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America's creditors get their pound of flesh

by David Goldman

America's foreign creditors will have their "pound of flesh" in September, by one means or another, as the London *Times* put it Sept. 2. That means some combination of higher interest rates, dollar devaluation, and budget cuts. Whatever happens, the administration's "recovery" illusion, centered on the stock-market bubble, will fade, either by the end of this month, or very soon thereafter. There is no basis to predict what will go wrong with the monetary system, because *everything* has gone wrong. There is no basis to predict whether the Federal Reserve will push interest rates up far enough to collapse the savings and loans, or opt, instead, for a big enough devaluation of the dollar to spark a run by foreign investors, or, indeed, whether runs against bankrupt Texas thrift institutions, or the collapse of negotiations between U.S. banks and Brazil, will trigger a financial crisis, before the Federal Reserve has the opportunity to provoke a crisis through its own blundering.

When Congress returns to session Sept. 9, the first item on its agenda will be the same as the last item before it recessed, namely, the expiration of the federal debt ceiling Sept. 23. Congress extended the Treasury's capacity to borrow Aug. 7 to the end of this month, after the Oval Office and the Speaker of the House conspired to wreck a supposed budget-cutting compromise. There is no more basis for compromise now than before. The White House will not accept House Ways and Means Committee chairman Rostenkowski's demands for budget cuts that would reduce defense spending by $20 billion or more. Speaker Wright has set a collision course with the Administration to force tax increases, partly to save domestic programs, but also, to humiliate the White House in advance of the presidential elections.

Meanwhile, events in the financial markets could make the congressional debate academic, since it is far from certain that the United States will be in any position to borrow the $150 billion per annum from foreigners it presently requires to finance its trade deficit; the same borrowings, which take the form of purchases of U.S. securities, directly or indirectly finance the U.S. government deficit as well.

Since mid-August, the U.S. dollar has fallen from DM 1.90 to DM 1.79, and threatens to fall much farther, very quickly. On the surface of events, the occasion for the dollar's plunge appeared in the form of last month's announcement that the United States, in June, ran the worst monthly trade deficit in its history. More fundamental forces are at work, however. The United States economy cannot produce the physical product to meet its own internal requirements; in the fiscal sphere, that translates into a shrinking tax base, or "insufficient savings" to finance government spending, either by internal taxing or borrowing.

Through the middle of 1987, the external and internal deficits of the United States were financed on the printing-presses of foreign central banks. Foreign central banks, including the Japanese, German, and Taiwanese, printed $70 billion worth of their own currencies, to purchase dollars off the floor of the market. The central banks then purchased U.S. Treasury securities with the dollars they had purchased, while the local currencies they printed took off to chase rising stock prices or similar speculative activity. That makes up the entire content of the various "dollar stabilization" agreements among the various central banks.

By sometime in July, the Bank of Tokyo and the Bundesbank decided to stop debasing their own currencies in order to finance America's internal and external deficits, and that set the stage for the new dollar crisis. Fresh evidence that the

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United States economy remained in disastrous condition, i.e., the trade deficit announcement, merely detonated the monetary powder.

Long-term U.S. interest rates rose, correspondingly, roughly a percentage point, to almost 9.5% on the 30-year Treasury bond, the highest rate in almost two years, as of Sept. 3. That leaves Federal Reserve chairman Alan Greenspan in a miserable position; if he merely permits the dollar's deterioration to continue, interest rates will rise far enough to endanger the financial sector, which made most of its income since 1985 speculating in bonds. The enormous losses announced by Merrill Lynch, First Boston, and other institutions for the second quarter, the last time the bond market crashed, were warning enough.

Various Wall Street pundits now demand that the Federal Reserve force up short-term interest rates sharply, in the strange belief that "investor confidence" that the Federal Reserve is "fighting inflation" will take pressure off long-term interest rates. However, any but a very small rise in short-term rates will pull the rug out from under savings and loans which balance between a largely fixed-income mortgage portfolio, and short-term deposits (see *Banking*) The heroic Federal Reserve Board chose to raise the discount rate Sept. 4 by 0.5% to 6%, a pusillanimous, irrelevant gesture.

