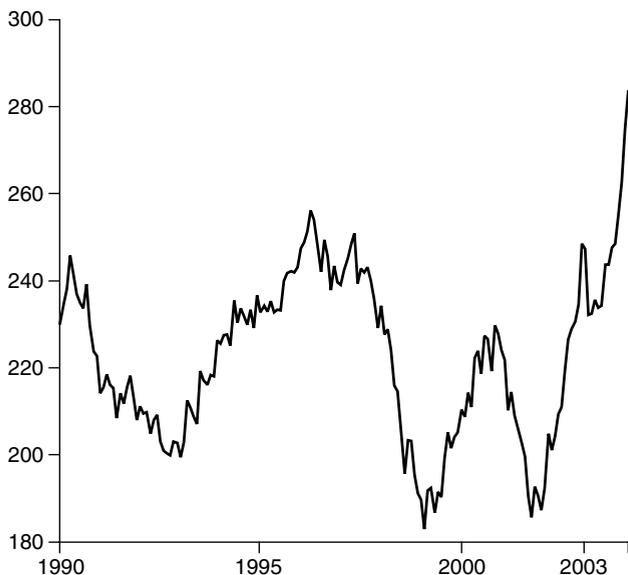
just before the September crisis; and increased by another \$8 trillion in just six months to the end of that year. By the end of June 2003, the BIS reported the level of derivatives outstanding had jumped to \$208 trillion, more than doubling under the “wall of money” approach. While *EIR* believes that the BIS figures significantly understate the true volume of derivatives contracts outstanding by as much as a factor of three, even that \$122 trillion reported increase in derivatives was 64 times the growth of the U.S. GDP over the same period, which was \$1.9 trillion.

As the financial problems deepen, the level of derivatives outstanding is accelerating. From June 2002 to June 2003, the level of global derivatives reported by the BIS grew from \$152 trillion to \$208 trillion, an increase of 34% in just one year. Over the same period, the GDP of the United States, with an economy claimed to be in a recovery, rose just \$418 billion, or 4%. This growth in derivatives bets is not a reflection of real economic growth, but rather a mechanism by which the lack of growth, and the bankruptcy of the system itself, is being hidden.

Driven by Debt

In reality, the so-called growth in the U.S. economy is offset several times over by the accumulation of debt. According to the Federal Reserve, total debt in the U.S. economy

FIGURE 2
Reuters-CRB Futures Index, 1990-March, 2004
 (1967 = 100)



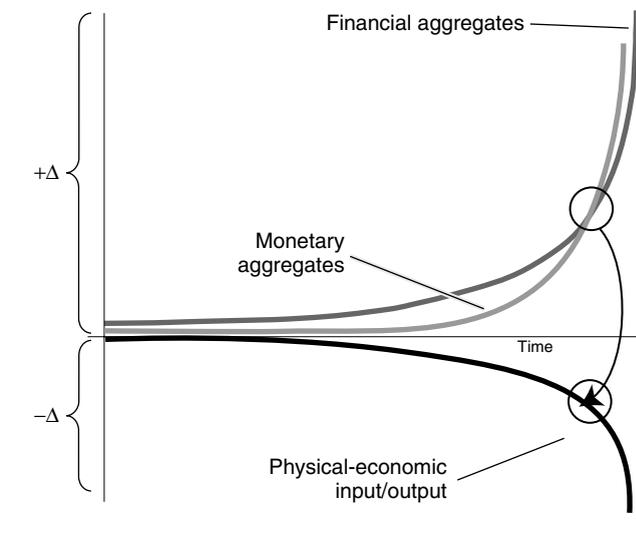
Source: Commodity Research Bureau.

stood at \$34 trillion at the end of 2003, or \$3.06 in debt for every dollar of the \$11 trillion GDP. Since mid-1998, the debt has increased \$12 trillion—54%—while GDP has increased just \$2.6 trillion, or 30%. That's \$4.64 in *new* debt for every one-dollar increase in GDP, and GDP itself is full of fluff; only about one-third of GDP represents productive economic activity, with the rest representing services, overhead, and the effects of the bubble.

