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Will BIS 'kill the goose that laid the golden egg?'

by David Goldman

Preston Martin, the vice-chairman of the Federal Reserve, resigned March 21, apparently ending a public squabble between Fed chairman Paul Volcker and the four Reagan appointees on the Fed Board, led by Martin. The latter voted down the Fed chairman earlier this month, and forced through a cut in the Fed's discount rate, the first time a Federal Reserve chairman had lost a vote on this issue since President Truman bore down on William McChesney Martin.

What Martin's resignation demonstrates is not that Volcker has won the point, but rather, that the press accounts thoroughly misunderstood what was at issue.

Fed chairman Paul Volcker's earlier embarassment at the hands of Preston Martin, and other Reagan administration appointees, must be understood in the context of a much broader division among central banking circles worldwide. Many central bankers, including Volcker, are divided in their own minds over which poison they should swallow.

The dilemma reads as follows: If the central banks fail to rein in an "off-balance-sheet" banking market approaching $3 trillion, they will be helpless to prevent a catastrophic fall of the American dollar later this year, and the resulting collapse of the American economy. If they rein it in, they will "kill the goose that laid the golden egg," as one senior Federal Reserve specialist complained.

The $3 trillion bubble

The "golden egg," of course, is the spurious Reagan recovery, which has occurred only in the securities markets. "Off-balance-sheet" operations of the 15 largest U.S. banks are officially estimated at $1.256 trillion, and the Federal Reserve believes that their estimate fails to capture the entire picture. Globally, such assets probably approach $3 trillion. These include futures market participation, foreign-exchange "swaps," guaranteed note-issuance facilities, and similar forms of exposure not registered on balance sheets. Their financial effect is simple: They permit banks or their customers to buy securities on credit (through the futures markets) or to sell currency they do not own. All of these are means of creating credit, no different than a direct loan to a broker to finance margin purchases of securities on the stock exchange.

"Off-balance-sheet" liabilities are now almost double the banks' official liabilities; for example, against more than one-and-a-quarter trillion dollars of the former, the 15 largest U.S. banks have only $750 billion of liabilities on their balance sheets.

The implication of this for securities and currency markets is obvious, and has, in fact, been much commented upon in the margins of the financial press. The markets are now far more volatile than in 1929, when the supposedly insufficient 10% margin requirement permitted speculators to gamble with borrowed money. With futures-market margins well below any historical level for the stock market, the banking system can create a virtually infinite volume of credit to fuel the massive speculation of the past two years.

Without taking into account this multi-trillion-dollar phenomenon, which has ballooned upwards from virtual zero only a few years ago, it is impossible to fathom the simultaneous collapse of the dollar and the rise of the American markets. The simple equation between the financing requirements of the U.S. budget deficit and America's capital imports, so often intoned by central bankers and economists, breaks down: If America must import about $180 billion a year in "savings" to finance its budget deficit, and if it sends

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abroad $200 billion in payments for the trade deficit, why should the dollar rise?

If the dollar falls, by this supposition, it must be the result of the withdrawal of "savings," which would then raise interest rates at home. In fact, this scenario is the basis of the warnings of a "hard landi
economy by Stephen Marris of the Institute for International Economics and others.

The answer, of course, is that the notion that "savings" have anything to do with monetary developments in the short-run is ludicrous. We live in a world that the worst of the wildcat bankers of Andrew Jackson's era would find vertiginous. The generation of nearly $3 trillion dollars in "off-balance-sheet" liabilities *ex nihilo* during the past couple of years is unique in financial history, possibly excepting the 17th-century tulip bulb craze, the 18th-century "Mississippi" and "South Sea" bubbles, or the Kuwaiti stock exchange (based on post-dated checks) before its crash in 1984.

Making it up on the volume

The banks can and have financed any amount of financial-market speculation they want. They did it on purpose. It is impossible to estimate how much interest the banks are really earning on their Third World, energy, and real-estate loans. The regulators have docilely granted them leeway to keep such bad loans on their books, writing off the capital value over whatever period of time suits their accounts. But if interest isn't being paid, where is the money coming from to pay their depositors? Part of the answer is, simply, that the banks have made up the difference by soliciting fees and commissions by diving into whatever speculative markets are available. The result resembles the old Jewish joke whose punch-line goes, "I make it up on the volume."

Bankers who manage this business report that competition has driven down margins to such a point that many of these operations barely break even. That further encourages the banks to "take a view," that is, speculate for their own account.

The point has been reached at which the company treasurer takes the last of the accounts receiveable to the race-track. Understandably, the regulators are terrified that the banks will fail as a result.

But (in the very short run) the banks are less likely to fail, than to gang up upon the American dollar as a "sure bet," at the expense of the central banks, and the monetary system in general. The central banks of the industrial world have, in aggregate, less than $250 billion of foreign-exchange reserves available for intervention on the foreign-exchange markets. The current size of banks' "off-balance-sheet" operations is 10 times that amount, and nothing is stopping them from doubling or tripling that amount at whim. Ronald Layton-Liesching of Chase Manhattan's investment banking arm warns, "There is absolutely nothing the central banks can do to prevent the dollar from collapsing."

Federal Reserve chairman Volcker has been warning any

NSIPS/Stuart Lewis

Paul A. Volcker

congressional committee that will hear him of the consequences of an outflow of dollars for the U.S. economy, and his attempt to prevent a "premature" cut in the U.S. discount rate was motivated by this fear.

