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Dollar Speculation Goes Out Of Control

Two-Tier Credit System The Only Answer

The collapse of the U.S. dollar on the international markets broke out of the control of the U.S. Federal Reserve and other central banks this week, with potentially disastrous effects on the U.S. economy.

Instead of taking the form of a downward collapse of the dollar's value against other major currencies, the dollar's weakness has turned into an *upward collapse of interest rates*, outside the influence of the Fed's usual monetary gimmicks. Masses of dollars — including several hundred million per day on the Tokyo market alone — have been borrowed by international banks and corporations, and then sold for other currencies.

Speculators "sell short" against the dollar in expectation of a fall in the currency's market value, allowing them to repay their dollar loans at a profit. But the enormity of the speculation against the dollar has engulfed all the world's credit markets, to the point that speculative borrowing of dollars for short-selling has driven dollar interest rates through the ceiling.

The touchstone rates in the international market have risen by an extraordinary 1 percent in the last week — solely on the basis of the weak dollar. Eurodollar six-month rates are nearing 8 percent. More dangerous is the fact that U.S. commercial banks have found they can borrow short-term money in the U.S. banking system — so-called "federal funds" — and lend them out at much higher rates as Eurodollars.

In reaction, the speculation against the dollar has taken over the home credit system of the U.S. Federal funds, the money banks lend to each other, bore an interest rate of 7 percent at last night's market close — almost 1 percent higher than last week. This gigantic rise took place despite frantic efforts by the Federal Reserve to hold the Fed funds rate down. Several times during the Oct. 11 trading — and many times over the past week — the Fed's trading desk added funds to the banking system to reduce the intense demand for money.

But all these funds are disappearing down the Eurodollar sinkhole. The more Fed Chairman Arthur Burns adds funds to the banking system, the more the international buildup of dollars, and the weaker the dollar is on straightforward supply-and-demand terms.

Due to heavy central bank intervention, and even heavier political pressure on market participants, the weakness of the dollar did not force the rate below the record low versus the Deutschemark registered during August. The West German currency closed the week at 2.2855 to the dollar, down roughly one percent. The Swiss franc closed with a slightly greater gain. The real victim was the Japanese yen, now at 252.90 to the dollar (and 248 on the six-month forward), higher than the previous all-time record. The Japanese central bank did all it could on Friday, absorbing $500 million of the inflow, only managing to break the rise of the yen slightly. Total inflows into Japan this week probably came close to $2 billion. Since Japanese corporations have tried to keep their foreign markets by holding dollar prices steady despite the rise of the yen rate, this week's events will either wipe out Japan's foreign orders, or corporate liquidity, or both.

Who Are the Villains?

Unlike most foreign exchange market crises, there are easily identifiable villains in the current situation. The most prominent is U.S. Treasury Secretary Blumenthal, who told wire-service reporters last night that the appreciation of the yen, deutschemark, and Swiss franc against the dollar had not been significant. (The aggregate depreciation against these currencies since the Organization for Economic Cooperation and Development (OECD) recommended strengthening of the currencies of payments-surplus OECD nations has been 3.5 percent for the mark, 7.5 percent for the yen, and 9.5 percent for the Swiss franc.) If the depreciation had been significant, then there would have been some impact on the worsening U.S. trade balance, the U.S. Treasury Secretary said, with a sort of logic that gives foreign exchange departments a very clear idea of what to do the following morning.

The other villains are City of London merchant banks acting in an advisory capacity to Organization of Petroleum Exporting Countries (OPEC) governments, who have been recommending that OPEC governments sell off dollars. Foreign exchange market sources agree that OPEC sales have amounted to a substantial portion of total turnover, and that the Arabs are fleeing the dollar in all directions.

The *Executive Intelligence Review* interviewed a prominent British banker who advises one oil-producing state, who confirmed that the British advisors had major influence in the trouncing of the dollar. "But it's just my personal opinion, just like it's the personal opinion of my counterpart at Baring's (Baring Brothers, Ltd. investment bank — ed.) who advise Saudi Arabia. It's not like it was a City of London conspiracy or anything."

The same banker added, "The real problem is in your Administration. As long as it's divided as to what should be done about the trade balance, then the markets will remain extremely volatile." Considering that the present Walpurgisnacht of foreign-currency speculation, interest-rate arbitrage, and speculation on interest rates themselves is the first clean chance that the major U.S. commercial banks have had to make a buck since the collapse of the Eurodollar lending spreads a few months

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ago, a relatively small kick would have been sufficient to set the last week's events into motion. Blumenthal and the British gave it a great deal more than that.

