EIR Economics

Europe Considers Controls, But Dollar Crisis Is Systemic

by Lothar Komp

A small wonder occurred on the foreign exchange markets on Tuesday, Dec. 9. On all eight of the previous trading days in succession, the U.S. dollar had fallen to new historic lows against the euro. Against currencies with longer histories like the British pound, the dollar had sunk at the same time to its lowest level in 11 years. But then on the 9th, the dollar's plunge was temporarily halted. Had a prospect for the continued financing of the gigantic foreign indebtedness of the United States suddenly come to light? Not at all. The pause for breath in the dollar's descent was much more the result of a special cause: renewed, massive interventions by the Bank of Japan to force the currency markets—in blatant opposition to the liberal economic dogma of free "floating" exchange rates.

During the course of 2003, the Bank of Japan has spent, by its own reports, an astonishing 17.8 trillion yen (roughly the equivalent of $165 billion) in such interventions. It has done this in the thus-far vain hope of braking the rise of the yen against the dollar, which is damaging Japan's exports. The interventions take place on orders of the government; the central bank is only their executive organ. In order to generate the financial means required for this enormous purchasing of dollar paper, the government of Japan has had to increase its issue of its own debt, during its current legislative session, to a total of 79 trillion yen, or $731 billion.

But this barricade could already be broken down within the next week. Therefore on Dec. 11, the Japanese Finance Ministry set the prospect of an upper level of debt issuance for the full year, including this exchange market intervention, of a round 100 trillion yen—$926 billion! If necessary, said Ministry official Hiroshi Watanabe, it would be possible to adopt retroactively an emergency provision and let the Bank of Japan issue foreign debt directly.

And indeed, following the announcement of a record-high US trade deficit for October—$41.77 billion in a single month—the dollar on Dec. 12 fell yet to another all-time low against the euro ($1.23), and to another 11-year low against the British pound. And neither the massive hype around the arrest of Saddam Hussein on Dec. 14, nor the Dec. 13 failure of the European Union summit to agree on the so-called EU "constitution," has stopped the dollar's decline.

European financial experts consider the Dec. 9-10 visit of Chinese Prime Minister Wen Jiabao to Washington as indicating a dramatic shift in the global financial system. That President George W. Bush publicly urged Taiwan to restrain itself vis-a-vis Beijing, is seen by market insiders as the first public signal that the Bush Administration is losing maneuvering room in foreign policy due to its dependence on foreign capital inflows.

Next to Japan, China has the largest holdings of U.S. Treasuries and other dollar assets—$383.9 billion as of September—and Wen was coolly playing out this situation during his U.S. visit. On Nov. 23, Beijing's *Peoples Daily* had run an article headlined, "China says it will not dump U.S. Treasuries to retaliate." The *China Business* newspaper quoted an unnamed official with the State Administration of Foreign Exchange, saying: "The nature of our agency is to manage the national forex assets well. To put it simply, we're looking at profits, and as long as we don't get instructions from the central bank, we won't sell U.S. Treasuries." Referring to China's vast dollar reserves, the *China Business* article states: "A large part of this money has been spent buying U.S. Treasuries and other debt instruments, helping to keep American interest rates low. If China was suddenly

