

## Foreign Exchange by David Goldman

### Dollar crisis returns with a vengeance

*The banking collapse has become the principal world strategic factor, and the dollar is the victim.*

After nearly returning to its January high point against leading European currencies during April and early May, the U.S. dollar dropped a sudden 2% the afternoon of Thursday, May 24.

Thursday's dollar crash, from about DM2.76 to 2.70, occurred in a matter of minutes due to massive selling in Europe, according to our contacts on the floor of the Chicago International Money Market. For a while there was no market for the dollar with bid-asked spreads of 0.4-0.6%.

The panic quality dissipated on Friday, May 25, as traders left for the holiday weekend, but the dollar barely recovered a pfennig of the ground it had lost.

Dow Jones reported at the end of trading that night:

"The dollar plummeted as a strongly denied rumor that Manufacturers Hanover Trust Co. is having funding troubles aroused fears of widespread instability in the U.S. banking system. Adding impetus to the dollar's sharp drop was the announcement by Deputy Treasury Secretary R. T. McNamar that the U.S. won't roll over its commitment of a \$300 million bridging loan to Argentina beyond the current May 31 expiration date. He later clarified his statement, saying the United States may roll over the loan if Argentina is near an agreement with the International Monetary Fund on an economic reform program. Later McNamar called today's currency markets 'disorderly,' implying possible Fed intervention to support the dollar."

In short, the usual nonsense concerning interest rates and inflation expectations is now ignored even by the wire services, and the principal consideration is the danger that the Federal Reserve will have to pump huge amounts of liquidity into the banking system.

What is impressive about the dollar crash is that it occurred during days on which six-month Eurodollar rates rose a clear  $\frac{3}{8}\%$ , the second-largest jump of the year, and also on the worst day of escalation of the Persian Gulf war, threatening European and Japanese oil supplies.

Previously, strategic factors, such as fear of an oil crisis and of Soviet military designs on Western Europe, had supported the dollar at a time at which every economic or financial consideration dictated a decline in the range of 30%. Now that the international banking disaster has become the principal strategic factor on the world stage, the dollar has become the victim.

This is precisely the situation which *EIR* foresaw in an *Alert Bulletin* released Dec. 17, 1983, when it became clear that the Ibero-American debt crisis would be postponed past the Dec. 31, 1983 deadline for Brazilian payments:

"Senior U.S. government officials warn that the patch job conducted to prevent a general banking crisis on Dec. 31 merely tracks the crisis to March. Although the Brazilians will have managed to avoid the Dec. 31 disaster, a confidential U.S. govern-

ment study shows that many of the banks who committed money to the project (still incomplete with only \$6.2 billion available) did so with no intent of ever disbursing that money, since the Brazilians' clear inability to meet IMF economic targets under the IMF's present 'stabilization' program for Brazil gives them an escape clause.

"The collapse of the Brazil package would trigger a run against the dollar, triggered by Soviet and allied European banking interests, as a form of strategic bombardment of the U.S. economy, and of the President's defense budget in particular."

The enormous danger to the dollar is shown by the following:

Total Federal Reserve bank credit, i.e., the balance-sheet size of the Federal Reserve, is only about \$180 billion. As a bank, the Fed is smaller than Citibank and Bank of America combined.

The explosive growth of the Eurodollar market to about \$2 trillion, of which almost \$1 trillion is in interbank deposits, has permitted the total size of the credit system to expand much faster than central bank credit. This ensued because every \$1 of central bank credit could become \$10 or more of Eurodollar deposits, since the offshore banks must hold no reserves against deposits.

However, when banks lose deposits during a confidence crisis, the Federal Reserve will have to replace lost deposits virtually on a one-for-one basis, as it did in the case of Continental Illinois.

The Eurodollar fluff will disappear as a "reverse money multiplier" takes hold, and the Federal Reserve will have to replace the fluff with obligations of the U.S. government. It is thus no surprise that West German central bank head Karl-Otto Pöhl warns that the dollar will "overshoot" its appropriate value on the way down.