

CRASH COURSE

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In this excerpted version of an article in the *Economic and Political Weekly* of Nov. 14, 1987 one of the foremost dependency theorists, Gunder Frank, observes that the stock market crash of Monday Oct. 18 was the alarm not the fire, and the question was posed whether the events in the financial sector could be prevented from spreading to the real economy of jobs, income and production. He finally raises the issue whether the post-war system of international finance and world trade as we know it may become unsustainable.

In October 1987 under the helicopter blade of Damocles, an irrelevant emperor, without clothes, living an economic fantasy in a looking glass world that he was unable to comprehend or control, was yelling befuddled Hooverisms (to make a collage of commentary from *Time* magazine and the *International Herald Tribune* or *Trib* for short, which also publishes editorial and other material from the *New York Times* and *The Washington Post*), in the meantime money talked as Carl Gewirtz noted in the *Trib*, citing the Morgan Guaranty Trust Bank's Rimmer de Vries, who observed that the markets were imposing what politicians are unable to do (or even to comprehend?). As a result, Ronald Reagan's favourite magic of the market itself was writing what John Kenneth Galbraith called the last chapter of Reaganomics. This was, in other words (of *New York Times* columnist Anthony Lewis), the turning point to the end of the Age of Reagan. Some months before already, reviewing *The Wall Street Journal* columnist Alfred Malabre's book "Beyond Our Means: How America's Long Years of Debt, Deficits and Reckless Borrowing Now Threaten to Overwhelm Us", 'Adam Smith' had already foreseen in *The New York Review of Books* that president Reagan "will be seen like Hoover, a nice fellow who blew our patrimony and who presided over a great fall". Yuppie young urban upward mobile professionals are transformed into poor urban professional Puppies instead.

On Black Monday, October 19, 1987, the *Trib* published *The Washington Post* editorial commenting on the previous Friday's 108 point decline of the Dow Jones Index. On the New

York Stock Exchange: "Don't Panic, but Act now. Comparisons with 1929 are inevitable. But.....there will not be another crash *a la* 1929....Since then the American financial system has been substantially panic-proofed". That day apparently, Yuppies and others had suddenly become illiterate. The *Post* batting average was about 100: It was doubly right (200) on the first score, since that very day the Dow Jones crashed 508 points, or double its October 1929 percentage decline. Unfortunately, the *Post* batted only .001 on the second score: After 90 stocks had stopped trading altogether for lack of buyers at noon, the Big Board's Chairman John Phelan, himself nearly shut down the market entirely for fear of a "melt-down", from which it was only saved by the temporary shutdown of the stock futures exchange in Chicago. Not panic-proof confidence, but chaos. American Roulette became more like its Russian counterpart.

Confused Comparisons

Confusion worse confounded comparisons between and with the years before and after 1929 now abound. Many are willing to go to any lengths to find supposed differences. On October 30, the *Trib* printed the *Washington Post* editorial to the effect that the differences between then and now are night-and-day because the US and world economy were already in recession before the 1929 crash, while now in contrast the economy is expanding rapidly. On October 23, the *Trib* had informed that in 1929 stocks had fallen before the recession. Both times unfortunately, they had neglected to read the *Trib* of October 20, which cited the general manager of the central banker's Bank for Interna-

tional Settlement to the effect that the 1929 crash followed a period of excessive economic boom that is nowhere apparent today. So there is no reason to fear any resultant decline of business investments, he said, because there are hardly any to begin with! From the *Financial Times*, and elsewhere we learn that stocks recovered significantly in 1930, but economic growth turned increasingly negative in the depression until 1933; and by then stock prices had declined to a small fraction of the level to which they had fallen in the 1929 crash.

Other supposed saving grace differences between then and now are that the banking system has been shatter-proofed by FDIC (Federal Deposit Insurance Corporation) and the Glass-Steagall Act in the US, which bars US banks from the security business. Moreover, monetary and fiscal policy has supposedly become much more sophisticated and effective. While then the US Federal Reserve (Central) Bank squeezed credit and liquidity, on October 20, 1987 its new chairman announced himself "ready to serve as a source of liquidity to support the economic and financial system" (thereby confirming, contrary to Milton Friedman's monetary gospel, that central bank's monetary 'policy' really accommodates to economic events rather than determining them). Finally, world economic integration and co-ordination is much greater and facilitated by round-the-clock computer communication. Indeed, the truth, albeit not necessarily the virtual protection or protective virtue, of this last proposition was demonstrated by the round-the-world domino-like chain reaction to the October 19, 1987 Wall Street crash.