America imports one-sixth of its livelihood, by borrowing the difference from foreigners. Perhaps half of what we borrow derives, ultimately, from illegal monies, including narcotics revenues recycled back into the United States. At the current rate of increase, our national debt will exceed $1 trillion before 1990.

As the dollar falls, matters become worse, because we must pay out more dollars to purchase the same volume of goods priced in Japanese yen or German marks. (The one ironically mitigating side of the business is that 40% of our imports come from the Third World, whose currencies have been devalued to garage-sale levels by the International Monetary Fund. Most of these currencies fall with the dollar, putting the victim-countries in even worse shape).

Some bankers suspect that current discussions at the bank-regulatory, or "Cooke," committee of the Bank for International Settlements, concerning means to limit expansion of banks' off-balance-sheet operations, have to do with the central banks' attempt to get back in control of the foreign-exchange markets. The Cooke Committee met during the second week of March to review proposals. At this point, however, Federal Reserve staffers familiar with the issue do not see any means of overcoming the danger of "killing the goose."

Not only the central bankers, but part of the banking community, fear what will happen when the bubble bursts. The London monthly *Euromoney*, the glossy house-organ of

the London banking establishment, entitled its January editorial, "Cool It." The editorial warned:

"The explosion of trading volume in every type of financial instrument may not be a cause for celebration. It may be the beginning of a very unpleasant chain of events.

"Last year trading in foreign currency futures in the U.S. increased by more than 70%. . . . Market crashes are usually preceded by a sharp increase in the number of buys and sells. . . . Why is activity in the securities markets ballooning, when the real world of making and exporting widgets is almost static? We hope the answer is not what we think it is."

The central banks are in the same position that the Fed and the Bank of England found themselves in early in 1929, when the American stock market functioned like a gigantic vacuum for capital from the rest of the world. Capital flowed out of Germany, threatening to bring down the entire structure of refinancing of postwar reparations, thus ruining the City of London. Bank of England Governor Montagu Norman, observing the ruins of the City's loans to Germany and Eastern Europe, demanded that the American authorities take action to stop the bubble; after the Fed raised the discount rate, and the market crashed, he sent a congratulatory telegram to his counterparts at the New York Federal Reserve Bank.

Norman, of course, had killed the goose, namely, the Wall Street capital market which had financed London in the first place.
pound sterling, and began the collapse of world trade which left the world in depression until the beginning of World War II.

As matters stand, it does not matter much whether the Fed or the Treasury has the final word, since neither offers a policy leading to a different result.

'Merrill Lynch Mafia' rides the dollar down

by William Engdahl

"I just returned from Zurich, and people in the banking community there and in London compare the current Washington policy on the dollar to the 'malign neglect' which reigned during the Carter presidency." This is the comment of one of the leading monetary analysts in the City of London. "The power, we see, has shifted. Monetary policy is no longer being controlled by central banks, but by finance ministers. In the United States, the man running things is David Mulford."

To the horror of Federal Reserve chairman Paul Volcker, Treasury Assistant Secretary David C. Mulford is riding the dollar's freefall, in fair imitation of Slim Pickens' rodeo ride on a hydrogen bomb in the 1961 film, *Dr. Strangelove*. London market participants, whose activity centers on dollar-denomination paper, are aghast.

Since the Sept. 22, 1985 Group of Five meeting at New York's Plaza Hotel, engineered by Mulford, the U.S. dollar, still the major currency of world trade, has collapsed at an alarming rate. Fueled by official government propaganda that the dollar fall would produce beneficial results for the U.S. economy, the dollar has lost 30% of its value of only five months ago. Its rise occurred over almost four years, up until the Plaza Hotel meeting, organized by Mulford with reported help from his former boss, Donald Regan. Volcker was kept uninformed of the important meeting until two hours before and had to be picked up by helicopter from a Potomac fishing trip.

The dollar was due for a crash in any event, and the current decline has only brought the U.S. currency roughly into range of commodity market-basket parity with the German mark and the Japanese yen. However, Mulford has created the conditions for what observers call the "hard landing scenario," or, more politely, "overshooting" of the dollar's proper exchange rate—and total chaos in the world economy.

Collapsing world trade further

Until now, the only obvious gainers from the dramatic dollar coup of the past several months have been the stock exchanges of Wall Street and major industrial countries. The real economy, and most importantly, world trade, appear to be undergoing major dislocations as a result of the rapid freefall. Since George Shultz, Paul Volcker, and others in the Nixon Treasury Department engineered the decoupling of the 1945 Bretton Woods fixed exchange rates, on Aug. 15, 1971, the world has undergone an escalating series of monetary shocks which have devastated the real trade in goods throughout the economy.

Europe geared its entire economy to exporting to the United States while
dollar's collapse leaves Europe without an export market, and the threat of economic breakdown.

"European farmers are being devastated by the collapse of the dollar," one West German beef trader told *EIR*. Since last fall, the West German mark has risen in value from about 3.35 DM to under 2.25 DM to the dollar. Since world food trade for grain and other major exports is priced in dollars, this has meant an effective loss of almost 30% in the value of German farm exports alone. This has produced a major budget crisis in the European Community as West German Finance Minister (and Trilateral Commission member) Gerhard Stoltenberg announced that no new monies would come from EC finance ministers for the troubled farm sector. Under EC farm-export subsidy programs, if the dollar price of world grain and other food falls below EC cost prices, the EC should pay farmers the differential. A collapsing dollar has meant in