Has the money really run out?

by David Goldman, Economics Editor

Morgan Grenfell, the British merchant bankers, threw a zinger into the American crisis over the management of the federal debt in their January *Economic Review,* which argued, in effect, that the money had run out on the international monetary system. The fact that the nominal rate of interest was often less than the rate of inflation during the 1970's, Morgan Grenfell claims, is due to the availability of a huge pool of "savings" in the form of the OPEC surplus, the investable revenues of the oil-exporting countries. Recycled back into the treasuries of the industrial nations, or the capital import accounts of hard-pressed developing-sector borrowers, OPEC savings created a sufficient "supply" of savings to match growing "demand" for funds.

Now that the OPEC surplus, which fell from $110 billion in 1980 to only $47 billion last year, will turn into a deficit of $40 to $60 billion for 1982, the world is thrown back into an era of "persistently high real interest rates," with all its terrible consequences, the British bank concludes. There is no other choice—as the London *Financial Times* argued in an editorial on the Morgan Grenfell report—than for governments to meet expenditures out of current revenues, i.e., raise taxes and cut spending. Manufacturers Hanover Trust's economist Irwing Kellner has argued that federal financing requirements, which he estimates conservatively at $154 billion, will eat up virtually the entire supply of savings for 1982. Kellner places that supply at about $190 billion (and the Federal Reserve at only $160 billion).

What is wrong with this sort of bookkeeping is the simple truth that the actual rate of monetary growth, as measured by Merrill Lynch economist Peter Canella (in the form of "adjusted" M2) has been well above a 20 percent annual rate for most of last year. As we have emphasized for a year now, the Fed chooses to "target" so-called M-1, the narrowly defined money supply, while deregulating banking in such fashion as to enable every money-market fund in the country to manufacture what used to be called "bank money." While 50 percent of all new credits (or more) is absorbed in refinancing old debt service, the actual rate of credit expansion is the highest in U.S. peacetime history.

Debt finance and the dollar

The question is not whether the supply of savings has run out, but rather under what conditions will the Eurodollar market and other institutions who can manufacture "bank money" at will fear to overextend themselves further by lending money they created out of thin air to borrowers who can never pay it back? Canella's conclusion from this regrettable set of circumstances, as he told *EIR* this month, is that "the problem with the Fed is that it doesn't have the guts to make everybody go bankrupt!" He adds, "We will end up with an accidental disinflation, through a collapse of the credit system. It's inevitable." The point at which such a collapse occurs is when debt-financing requirements rise geometrically (as they are doing now), while real income out of which debt service may be paid falls geometrically through economic depression (as it is now doing). March or April of this year will be a remarkable time to live through.

However, the dollar's unique position as the world's international reserve currency means that, while the

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individual bankrupt corporation or political entity will see its debt-paper devalued through reorganization, the currency which denominates such bad paper may well go through the identical process. Technically the dollar is bankrupt, and it is held up by the willingness of speculators to risk major capital losses in return for high current return, much like sterling on the eve of its slide to $1.60 five years ago.

What is implied with the exhaustion of the OPEC surplus, the main prop to the dollar since 1973, is not a lack of savings, but a massive shift of financial power. In a recent discussion Morgan Guaranty Trust chief economist Rimmer de Vries said, "Morgan Grenfell's conclusions seem plausible. It could be a drop in the savings rate, but it doesn't need to be that way. What we know is that Japan and other exporting countries will have a much bigger surplus. There is a constant shift in the direction of capital flows, they are shifting all the time. It's a swing of over $100 billion in just two years' time, to the advantage of West Germany, Japan, and a little bit to the United States, which will have less deficit." The category of savings is merely an accountant's residual; what is not spent is saved. It is not known that Germany and Japan will spend rather than save their surpluses, merely that they will enjoy the end of several years of brutal financial pressure.

The Blumenthal method

This shift in favor of the Japanese yen and other trading currencies was the subject of an extraordinary talk by Daiwa Securities' London-based economist T. Nakamae in New York Jan. 19. Nakamae put the 1982 OPEC payments position at $9 billion in deficit (although by his own reasoning it could easily go to the $40-$60 billion range), and predicted a 30 percent devaluation of the American dollar.

The special importance of this for the ongoing debate about what on earth to do concerning the federal deficit should not be missed. It is possible to keep American interest rates rising, and speculative money in the dollar, until the ensuing bankruptcies shatter the international monetary system—which is roughly what Morgan Grenfell's John Forsyth and Merrill's Peter Canella proposed to do. There is nonetheless a time-honored method of dealing with such problems, namely, to *finance the deficit through a collapse of the dollar.* That is not as strange as it seems; John Connally and W. Michael Blumenthal both did it.

Foreign central banks are the biggest purchasers of U.S. Treasury securities of any single investor group, with about $160 billion in their portfolios at present. When the dollar crashed in the past, foreign central banks exchanged their own currencies for dollars, i.e. bought them off the market, to prevent their own currencies from rising too fast. The resulting dollar holdings, by an agreement of the Group of 10 in 1967, are invested in U.S. Treasury securities. Dollar runs are highly inflationary, because foreign central banks must print more of their own currencies to buy up dollars sold by speculators. Mechanically, what occurs is no different from monetization of Treasury debt by the Federal Reserve (that is, open-market purchases of Treasury securities by the Fed), except that 1) the excess money is printed not by the Fed but by foreign central banks, and 2) the Treasury securities are bought by the foreign central banks rather than the Fed.

The options at this point boil down to 1) remonetization of gold and directed credit in the industrial countries to productive ends, as Lyndon LaRouche has proposed in these pages; 2) "disinflation through a collapse of the credit system," as noted; or 3) a brief wave of monetary hyperinflation disguised as a dollar collapse.

With the Reagan administration maneuvering to "avoid a demonstration that the NATO alliance is only on paper," as a senior State Department aide said in a recent background discussion, and West German Chancellor Helmut Schmidt warning that the threat of depression is the greatest danger to the alliance, the situation is far from simple. The Carter administration's, and now Secretary Haig's, greatest instrument of pressure against the Europeans is the oppressive monetary regime that constricts their maneuvering room and poisons their political life with record postwar unemployment. To continue the pressure threatens to throw the United States itself into chaos, leaving the Europeans to seek what refuge they can.

But to permit a collapse of the dollar means to acknowledge what has, in fact, already occurred: a massive shift in world trading power away from the United States and in favor of the Europeans and Japanese, reflected in the shift of world flow of funds that Morgan's Rimmer de Vries considers the signal feature of the situation. With such power comes the ability to maintain European and Japanese trading relations, not least with the Soviet Union.

All the foregoing can be summarized in one simple statement, namely, that reality is asserting itself. America's two-year experience with Fed Chairman Paul Volcker's form of monetary suicide is leading to precisely those consequences which the West Germans first began to warn of a year ago. The present situation is uncomfortably similar to the late 1973 period, when the prospects for a further devastating dollar crisis were cut short by the Arab-Israeli war that first quadrupled the price of oil. Short of an adventure which would lead to even more disastrous consequences, Haig and Volcker face the gravest embarassment of any American policy-makers since the British burned James Madison's White House.