Swiss Shift

On the other side, Swiss National Bank President Fritz Leutwiler called reporters in Thursday and accused the U.S. Administration of intentionally trying to depress the dollar's rate, calling on them to support their currency instead. This marks a 180 degree shift in line for the Swiss central banker, who warned last month that the Swiss would not act to bail out the U.S. fund. Leutwiler's unusually strong statement probably had some calming effect on the foreign exchange markets Friday, when some traders wondered that the dollar had not been hit even harder than it was in continental markets. There have been unconfirmed reports from very good Western European banking sources that the European central banks, and the Fed, acted jointly to intervene to support the dollar and also to persuade commercial banks to stop speculating against it. There are also strong predictions from very good banking sources both in New York and Europe that the Europeans will impose exchange controls shortly to stem the inflow of dollars into their credit systems. If there were indeed such mitigating actions, beyond the expected level of central bank reaction, their significance will be relatively minor in the overall scope of events.

A senior official at Bank of America commented, "The only people who benefit from this are the British." Sterling's strength this week despite the sharp rise in dollar interest rates indicates that a new ball game is underway for the sterling-dollar relationship. "There's been no direct reaction on the London market to the rise in dollar interest rates," said Peter Buer at Arnhold S. Bleichroeder and Company in New York. "There is no longer a direct relationship between sterling and dollar interest rates. The hot money that has flown into sterling will remain there, and keep rates at 5 to 5.5 percent," Buer added, even though dollar rates have risen higher. "A rise in dollar rates will have a positive not negative effect on sterling."

The explanation for this unnatural situation is that since the rise in dollar rates is a side effect of foreign exchange speculation against the dollar, funds will hedge against the dollar by moving into sterling.

On top of the short-term developments, the dollar is weakening on fundamentals. Comparing Jan.-Aug. 1976 with Jan.-Aug. 1977, the U.S. balance of trade surplus on manufactures collapsed from $9.5 billion to $3.3 billion.

British 'Boom' May Be Bust

The expected increase in the money supply and the continued inflow of short-term funds into the city of London has stirred fears even within that complacent community that the "British boom" is far from stable. As the Oct. 11 Financial Times *noted, the gilt (government paper) market weakened in the beginning part of this week "following cautionary weekend press comment that the upsurge may be nearing its end and pointing to the problems facing the authorities in the wake of the recent heavy demand for sterling." Below are extracts from the London news alluded to by the* Times.

Daily Telegraph, Oct. 8—In the "City Comment" column entitled "Gilt market starts to look dangerous,"the *Telegraph* points to the danger of massive foreign intervention in the gilt market during recent international euphoria over the pound. "These overseas buyers have suddenly become convinced that the pound is a hard currency, and that it must appreciate as North Sea oil swings our balance of payments into massive surplus...The danger is that this foreign interest is fickle. Foreign investors on the whole do not know much about the London fixed interest market. Their buying is indiscriminate. They have been caught up in a swing in international fashion which for the time being favours Britain. All of which the more experienced
worrying. When newcomers take over a market, they normally drive prices to absurdly high levels. Then prices crack and fall very sharply. The fear is that we could soon see something of this sort happen in the gilt-edged market. . ."

Sunday Times, Oct. 9 — *Sunday Times* Business-news editor Kenneth Fleet writes in his weekly column that now is the "Time to Start Selling Gilts," suggesting that the foreign investors in London may soon start to leave the market. Of discussion of Chancellor of the Exchequer Denis Healey's speech at the recently concluded Labour Party conference, Fleet comments, "I would have felt distinctly uneasy that the vivid manifestations of socialist success are a boom on the Stock Exchange and a huge inflow of hot money from overseas. I would not have been reassured but the Chancellor's boast, made surely in cheek, that record reserves meant 'we can thumb our noses at the financial speculators.' The gnomes have made sterling suddenly a strong currency and stimulated gains in the gilt-edged market of perhaps £10 billion in a year. If for any reason, they make for the exits, I suspect Denis's thumb will be in his mouth rather than up his nose..." Calling the possibility of hot money outflows the "two billion pound question," Fleet argues that Wall Street may well be on its way to recovery, raising problems for the London markets. While no immediate drop in the gilt market is expected, he concludes that "I would not rule out further gains, though on a much more modest scale than in the past two months. But I would let others enjoy the final assault on the summit and the view from the peak. In three months, those looking back on the profits they took in October will be congratulating themselves on their perceptiveness."