Figure 1 compares the growth in debt to the growth of GDP by quarter since 1980. Since GDP is reported as an annualized figure, these quarterly figures are annualized, and understate the problem. For example, in the fourth quarter of 2003, the amount of debt outstanding grew by \$807 billion, while the annualized figure for GDP grew by \$155 billion. Since the annualized figure is for four quarters at that rate, dividing by four yields a GDP growth during the quarter of just under \$39 billion. That puts debt growth at some 21 times the growth of GDP. Calling this growth is like calling credit-card spending, income.

This orgy of debt is reflected in the record levels of bonds sold in the United States in recent years. Some \$6.9 trillion in new bonds were issued in 2003, topping the previous record of \$5.4 trillion in 2002 by 30%, and pushing the value of bonds outstanding to \$21.9 trillion, according to the Bond Market Association. Leading the pack were mortgage-related securities, which accounted for a record \$3.2 trillion of the new bonds issued. That's an increase of 39% from 2002's record \$2.3 trillion.

FIGURE 3
The Collapse Reaches a Critical Point Of Instability



Mortgage originations increased to a record \$3.8 trillion for the year, of which \$2.5 trillion were refinancings. There were, in fact, more mortgage refinancings alone in 2003 than there were total mortgage originations in 2002, a year which saw \$2.48 trillion in originations, of which \$1.5 trillion were refinancings. However, the rate of mortgage originations slowed noticeably during the latter half of 2003 as mortgage interest rates increased, and the Mortgage Bankers Association expects originations to fall to \$2.0 trillion in 2004. Any slowdown in mortgage originations spells trouble for the U.S. economy, which is dependent upon increasing housing prices to keep household assets rising, and upon the cash spun off from mortgage refinancings to allow households to keep up their debt-service payments.

Hyperinflation

In an era in which the level of debt outstanding is growing and the productive economy is shrinking, the ability to service the debt becomes paramount. *EIR* has previously estimated that debt-service payments—including interest and principal—in the U.S. economy are equivalent to about 70% of GDP. The trick to meeting debt-service payments under such circumstances is to borrow new money to pay off the old debts. This works well, in the short term, when interest rates are falling, since it allows corporations and households to replace more expensive debts with cheaper money—but, at the expense of increasing the overall debt.

This doesn't solve the problem, however; it merely postpones it until interest rates rise. Also, just as the cost of money drops as interest rates fall, the cost will rise when rates rise, and borrowing new money to pay off existing debts will become a more expensive proposition.

FIGURE 4

Weimar Hyperinflation in 1923: Wholesale Prices (1913 = 1)

(logarithmic scale)

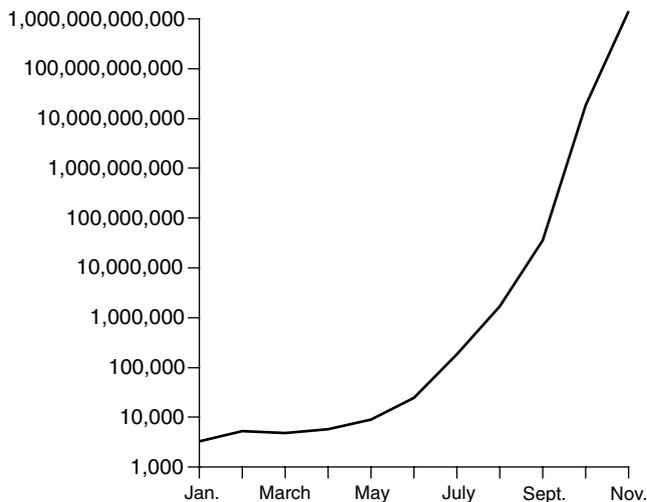
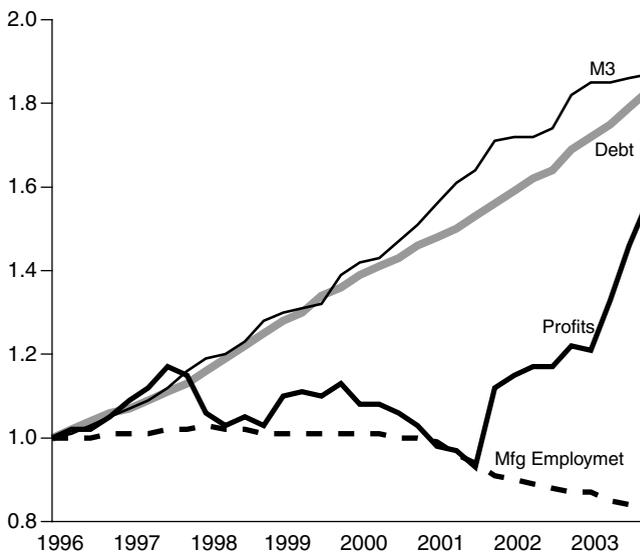