Greenspan's other alternative, of course, is a dollar devaluation. The London *Times* editorialized, Sept. 2, "The finance ministers have a choice. They can defend the dollar at present levels, and hope the current overwhelmingly bearish sentiment on the dollar passes over. Or they can retain the initiatve by moving the dollar goalposts. Shifting the dollar from its present levels of just above DM 1.80 and Y140 to, say, DM 1.60 and Y125 to Y135 would give the foreign exchange markets their pound of flesh."

This debate has only tactical, not strategic, importance. The majority of the Federal Reserve Board, composed of Reagan political appointees, wants America's foreign creditors to continue to finance the deficit at affordable rates through the 1988 elections. Knowledgeable Republican sources report that the present line-up on the Fed board stands at 4-2 for an old college try, to hold the dollar at around DM 1.80 and Yen 140, with only Carter appointee Martha Seeger and former Bank of America economist Robert Heller in doubt. However, Heller's remarks to the Swiss-American Chamber of Commerce in Zurich Sept. 1 argued that the present dollar level was defensible.

But the Federal Reserve has a big problem: the unwillingness of America's trading partners to continue to finance its deficit on the printing presses of their central banks. That is not an issue of convenience, but survival.

U.S. Treasury bonds lost almost 2% of their outstanding value on Sept. 2, meanwhile, after Japan's Takeho Chemical Co. announced it faced bankruptcy due to bond-trading losses. The Bank of Japan's new monetary stringency has hit bond speculators hard, and there is suspicion that Takeho, a small player, was made into a horrible example to discourage other companies. The incident signaled to analysts that Japanese companies might also pull their horns in from the U.S. market.

The Fed cannot defend the dollar, if the foreign investors who lend America $150 billion a year, come under pressure from their central banks to stop. That is why the Federal Reserve abstained from foreign exchange market intervention after the dollar hit the "psychological trigger level" of DM 1.80 at the end of August, while other central banks intervened. "The Fed wanted to make the Bundesbank and the Bank of Japan sweat," explained one knowledgeable analyst. "They didn't like recent statements from the Bundesbank and from Japanese Finance Minister Miyazawa to the effect that they were worried about growth in the monetary aggregates."

The Fed is playing chicken with the dollar. Japan and West Germany, the most trade-dependent of the industrial nations, would suffer, were the dollar to crash out of control. They have an interest in avoiding a dollar crash, but their interest in preserving the existence of their banking systems is overpowering. They are playing chicken as well, demanding that the United States drastically reduce consumption, through a combination of fiscal and monetary austerity, in order to forcibly reduce its trade deficit, and its dependence on foreign financial sources.

The Chinese fire drill

The Federal Reserve and the other central banks are locked into a fair imitation of what American juvenile delinquents with fast cars used to call, "chicken." But between them, a drunk is weaving down the road, namely, the administration. Whatever the Fed's current views on the subject, it is far from clear that it will not force a competitive devaluation of the dollar, as a response to the trade deficit. Another monstrous deficit will be announced on Sept. 11, just as Congress prepares action on a new trade bill. Whether the President's veto can stop a protectionist trade bill is not clear, either. Faced with the prospect of a veto-proof protectionist bill, the White House might well decide to "talk down the dollar," in order to convince Congress that it is taking strong action on behalf of American exports, without direct retaliation against America's trading partners.

For the moment, the administration remains cautious. Special Trade Representative Clayton Yeutter, the official most likely to pursue a soft-dollar policy, warned recently that a weaker dollar would only raise interest rates at home. But a good deal of well-informed European money is still betting that Washington will tumble toward a competitive devaluation, for lack of a better response to the trade deficit.

The confrontation over the federal debt ceiling, meanwhile, will interrupt all the crisis-management scenarios, with a Chinese fire drill in the grand style only Washington seems able to stage.