By June, the traditional manufactures surplus of the U.S. with respect to the EEC countries turned around, leaving a $1 billion deficit for the three months to August.

Effects on U.S. Economy

Within weeks, the effects of this self-feeding interest rate spiral on the U.S. economy will start to choke off activity in the U.S. economy:

1) Rising short-term rates have already started to undermine the long-term credit markets. New issues on the international bond market will virtually cease within a week if the trend continues, according to market specialists. Already, the prices of long-term U.S. Treasury securities have fallen to their lowest level for the year. Higher interest rates for long-term capital will push new capital investment in the U.S. economy below even currently prevailing recession levels.

In addition — as a number of leading British merchant banks predicted to NSIPS — the destabilization of the U.S. long-term credit markets will drive even more international money out of the dollar, by shutting off the main channel of viable dollar investments!

2) By the end of the month, the U.S. prime rate will probably rise to 8 percent (from 7.5 percent) in direct response to the jump in the cost of short-term money borrowed by the banks themselves. This will act as a brake on economic activity by raising the cost of accumulating inventories on borrowed funds. Bank loans to business are now rising at an 11 percent annual rate, mainly to finance purchases of higher-priced raw materials and other inventories. If the prime rate hits the ceiling, corporations will cancel orders in less-profitable areas, choking off production.

3) The interest rate rise will dig into the most important area of bank lending, credit to consumers. According to David Jones at Aubrey, Langston and Co., consumer loans are running at double last year's rate, and have a major effect on the increase of the money supply. Rising rates will discourage consumer borrowing, virtually the only remaining prop to the depressed national economy.

4) If interest rates rise much further, according to Jones, funds will begin flowing out of savings and loan institutions which finance home construction — the one active sector in the economy.

London's Scenario for Destroying the Dollar

NSIPS has documented London's central role in bringing on the dollar collapse. This week's trouncing of the dollar directly follows a script, written by International Currency Review (ICR), an elite London journal with close ties to N.M. Rothschild and Sons.

"While American bankers may show concern about the dollar's depreciation when the adverse international news surrounding it becomes impossible to ignore," the London journal explains, "it is generally believed in U.S. banking circles that a really catastrophic run on the currency cannot develop, for a whole range of reasons," for example, that "the U.S. economy is fundamentally and relatively in a much stronger position than all other economies." Nonsense, says ICR.

"Today's international financial situation...is in essence little different from the German experience of 1920-1923," when hyperinflation ended up with the printing of trillion-mark notes. "The multiplication of dollars outside the United States has reached such proportions that it has begun to undermine the confidence of *foreigners* in the reliability of the U.S. dollar as a store of value." Can the Fed do anything about it? "It has not been open to the Fed for some years to restrict the domestic supply of dollars for the specific purpose of trying to preserve the dollar's international value. This is because domestic money supply restrictions would not affect the dollar-multiplication process that is taking place externally," *through the London markets.* Put another way, the U.S. authorities are in no position to employ conventional central banking techniques "to control the value to foreigners of their currency."

Two-Tier Credit Market

While traditional credit policies are now as bankrupt as the dollar appears to be, there is a policy that will stop the panic: creating a two-tier credit market, through the Federal Reserve itself. The problem is to dry out speculation against the dollar, without cutting off funds to industry. The solution is to open a second lending window at the Federal Reserve for long-term, low interest loans to industry for investment, production, and exports. A Federal Reserve spokesman confirmed that this is legal under Section 13, paragraphs 3 and 13, of the Federal Reserve Act, if an emergency exists — "but the Federal Reserve doesn't believe there is an emergency."

With a special credit tier for industry, the Fed could *successfully* tighten up on short-term credit for speculation. Foreign central banks are more than happy to collaborate with the Federal Reserve. The Banque de France, according to one of its officials, would be more than willing to second such Fed action by imposing a two-tier credit regime on the Eurodollar market itself, and restore the international viability of the U.S. dollar.

Some New York commercial banks, who are falling into London's trap by making a buck off the dollar's problems, might be mildly disturbed by such action. But several senior New York bank spokesmen have indicated their general sympathy with the two-tier proposal, initiated by U.S. Labor Party Chairman Lyndon H. LaRouche, Jr. The real losers would be the City of London banks.

—David Goldman