After Black Monday, the *New York Times* correctly observed that the market crash was the alarm, not the fire; and the *Washington Post* and others posed the crucial question whether events in the financial sector can be confined there without spreading through the fire walls to the real economy of jobs, income and production. All these metaphors, however, reflect a serious lack of depth, vision and historical perspective. Beyond the chicken-and-egg debate over crash and recession, reflected in the *Trib*, the interactions between the financial and real

economies are much more complex and longer lasting. Last time, real economic crisis conditions already prevailed during the 1920s, particularly in the previously leading economy of Britain and the upcoming one of Germany. Indeed, some students of long economic cycles date the downturn from 1913.

By that reckoning, 1929 was 16 (or 9) years into the development of the economic crisis. As in previous economic crisis developments (including that observed after 1762 by the real Adam Smith, who published his "Wealth of Nations" in 1776), the run-down of profits and growth rates in the real economy, as well as its increasing sectoral and regional imbalances, generated the flight into financial speculation characteristic of the 1920s. By the late 1920s, real growth rates were down, and commodities and agriculture were depressed. Germany was obliged to make war reparations payments of 2 to 3.5 percent of GNP, which in his "The Economic Consequences of the Peace" John Maynard Keynes had already pronounced unsustainable for Germany and counter-productive for the world. The political agreements of the Young and Dawes plans were unable to reduce Germany's payments sufficiently. They were financed by the inflow of American capital while it lasted: but in 1929 the market stopped the flow, the increased hardships in Germany helped bring on Hitler in 1933, and he stopped the unsustainable reparations. In the meantime, all other international economic cooperation had broken down, and depression had engulfed the world.

Origin in Real Economy.

The present world economic crisis also began in the real economy with the decline in the rate of profit in the mid-1960s and the recessions of 1967 and 1969-70. In the United States, President Johnson's Great Society and Vietnam War were financed with inflation and foreign capital. Growing real and financial competitive imbalances and refusal of Europeans to sustain them obliged President Nixon to unpeg the dollar from gold and devalue it in 1971 and led to the breakdown of the post-war Bretton Woods Agreement (and the failure to replace

it). Exchange rate pegs were sacrificed to allow floating exchange rates to act as shock absorbers of economic imbalances and other disturbances; but instead they acted as coil springs, which have transmitted and magnified economic shocks. The 1973-75 recession, which turned growth rates and world trade negative and doubled unemployment, shocked analysts into attributing it to an 'exogenous' oil shocks, instead of analysing it as the further development of the world economic crisis. The markets, however, responded with the historically normal solution to the real problem; debt financed financial speculation. In 1974, *Business Week* dedicated a special issue to 'The Debt Economy' and in 1978 to 'The New Debt Economy', which it found to have more than doubled in the four years past. By 1985, the same *Business Week* devoted another special issue to ringing the alarm bells about the 'Casino Society'. Tight monetary policy notwithstanding, Robert Triffin observed that world financial reserves had grown over tenfold in ten years (confirming again that monetary authorities only accommodate financial liquidity to real needs if even that, since in this case much of the money was created by the Eurocurrency market beyond the control of any monetary authority).

In the 1970's, in direct response to the 1973-75 recession and in support of the 1975-79 'recovery' much of the financial speculation was directed at the debt finance of 'export led growth' in the Third World South (in the Newly Industrialising Countries and OPEC surplus countries) and 'import led growth' in the Socialist East. The debt financed import demand of both, sustained Western industrial exports and bank earnings, which replaced the inadequate investment demand and profitability in the West itself during the still growing crisis. Unfortunately as had to be, this apparent speculative 'solution' to real problems ceased to work in the South and the East after the 1979-82 recession. The 1975-79 recovery had been even weaker and less solid, based than the one preceding the 1973-75 recession. Now the 1979-82 recession was much more severe (doubling Western unemployment once again) compared to the pre-

ceding one, third world and socialist countries experienced an acute liquidity crisis as first the recession drove down raw material commodity prices and therewith their export earnings. Then the US monetary 'authority' responded by raising the dollar and the rate of interest, and suddenly western banks dried up their voluntary flow of loan capital to the South and East, which brought on their debt crisis in 1981-82.

