EIR Economics

America's foreign subsidy comes to an end at Venice

by David Goldman

For the past year, the national finances of the United States have depended upon the printing-presses of its trading partners; since the first of the year, exclusively so. Foreign private investment in the United States, which must borrow $150 billion a year to finance its external and budget deficits, long since gave way to the ballooning of unwanted dollar holdings in the official reserves of foreign central banks. *EIR* warned in its *Quarterly Economic Report* of September 1986, that the political agreements under which America's foreign subsidy might be financed were eroding. The summit meeting of industrial nations at Venice will bury them.

That much was already made clear by the Western leader most hostile to American interests, Italian Foreign Minister Giulio Andreotti, who told Italian reporters that he would propose *a system of currency blocs* before the Venice meeting. That is as much as to say: *to eliminate the dollar as principal international reserve instrument*, or, the same thing: *to eliminate foreign central banks' need to accumulate more dollar holdings*.

Andreotti, to be sure, represents a fringe viewpoint, shared only by the most anti-American "Central Europeans" among European bankers and the European Commission bureaucracy. But the reality of the international banking crisis pushes such plans onto the international agenda, regardless of the policy-intent of America's trading partners.

They accumulated $30 billion of additional dollar reserves during the first quarter of 1987, about equal to America's $34 billion trade deficit, by purchasing unwanted dollars on the market (foreign exchange market "intervention"), and purchasing U.S. Treasury securities with these dollars. In other words, they financed the entire U.S. trade deficit with these purchases, and, by purchasing Treasury securities, financed almost two-thirds of the U.S. government's borrowing requirement for the quarter.

"Such official financing cannot be continued indefinitely," warned the dominant Treasury dealer, Salomon Brothers, in a commentary last Oct. 10. "U.S. securities will have to offer foreign investors adequate compensation for currency risks."

However, to purchase these dollars on the foreign exchange markets, foreign central banks created more of their own currencies, and sold them to private institutions in exchange for unwanted dollars. $30 billion of yen, marks, and other foreign currencies were thus added to the so-called Eurocurrency deposit pool.

To precisely the extent that the Japanese, West Germans, or others purchase unwanted dollars with their own currencies, they increase the exposure of their national banking systems on the shaky offshore market, since every unit of their currency held offshore, constitutes a potential claim upon their national banking system.

At a moment when the American banks are taking unprecedented crisis-measures to reduce their exposure, including multi-billion-dollar additions to reserves against Third World loan losses, it is ridiculous to presume that foreign central banks will permit the banks they supervise to increase their foreign exposure, and at an unprecedented rate. Their massive support operation for the dollar's market parity (and for the U.S. Treasury), i.e., the creation of massive amounts of national currencies with which to purchase dollars, nourished a drastic shift toward non-dollar-lending in the Euromarkets.

Between 1980 and 1986, between 60% and 80% of each year's issuance of international securities was denominated

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in U.S. dollars. However, between the last quarter of 1986 and the first quarter of 1987, the volume of dollar securities in the nearly $200 billion per year market fell by about half, from about 65% to about 38%. That corresponded to a shift from the American syndicate managers' historic domination of the market, to the emergence of the Japanese investment banks as the dominant managers of new securities issues. In 1986, Crédit Suisse-First Boston ruled the Eurosecurities market, leading 105 issues totalling over $20 billion. In 1987, Japan's Nomura Securities came in first, with almost $8 billion of new issues, while Crédit Suisse-First Boston fell to less than $4 billion.

That pinpoints European central banks' principal area of concern. The collapse of major portions of the Euromarket, including the now-infamous $200 billion market in "floating rate notes," defines the epicenter of banking risk. Central banks concerned about the safety of their national banking systems will be forced to contain the expansion of such risk, i.e., the involvement of non-U.S. institutions in the floating of more yen, deutschemark, Australian dollar, or sterling Eurobonds.

The decline of America's economic power

America's dominant position in world trade made the reserve-role of the dollar inevitable during the postwar years. America's abuse of that reserve role, i.e., the employment of the dollar as a rentier currency, buying up foreign production facilities and labor at cheaper than domestic rates, set the stage for the present crisis. Nothing backs the reserve position of the dollar today, except for the perception of foreign governments that they must subsidize America's strategic role as the defender of the Free World; to the extent that the Reagan administration abandons that role, through such devices as the so-called "zero option," the justification for the subsidy disappears.

The substitution of foreign official purchases of dollar securities, for foreign private purchases, reflects the strictly *political-military nature* of support for the dollar. Some commentators, e.g., former Council of Economic Advisers chairman Alan Greenspan, woke up with a start to find that foreign central banks' reserve holdings financed the entire U.S. trade deficit during the first quarter of this year. In fact, the shift from private to public support was complete by the end of 1986. Foreign official participation in U.S. auctions and custody holdings at the Federal Reserve had already grown to $38 billion during the first nine months of last year, largely due to exchange-market intervention. During 1984, foreign official holdings of U.S. dollars rose by only $8.5 billion, and by only $4 billion in 1986. Between January and June of 1986, these purchases rose at an annual rate of $42 billion, and to an annual rate of $60 billion during the June-October period. That rate doubled to $120 billion per year during the first quarter of 1987.

Unpublished data circulated by Morgan Guaranty Trust show that Japanese institutional investors sold $30 billion worth of U.S. securities, both stocks and bonds, during the first quarter. Apparently, U.S. institutional investors picked up the difference. The Japanese institutions, by contrast, moved into DM, sterling, and Canadian dollar securities.

Large Japanese purchases of U.S. Treasury securities no longer necessarily reflect any net movement of funds by private investors into the U.S. market. Since mid-1986, according to a recent Bank for International Settlements study, Japanese banks began using *borrowed* dollars to finance purchases of U.S. Treasury bonds, rather than selling yen to buy them. The BIS, the central bankers' central bank, reportedly fears that the change has increased the vulnerability of the U.S. bond market to a Japanese fund withdrawal, e.g., at the point the dollar borrowing cost to Japanese banks outweighed the return from holding U.S. bonds.

How should America respond to Andreotti's proposal to eliminate the reserve role of the dollar? The trade data appear to support him. In 1986, West Germany became the world's leading exporter, shipping about $230 billion, overtaking America's $220 billion for the first time. Japan's share of world trade, meanwhile, continued to grow, reaching the level of 10% of world exports for the first time. The combined exports of Japan and West Germany last year were 100% greater than exports from the United States, against a 66% difference in 1978.

But U.S. dollars still account for more than 70% of total world reserves, even though American exports are a mere third of the combined Japanese-German-American total. That makes clear why gold has reached a four-year high point in the range of $470 an ounce. During 1986, Japan bought half of the total Free World gold output, or about 608 tons, more than triple the previous record of 197 tons in 1985. While official statements have claimed the gold is for a commemorative Emperor Hirohito coin, analysts believe that Japan may be building its central bank gold reserves. More importantly, the Japanese government and financial institutions believe that any gold in the hands of Japanese nationals constitutes a sort of national reserve.

The time has gone when the United States can hold its trading partners to their responsibility to the alliance, while destroying its own capacity to defend them. To follow the International Monetary Fund's advice, and throw America into a Brazilian-style austerity program, would immediately destroy the American credit system (see *EIR*, May 22, 1987, "President Reagan dives into the budget trap"). To attempt to prolong the present non-policy, will erode the dollar's foreign position and American securities markets, leading to a general financial crisis almost as quickly. Nothing short of a global financial reorganization, including the restoration of gold backing to the dollar, a low-interest, long-term rescheduling of Third World debt, and a concerted development program for the Third World, will avoid the long-overdue reckoning.