Has the plug been pulled on the U.S.?

by David Goldman

Immediately before the Dow-Jones index of the New York stock exchange fell 24 points during the last hour of trading on Feb. 8, Fed chairman Paul Volcker informed the Joint Economic Committee that the plug had been pulled on American credit markets. In earlier testimony, Volcker had warned of a "sudden collapse of the dollar" resulting in higher inflation and higher interest rates. On this occasion, he emphasized that the United States had become accustomed to substantial capital inflows, which had financed the Treasury's deficits during the past two years. The era of such capital flows was now over, Volcker concluded. If Congress refused to chop down the deficit, higher interest rates were now inevitable. Higher interest rates, in turn, would prejudice the financial position of the developing nations, posing threats in turn to the banking system.

In testimony before the House Banking Committee Feb. 7, Volcker had offered a figure of $50 billion as a significant budget reduction but hastened to add that "I'm not sure that much is absolutely required." Volcker would only characterize a failure to reduce deficits during 1984 as "a gamble" with the recovery, and admitted that inflationary expectations for this year were already built into the situation. Pressed by committee Democrats to target defense for cuts, Volcker excused himself as being "no judge of security needs." Rep. Henry Gonzalez (D-Tex.) concluded that Volcker's position was that he was "helpless" to break the interest-rate "gridlock" unless others took on the deficit.

Liberal Republican Stewart McKinney (Conn.) said he was having "nightmares" that the amount of foreign capital coming into the United States could lead to a foreign country "suggesting to the President or Secretary of State that they don't like our policies." Pointing to the potential setup, McKinney noted to Volcker that "when you do decide that the dollar has to be readjusted, you're going to be powerless. You will have to go to the President with two choices: massive recession, or double-digit inflation and interest rates."

Denying that the situation was "quite so dramatic," Volcker agreed that this danger "underlies my statement."

Given that Volcker staged a financial-markets recovery (while publishing falsified figures concerning a still-prostrate real economy) on the basis of foreign capital inflows, his "fears" on the subject are an extreme case of *chutzpah*. His conclusion that the federal budget must be reduced in the range of $50 billion immediately has obvious implications in the present military-strategic situation.

EIR reports on the stock market only for amusement. Various worshippers of the goddess Fortuna have spent the last three weeks waiting to sell out of a market they expect will collapse; at each point, they await the "rally" which will enable them to unload their paper onto less clever individuals before the "blowoff" occurs on the "downside." Each trading session of the week of Feb. 6, therefore, began with an attempt to "rally" the market, i.e. unload paper at a somewhat higher price than prevailing, and most ended with a further slump. Large foreign portfolios picked through the debris for stocks likely to benefit from a dollar collapse.

As *EIR* warned starting last October, an entirely new set of preconditions has emerged during the past month, in which a falling dollar coincides with higher interest rates and tumbling equity and bond markets. Of course, the movements apart from the 10% collapse of the equity market are still marginal: The dollar has fallen from DM 2.86 in early January to DM 2.73, about 4%, while interest rates have risen a fraction of a percent. No ruler-and-pencil projections will capture the developments of the next several months; should the Soviets unleash their pet Shi'ite hordes into Saudi Arabia, or stage an incursion across the Elbe into Germany's northernmost state of Schleswig-Holstein, the West German mark and other European currencies will sell for nothing.

Nonetheless a basic change has occurred, and the United States has entered the third and last phase of the Volcker regime. Between October 1979, when the dollar stood at DM 1.7, and mid-1982, Volcker crushed American living standards and reduced industrial capacity. Between late 1982 and December 1983, the Volcker high-interest regime precipitated a flood of capital flight into the United States estimated at $250 billion for the inclusive 1982-83 period. Now, as Volcker warned, there isn't any more where that came from. The dollar is set for a crash of at least 20% during the next six months. Any number of political events could interrupt the dollar's fall for periods of time. But the Volcker recovery hoax is finished.