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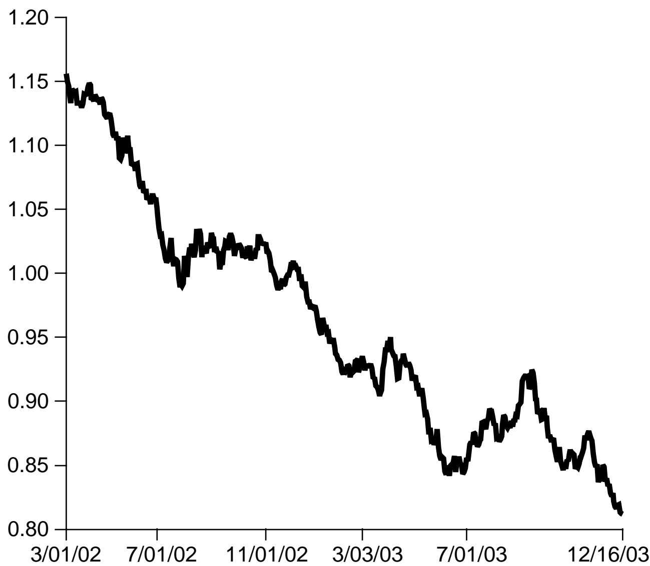
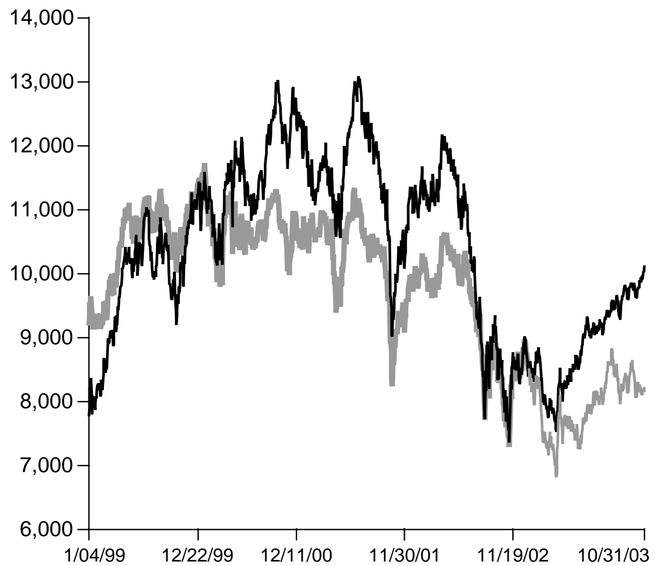
FIGURE 1
Value of Dollar in Euros
(Euros per Dollar)



Source: Wall Street Journal

Just since the euro officially became the single European currency, the dollar has lost more than a third of its value, and the decline is accelerating now. A similar fall against the yen has been braked only by stupendous dollar-buying interventions by the Bank of Japan—$165 billion worth during 2003.

FIGURE 2
Value of the Dow Jones Industrial Average, In Dollars and Euros, 1999-Date



Source: Wall Street Journal

The "recovery" on Wall Street looks quite different when measured in euros, making Europeans' investments in U.S. stocks and bonds still losers. European capital flows into the United States have fallen sharply; will Asia be next?

to sell off Treasuries, it could potentially cause U.S. interest rates to rise, wreaking significant damage on the U.S. economy."

But, at the same time, the Bank of International Settlements (BIS) has reported that Chinese banks have been cutting their overseas holdings during eight of the past ten quarters, through June 30. Funds deposited overseas by Chinese banks were down to $70.4 billion at the end of June, from $92.5 billion two years earlier. They repatriated $9.1 billion in second-quarter 2003 alone. The U.S. Treasury itself reported that China sold a net $2.8 billion of U.S. Treasuries and agency bonds during September.

Absurd Procedure, Impossible Strategy

In general, then, the procedure comes down to this: the U.S. Federal Reserve prints new dollars, to finance the American trade deficit; and the Bank of Japan attempts, by ever-faster printing of new yen, to buy these new dollars. The example also makes clear how the global financial system is breaking apart at the seams.

Meanwhile, representatives of the U.S. administration and of Wall Street put forward the most absurd arguments, to create the impression somehow that the dollar's plunge is really no problem, and that the situation is still under control. So it is claimed, among other things, that the falling dollar will strengthen American exports, and thereby further heat up the allegedly furious "recovery" in the U.S.A. But this strategy, as European financial analysts note, will undeniably fail. It could have worked in the 1950s or 1960s. But due to the structural changes—i.e., the post-industrial "consumer society" orientation—of the U.S. economy in recent decades, the dollar would have to sink by 40-60% in order to achieve such an effect, he said. Furthermore, one would have to combine the devaluation with an increase in taxes and interest rates to curtail consumption and imports. But that certainly will not happen in an election year. And, what would be the consequences for the U.S. housing market? As the capital flows into the United States are drying up, the Federal Reserve ultimately will have to print more money to finance the exploding current account deficit.