To prevent illiquidity from turning into insolvency, the third world had to generate much more foreign exchange just to service the interest on their debts. This obliged these countries to start slashing imports (thereby reducing Western industrial and agricultural exports), produce more for export (thereby driving commodities prices even further down), and become capital exporters on a massive scale. Compared to Germany's annual capital exports for war reparations of 2 percent of GNP in the 1920s and a maximum of 3.5 percent of GNP between 1929 and 1931, some third world countries today were being drained of 5 to 6 percent of their GNP just to service their foreign debts. Since the debt crisis erupted in 1981 in Poland and in 1982 in Argentina, Mexico and Brazil, the poor third world has been bled dry of over \$ 500 billions of dollars of capital exports to the richer West (\$ 200 bn in debt service, over \$ 100 bn in capital flight, \$ 100 bn in terms of trade loss, and \$ 100 bn in normal profit and royalty remittances). 'Growth' rates were negative, for several years; investment shrivelled into disinvestment, especially in productive infrastructure and social services; unemployment multiplied; real wages and earnings tumbled, especially for the poorest; and GNP per capita declined by over 10 percent in Latin America and Africa on the average, and in some countries including Poland and Bolivia by over 25 percent. In other words, the 'fire wall' between financial speculation and the real economy became the flood gates through which rushed onto Latin America and Africa (and parts of Eastern Europe and Asia), a depression that for them is already more severe than that of the 1930s.

US Voodoo Economics

Under these circumstances, which

also compromised recovery of export dependent western industry, of course speculation and cyclical recovery since 1983 had to seek greener pastures. They were found in the United States. There, in Vice President George Bush's terminology, Voodoo Economics reigned supreme in the form of Reaganomics. With an unstable amalgam of Laffer's laughable supply side and Friedman's frivolous monetarism, Ronald Reagan innocently tried to square the circle even more than his predecessor Lyndon Johnson: Reagan sought to increase defence spending, cut taxes, and eliminate the budget deficit simultaneously (when only a combination of any two of these was mathematically possible) and he wanted thereby to make America Number One Again to boot. Of course, the whole enterprise was doomed to failure, and the preliminary results are well known. The budget deficit became a gaping hole and the trade deficit became a spawning gap. The United States became the world's largest foreign debtor (soon to match that of all Latin America and then of the third world), and domestic debt of all kinds - federal, state and local public debt, corporate debt, and private consumer debt, not to mention the stock market and junk bonds - rose 15 to 20 percent faster than GNP. However, Reagan's Military Keynesianism in the American Casino Society permitted Europe, Japan, and the East Asian NICs (but not the rest of the third world, which was forced to place its losing bets) to play American Roulette. Their cyclical recovery and growth since 1983 was sustained by exports to the American market. In turn American 'Living Beyond Our Means' consumption, investment, defence expenditures, budget deficit, trade deficit, US treasury bonds, junk bonds, Wall Street, and the dollar itself were all sustained only by the inflow of speculative European and Japanese, and debt-bondage-forced third world, capital. The supply side turned out to be the supply of foreign capital.

Moreover, American Reaganomics, but also Thatcherism in Britain, Socialism and then cohabitation in France, Conservative-Liberal Alliance in Germany, Nakasone in Japan, and other Western governments have had to exhaust virtually all their readily avail-

able accommodation monetary and deficitary fiscal policy instruments just to sustain their speculatively based domestic cyclical recoveries. With gaping budget deficits and sky high debts already, what economic policy instruments remain for them to face the next recession, let alone depression, when anti-cyclical monetary and fiscal policy will really be needed? Furthermore, if the major economic powers failed in their feeble efforts to co-ordinate these monetary and fiscal policies on the easy street of speculatively based recovery, what prospect can they hold out when bursting speculative bubbles, capital flights, recessionary or depressionary dangers, protectionist threats, defence and other conflicts make political agreement and economic coordination even more necessary and difficult in the hard times to come?