FIGURE 5

Changes in Triple Curve Components, 1996-2003

(Indexed to 1Q/1996 = 1.00)



Sources: Federal Reserve; Bureau of Economic Analysis; Bureau of Labor Statistics; *EIR*.

The bankers are attempting to pay down the existing debt not only through very low interest rates, but through inflation, which allows the paying off of debts with devalued dollars. However, with debt levels so high and productive economic activity so low, the danger of inflation sliding into hyperinflation is very real.

Figure 3 shows this process in Lyndon LaRouche’s heuristic Triple Curve function. While the productive output of the economy falls, the rate of growth of monetary emissions begins to exceed the rate of growth of financial aggregates. Simply put, the amount of money being pumped into the system increases faster than the financial claims, at which point hyperinflation begins.

Figure 4 shows the end result of crossing this “boundary condition” in the historical situation of Weimar Germany’s extreme hyperinflation in the year 1923.

While accurate data for financial aggregates—derivatives in particular—are almost impossible to come by, we can approximate a “real-data” triple curve for what is now happening to the U.S. economy, by using certain official (but not necessarily accurate) figures. Figure 5 shows a triple curve using total credit market debt as a surrogate for financial aggregates, and manufacturing employment as a surrogate for productive activity. The crucial point is the way the rate of growth of the M3 money supply begins to run ahead of the rate of growth of the debt. By mid-2000, the U.S. economy was entering a hyperinflationary mode.

We also include corporate profits in the graph, to show that accounting fraud did not end with the demise of Enron. Tax breaks, war profits, and moving jobs overseas account

for some of the drastic increase while jobs collapsed (note in particular the relationship between corporate profits and manufacturing jobs), but not all. Arthur Andersen may be gone, but the game lives on.

The effects of this nascent hyperinflationary process can be seen all around, from the record gasoline prices, to increased prices in the grocery store and the commodities market. While some portion of these price increases might be explained by ordinary price-gouging (the oil cartel is notorious for rigging gasoline prices), the sharp rise in prices in so many areas shows that larger forces are at work.

American consumer prices, as reported in the Bureau of Labor Statistics’ February urban consumer price survey, rose at a 3.7% compound annual rate for the three months ended February 2004, led by a 9% increase in transportation and 5.4% for medical care. Food increased 2.7%, and energy costs increased 30%. The import-price index for March 2004, rose at an annualized rate of 6%.

Commodity prices are also rising sharply, as shown by Figure 2, the Reuters-CRB Futures Index, an index of major commodities which has risen by 53% since October 2001. Gold prices have risen dramatically, from \$252.50 per troy ounce in March 2001, to \$427.80 on April 1, 2004. The price of crude oil has risen 29% over the past year. Silver is at a 16-year high and platinum is at a 24-year high, while palladium has doubled in the last 12 months. The price of nickel rose 110% in 2003, while tin rose 55% and copper 40%.