Official circles in Europe, like those in America, act outwardly as if everything were in good order. But there are exceptions. And in private discussion, government representatives express alarm and helplessness in the face of the global financial and currency crisis, which more and more now is

depressing economic activity in Europe. Even on Dec. 9, German Finance Minister Wolfgang Clement was still claiming that he saw no signs of negative effects of the fall of the dollar on German exports. One day later, the Federal Statistical Bureau reported a drop in exports in October of 6.6% below the previous month, the worst month-to-month export fall in more than a decade. Also on Dec. 10 appeared an interview in *Le Figaro* with Italian Deputy Finance Minister Mario Baldassarri, who warned that the appreciation of the euro threatened the entire European economy, and asked: "Why do the two leading economic regions in the world let their currencies float freely, without any attempt to defend a parity band between 0.9 and 1.1 against the dollar?" Baldassarri insisted that that was the only way "to guarantee the stability of the international system."

But how could governments carry out such a decision on today's global foreign exchange markets? With permanent mega-interventions, Japanese style?

Capital, Currency Controls Necessary

In the Bretton Woods exchange-rate system, which the 1971 decisions of U.S. President Nixon broke up, currency relationships remained stable, because international capital flows lay under rigid limits. Interestingly, the British *Daily Telegraph* reported on Dec. 4 that the European Commission had just clarified the legal basis for the reintroduction of capital controls, which have not been used by European nations since the 1970s. A team in Commissioner Pedro Solbes' department for economic and currency questions, had decided that current law allowed the Commission in Brussels to publish immediate regulations to control capital flows. And an unnamed official of the European Union had specified that a

Foreign Investment Fell Sharply

The U.S. Department of Commerce reported on Dec. 16 that the country's current account deficit registered $135 billion for the third quarter of 2003, remaining at its extraordinarily high level. The third-quarter deficit was virtually the same as the record gap in the second quarter, smaller by only a few billion dollars. A critical new feature of the picture in the third quarter, however, was the sharp drop in the amount of net investment, or net flow of capital, from foreigners into the United States. It is this vacuum-like flow, at a rate reaching nearly $2 billion per day, which has been financing the huge trade and current-account deficits by which the United States economy has been looting the rest of the world's goods—importing those goods at cheaper and cheaper prices, and paying for them, in effect, with imported capital.

The total current-account deficits for the first three quarters of the years were $138.7 billion in the first quarter, $139.4 billion in the second, and $135 billion in the third, for a total of $413 billion with three months of the year remaining.

The U.S. current account balance is driven overwhelmingly by the U.S. deficit on trade of goods and services, which accounted for 90% of the third-quarter current account deficit. (The trade balance is one element of the current account; the other two elements are the balance on investment income, and the balance on unilateral transfers). America's shift to the "Roman" imperial economic paradigm of a collapsed United States no longer capable of producing its own existence, and exacting tribute—physical goods imports from around the world—is the principal cause of the current account deficit.

During the third quarter, there was a drop of more than one-half in the net foreign investment into the United States. In the second quarter, on a gross basis, foreign investors had invested $262.8 billion into American markets; i.e., buying stocks, bonds, real estate, and so forth. However, during the third quarter, foreign investors reduced their investments into the United States to $128.2 billion, a stark drop of $134.6 billion in the investment level.

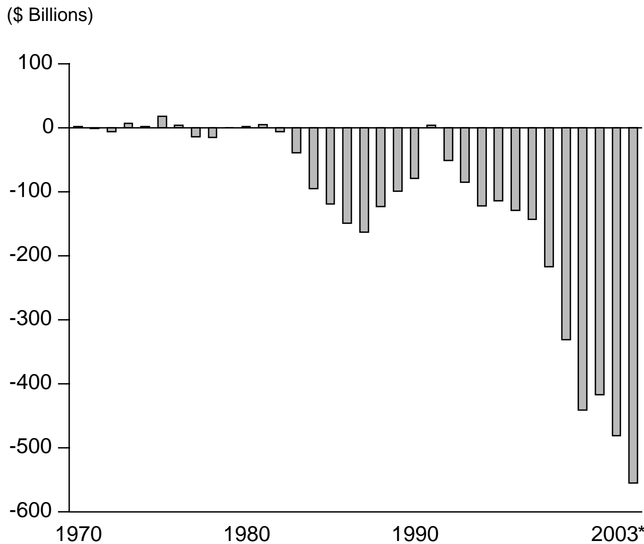
This drop was so sharp, in fact, that it produced a very unusual result: During the third quarter, the level of gross foreign investment, $128.2 billion, was not enough to cover the same quarter's current account deficit of $135.0 billion.