Third World debt: the other shoe

In earlier Congressional testimony, Volcker announced a token reduction of monetary growth targets (which the Fed chairman in any case believes are irrelevant) from a band of 5-9% per annum to a band of 4-8%. This is simply a polite way of telling the administration what the Fed chairman has warned since his first statements after President Reagan reappointed him last July: that the Fed will not accommodate the budget deficit of the Treasury.

One Fed official explained, "We've got a problem on interest rates. You will start seeing more market pressure, predominantly expectational, but nevertheless very real. You're going to have a political problem for Reagan and the Republicans if you have falling Treasury bond prices in the summer of 1984. Volcker won't change his policy. If the deficit is high, and rates rise, Volcker won't loosen up. Volcker is putting Reagan in a box and he's going to have to find a way out of it, because rates will be way up in the middle of an election year."

As such, Volcker's monetary pronouncements had an effect on the markets starting with the 25-point Dow-Jones index drop of Feb. 6. But the actual development of Federal Reserve monetary policy is likely to be very different. Volcker hinted at this in his Feb. 8 reference to the problems of developing nations. The status of Brazil's debt position indicates that the Fed may be compelled to liquefy the banking system to a startling extent during the second quarter.

According to the leading Swiss daily *Neue Zürcher Zeitung* of Feb. 3, the $6.5 billion supposedly raised by commercial banks to bail out Brazil may never be paid out. Banks put up the funds on condition that the industrial nations' governments shell out an additional $2.5 billion in export credits. However, the Swiss paper notes, the British government has outright refused to put up the funds, the U.S. Eximbank has made its contribution conditional on all the others chipping in, and the French and Germans have said nothing. Thus any payments of the $6.5 billion will be postponed indefinitely.

Even if the export-import banks of the industrial nations were to come through unexpectedly, the major banks still have a foolproof escape clause. If the Brazilians do not live up to the economic terms dictated to them by the International Monetary Fund, the bankers need not disburse in any event.

If payments are not made before the March 31 bank regulatory deadline, banks will have to start writing off $100 billion in Brazilian paper, triggering the crisis avoided by bookkeeping fraud during the Dec. 31 payments period. One sign of utter desperation is the Federal Reserve's announcement of new accounting rules for debt-service payments as of Feb. 1. The commercial banks may now accept such repayments in cruzeiros or bolivars, if their depositors and stockholders will stand for it.

The dollar's failure to rise as interest rates rose is not surprising, since the theory that high interest rates attract capital to the dollar has always been ludicrous. As Volcker indicated, the United States has been dependent on foreign capital inflows and has had to offer high interest rates in order to get them; but such flows are largely a matter of whim of large European and other fortunes, who might take their profits any Tuesday morning regardless of high American interest rates.

What is even more striking is the dollar's failure to display its properties as an alleged "haven currency" following the disaster in Lebanon. The implied strategic humiliation of the United States suggests a catastrophe for the dollar, combining an economic crisis with the strategic reverse.

Said a financial adviser to incoming NATO Secretary-General Lord Carrington, "If you look at the trade and current account deficits, they will be increasing on out as far as the eye can see. The economics of it are inexorable. But as for what will trigger the actual turnaround in the market, this will be a non-economic event. I steadfastly refuse to forecast timing. But I am thinking of something like, hypothetically, if the President were to announce tomorrow that he wouldn't run for re-election.

"If no adverse political development occurs, the dollar can remain on a plateau for some time, or bump further upwards. But the history of these things shows that something else always happens—an oil crisis, an assassination, a war, or something like that. What is tricky in this case is that the dollar is a haven currency, and some developments like this would be good for the United States, and lead to a stronger dollar in the short term. So it has to be something damaging to the United States, raising questions about U.S. economic policy."

The Soviets, as *EIR* has reported, still have a $30 billion short position against the West German mark and French franc which they have not yet covered; this alone could knock the dollar, and the American markets, down a long way further. An organized march out of the dollar has already begun, and represents a formidable weapon in the Soviets' arsenal to defeat an American President with whom they have sworn never to negotiate.