A collage of some more serious press commentary on Black Monday and its aftermath is that the stock market is one of the best leading indicators (*Trib*) (previous post-war declines have preceded recessions; including those of 1967, 1969, 1973 and 1979). People voted with dollars instead of ballots (*Journal*) in response to threatening long-term fundamentals (*Economist*) of which Europeans see adrift US economic policy and political power vacuum as the root cause (*Trib*). As a result, all previous forecasts are out of date (*Economist*), and indeed many growth rate forecasts were immediately revised downward by a third to a half (*Financial Times*). Thus, there is no return to business as usual (*Financial Times*), because things will never be the same again and caution is the new watchword even if the stock market recovers (*Economist*). While 60 percent of Americans polled expressed unconcern, the Chrysler Corporation treasurer warned that "you ain't seen nothing yet" as it reduced its pension fund equity exposure by nearly half (*Financial Times*). While the oil millionaire Rockefeller declared all sound in 1929, his oil billionaire successor Perot finds nothing sound in 1987

Global impasse

Indeed already before Black Monday many observers had long since diagnosed the serious illness of the Ameri-

can economy, an exposed financial system, inept monetary and fiscal policy, deficitary foreign trade even in high tech, uncompetitive industry, oversubsidised agriculture yet bankrupt farmers, and general down fall from highway bridges to space Challenger.

The United States and its partners are also trying to square the circle around the world. They seek simultaneous balance in (especially American) domestic budgets and foreign trade, European and Japanese export surpluses (as well as third world ones to finance their debts), stable interest and exchange rates, and economic growth without inflation or recession to boot. Such Globonomics would require even more political economic alchemy than Reaganomics. This is all the more the case since Black Monday condemned the contribution of the latter's magical now-you-see-it-now-you-don't hat trick to its last chapter, and pious verse.

The financial market and its political interpreters had pronounced that the United States now must inevitably reduce its twin budget and trade deficits. If policy makers would not do it 'voluntarily', the market would do it ruthlessly. But how, and with what consequences? Now lower budget deficits would be recessionary, and *The Economist* argues that at least double the \$ 23 billion schedule by Gramm-Rudman are a necessary minimum. Either government tax increases or spending cuts, let alone both together, to reduce the US federal budget deficit would be recessionary per se, and they could contribute to a deeper depression in an already market generated recession. Even Herbert Hoover offered tax deductions and new public works spending and Franklin Delano Roosevelt's New Deal carried them even further. Unlike Ronald Reagan, they had not already wasted these anticyclical munitions before the real battle began.

Indeed, if America were ever to pay even the interest, let alone the principal, of its still growing foreign debt, it would have not only to eliminate its trade deficit. The United States, like the third world debtors before it, would have to convert its present massive import surplus into an export sur-

plus instead. This would mean an enormous turn around in US and world trade. Either US imports would have to dwindle to less than exports, or US exports would have to increase enormously, or some of both. Who would absorb such US exports in an economic crisis, which would itself be aggravated by them? Certainly not the poor and still debt-overburdened third world, as long as it is obliged to run an export surplus itself. Only Western Europe, Japan, and the socialist countries remain, but not likely as potential importers of such American export surpluses. Alternatively, Americans could reduce their debt service by reducing or devaluing their foreign debts. One mechanism is through deflationary write downs and bankruptcies or renunciation of part of the debt, presaged by the Wall Street crash. Another way to devalue dollar denominated debts is to devalue the dollar itself, as in the recent past and the foreseeable future. A third way, would be through domestic inflation, which would reduce the real value of the debts directly, as well as indirectly by contributing to further devaluation of the dollar itself. Of course, each of these or any combination of these possible American responses to its foreign debt also has important deflationary effects on America's European and Japanese creditors. Thus, any attempt to square the international financial and economic circle of interest and exchange rates, and budget and trade deficits at this juncture must fail in something and entail serious costs in terms of economic growth and welfare. What is to replace the United States as the global borrower and spender of last resort, especially when it is most needed? Total irresponsibility during the Reagan Recovery since 1983 has created a Catch 22 situation, whatever you do. Damned if you do and demand if you don't.

The post-war system of international finance and world trade as we know it may therefore become unsustainable as American hegemony over it declines in the still deepening present world economic crisis. Yet no other power is ready to replace the United States, and international - let alone supernational-coordination appears beyond immediate reach.

Therefore in a previous article, this author has examined some of the alternative developments and in particular the possible resurgence of neo-mercantilism and the reemergence of financial zones or even economic blocs. Recent losses at American roulette and the present troubles in the globonomic casino now make these possibilities all the more likely.

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