Preliminary reports comparing October and November, and unofficial estimates for early December, have indicated that this process is significantly worsening during the fourth quarter, threatening a systemic breakdown of the dollar-based banking system.

The German central bank, the Bundesbank, warned in its December report that "external geopolitical shocks and strong gyrations on global financial markets" are the biggest risks for the financial system, because "the extraordinary current account imbalances, in particular in the U.S." could lead to "abrupt movements on foreign exchange markets."

The Bundesbank also warned of the means of all this purchasing in the United States: The "indebtedness of private households has increased sharply in recent years, and in 2002 reached 110% of disposable incomes, an all-time high."—*Richard Freeman*

FIGURE 3
U.S. Current Account Deficit Swells, 1970–2003
($ Billions)



* Projection of Commerce data, based on first three quarters of 2003.

Source: U.S. Department of Commerce.

The huge American current-account deficit has become a huge problem for Europe, leading to discussion in government circles of reintroduction of capital controls.

euro level of $1.35 would presumably be the trigger for the introduction of the controls.

While the European Commission subsequently characterized this report as "completely misleading," and the European Central Bank declined to make any comment, the *Daily Telegraph* did not pull it out of the air. In the *European Union Economy: Review of 2003* report of the European Commission published on Nov. 26, a surprising 45 of the 246 pages were devoted to the theme "Determinants of International Capital Flows." That chapter contains a detailed compilation of the legal bases or capital controls, both within the European economies, and between them and so-called third countries. It noted that the free movement of capital was made one of the core principles of the European Community already by the 1957 Treaty of Rome. But this principle was limited by a whole series of exceptions. Most definitively, the Bretton Woods fixed-exchange-rate order ruled at that time.

The Commission's 2003 report stated: "The Bretton Woods system embodied the idea that capital flows posed a threat to monetary and financial stability, and to national and political sovereignty. The experience of the 1930s was taken as proof that international flows of capital destabilized economies. For this reason, in the 1950s and 1960s, capital flows were the subject of exchange controls and regulations, through which cross-border financial transactions were limited to a minimum."

The article on exceptions to the free international flow of capital was extensively confirmed in the Maastricht Treaty of 1991, and in the Amsterdam Treaty of 1997. Article 57 of the latter Treaty says expressly that the obligation to allow free capital flows does not affect the power to use any of those regulations " which exist as of Dec. 31, 1993 . . . for capital movements with third countries. . . ." Another article allows the introduction of "quantitative restrictions" of capital flows and "defense measures" against third countries—especially with regard to capital movements, insofar as member countries of the European Union would otherwise suffer serious balance of payments crises.

For the case of the current dollar crisis, Article 59 of the Amsterdam Treaty is most important: "In the case in which capital movements to or out of third countries, under unusual circumstances, seriously disturb or threaten to disturb the functioning of the economic and currency union, a qualified majority of members, on the proposal of the European Commission, . . . can take defensive measures against third countries which remain in force for a maximum of six months, if these [measures] are absolutely required."

Maneuvers, Not Solutions

It is certainly no accident that the European Commission set forth the existing legal grounds for re-imposing capital controls in its yearly report just at this time. There are other notable developments. Some European governments, including those of France and Germany, have gotten into a serious fight with the European Central Bank. And they certainly propose, in the future European Union constitution, to change decisive elements of the basis for the currency union anchored in the Maastricht Treaty. Article 105, "Currency Politics," in the Maastricht Treaty begins with the words: "The first-ranking purpose of the European System of Central Banks is to guarantee price stability."

This one-sided choice of objectives ought to be stricken in the EU constitution. The nations will also have to abolish the formal independence of the European Central Bank, by which it is made into an "organ" of the European Union. Finally, the Italian government has made the proposal for an "emergency clause," which would make it easier in the future for the European governments to adopt changes in the charter of the Central Bank.

All these maneuvers are signals of the oncoming systemic crisis, but offer no fundamental solution for it. More, they document the searches of governments, seeing the out-of-control spiral of debt and currency chaos, to win back some room for action. But it is far too late for the half-measures being planned. Only a complete change in the monetary system has a prospect of success today—the financial, trade, and economic reform proposed by Lyndon LaRouche as the framework of a "new Bretton Woods."