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EIR Economics

Dollar's surge prepares a new financial blowout

by David Goldman

Fed chairman Paul Volcker is pulling liquidity into the strained American banking system by provoking yet another round of flight capital into the dollar from Western Europe and Japan, according to well-placed British financial sources. This has provoked an immediate crisis in Britain and a simmering crisis in the rest of Europe. Political consequences could be disastrous: Volcker has given Europe a gigantic shove in the direction of an "independent" European monetary system, i.e., economic dependency on the Soviets. The British believe that Volcker has set in motion a panic dollar rise, to be followed by a panic dollar fall.

At the same time, the related surge in short-term U.S. interest rates is a powerful demonstration to the Ibero-American debtors that their joint action last month at the historic Cartagena meeting represents the only way out of collective disaster. Volcker has not merely abandoned various half-baked schemes to mollify the debtors (through token interest-rate reductions), but provoked them in the most poignant imaginable way. On July 9, Colombian President Belisario Betancur denounced the recent interest rate rise as "folly" and warned of the international political consequences of the present monetary development.

The dollar last week reached record high levels against most European currencies, including the British pound and Italian lira, and also reached a 10-year peak against the West German mark. European finance ministers meeting July 9 in Brussels warned against the impact of the rising dollar and rising interest rates on the European economies, as well as the Third World debt crisis.

British banks lifted their base lending rate (prime rate) by a whopping 2% on July 12, one week after another increase, in order to decelerate the precipitous drop of the pound, which has sunk to the new historical low of $1.30. Aside from the acute embarrassment for British Prime Minister Margaret Thatcher, who predicted rate stability only July 11, the pound collapse reflects the hurricane of currencies rushing into dollar assets to reap benefits from the dollar's strength and high paper returns.

"Today was one of the most hectic in memory," a London broker said at the height of the dollar's rise on July 11. "We are reaching the limits of the elasticity of European currencies with respect to the dollar: we should expect dramatic events in the next days, sterling is only the first victim." However, the West German Bundesbank failed to follow the British in raising interest rates at its July 12 meeting. The German mark nonetheless recovered slightly on July 13.

Volcker finances America's deficits

What galls the Europeans above all is the Federal Reserve's role in the dollar's rise, i.e., that Paul Volcker has determined to continue precisely the policy denounced as unacceptable by the June conferences of the Bank for International Settlements and the Organization for Economic Cooperation and Development: financing America's Federal budget and current-account deficits on the foreign exchange market.

"The reason why Paul Volcker, the Fed, and the Treasury are letting U.S. interest rates go up and up and up is that it is the best, easiest, cheapest way of funding the liabilities of American banks which are not being paid by Third World

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debtors. High interest rates suck in billions of dollars which the banks can use. The only other alternative would be for the Fed to print money massively itself—they might do that, but only later," a City of London financier explained, commenting upon the market roller-coaster of the first weeks of July.

"Volcker is playing tough. He's keeping up the pain for much longer than other market participants—including the Bank of England—expected or can afford," the banker concluded.

Another British banker said, "The U.S. has simply decided that the only way to live with the deficit is to have somebody else finance it—that means the rest of the world. This will allow U.S. banks to survive. The Fed and the Treasury are in a corner and they are doing whatever they can think of to get out of it . . . we're going to have to say very harsh things about the U.S. policy."

"The question is whether Europe will say *no* and take counter measures: a two-tier market, an interest equalization tax . . . something nasty which will drive the dollar down, U.S. rates up, and create a monstrously impossible situation for the U.S. Secretary of the Treasury."

As *EIR* demonstrated in its *Quarterly Economic Report* released in June, the so-called economic recovery is largely a result of statistic invention; the margin of improvement in industrial output, less than half of what the Federal Reserve says it is, depends on a subsidy to the U.S. economy from the rest of the world, largely from Asia and Ibero-America. America's $150 billion trade deficit represents, adjusting for the overvalued dollar, close to $240 billion in "free goods" from the rest of the world at current U.S. prices. These "free goods" include a $30 billion subsidy of capital goods, and a $50 billion subsidy of semi-manufactures for U.S. industry.

Volcker has turned America from a net creditor into a net debtor nation in order to obtain this subsidy, and the resulting illusion of recovery. But the price is a global financial crisis, especially a crisis for American banks, who have had to finance the trade deficit by borrowing on the Eurodollar market. The rebound of a dollar crash upon the American economy will, therefore, be disastrous; a projection contained in *EIR*'s report, prepared with the LaRouche-Riemann computer model of the U.S. economy, shows that 1985 will look much like 1982.

Dollar's weakness provokes dollar rise

Despite the sharp upward movement in dollar rates, there is no great movement towards the dollar by investors. A collapse of dollar availability, brought on by a worsening international banking crisis, rather than a rise in dollar demand, generated the shift of the dollar exchange rate. The dollar fell on July 13, for the first time in the week of July 9, largely because traders had no intention of accumulating excess dollar balances once they had covered payment requirements in dollars. Some foreign exchange traders argue that this demonstrates that there is no underlying strength in the dollar whatever, and that a turnaround is possible at virtually any moment.

The London interbank rate for six-month money, the benchmark rate for international lending, is at 12.75, the highest in two years. This is what British banking sources describe as a "prohibitive rate," i.e., one that prevents borrowing.

American banks, meanwhile, have been scourged from London and must fund themselves, to a rising extent, in their own interbank market, pushing domestic rates up towards the "prohibitive" rates charged in the offshore market.

Under the circumstances, a large number of dollar debtors, especially in Western Europe, must liquidate their own currencies to obtain dollars required for interest payments, rather than pay the prohibitive rate to borrow dollars. The worsening liquidity squeeze is very good for the dollar's short-term performance and very bad for the continued existence of the American banking system.

The continuing deterioration of Continental Illinois's position is the most dramatic public evidence of the worsening crisis; the stricken bank almost doubled its borrowings from the Federal Reserve during the week of July 2, to a total of $4.39 billion, and borrowed an additional $2 billion from the 26-bank rescue consortium. Close to half of Conti's deposits now represent borrowings from the rescue operation.

Banks outside the United States are also suffering terrible funding problems at present. "Illiquidity is breaking out all over the place on the Euromarkets," a London source reported. There is a gigantic 0.5% "spread" between the cost of selling certificates of deposits between major triple-A banks and the others—the latter category includes Chase, Citibank, the big British banks, and so forth.

A further negative for Eurodollar market liquidity may be a drop in oil prices, forcing additional liquidation of now-shrinking petrodollar balances at international banks. The Soviets are reportedly dumping oil on the market, putting pressure on already-soft oil prices, according to sources at the Vienna OPEC meeting, and Iran is discounting light crude to only $25-26 per barrel.

In this context, the rise of the dollar and the collapse of the gold price is not surprising.

For obvious political reasons, the Federal Reserve does not want to open the monetary floodgates quite yet; this would be to admit that the banking crisis is out of control.

Ranking advisers to the Reagan campaign now fear that a monetary blowout could either prevent Reagan's re-election, or "Hooverize" the new administration such that the Republicans might not regain office for the next 20 years. A national-security evaluation is circulating at the White House—but not acted upon—that Moscow's "grand strategic calculation" is a monetary crisis that would destroy America's ability to finance its defense budget.

Well-placed European financial sources report steady Soviet accumulation of European currencies, in anticipation of a dollar blowout during September or October.