How long can the dollar bubble last?

by David Goldman, Economics Editor

The dollar's 10-year high as of this month coincides with a contraction of world trade faster than that of the early 1930s, including an American trade deficit which, according to the warnings of the director of the Institute for International Economics in Washington, will reach $100 billion during 1983 at present rates of deterioration. As the economists of the Swiss Bank Corporation explained in their Nov. 9 report, the dollar's present value has little to do with objective conditions of any kind; it has become "a full-fledged currency of flight capital," drawing in speculative and portfolio funds from around the world.

In principle, the current rise of the dollar (and of American securities markets) is not much different from the 1928 inflows of capital into the United States, which puffed the domestic markets, while throwing much of Europe (which had been dependent on earlier *outflows* of capital from the U.S.) into depression, a year before the stock market bubble burst. But the present bubble is different, and much worse, for one fundamental reason: the dollar (unlike 1928) is the unit of account of world trade and lending, and its value ultimately depends upon the functioning of the world trade and lending system. In other words, the currency as unit-of-account for trade and debt claims is ultimately worth only as much as those claims themselves.

A 20 percent trade drop

The value of foreign trade, reported the International Monetary Fund Nov. 1, fell by over 20 percent in the months of July and August alone; part of this is the result of currency devaluations against the dollar, which understate the physical volume of the exports of the industrial countries, and part of this is due to normal seasonal factors. Even taking these mitigating factors into account, the two months showed a currency- and seasonally-adjusted decline in industrial nations' exports of about 15 percent. The collapse of trade is the result of the continued sharp rate of economic contraction in the United States and West Germany and the slowdown of growth in Japan, and, more pronouncedly, the collapse of lending to developing nations.

The importance of the collapse of exports to the developing sector is shown by the fact that whereas exports of industrial nations fell by 20 percent, their imports fell by only 11 percent during the same two months, i.e., their exports to each other fell less than their total exports. While data are not yet available on the imports of the developing nations, it would appear that their fall during the summer exceeded 30 percent. A large part of this may be due to the virtual cessation of imports into Mexico, whose total import level during September 1982 was barely one-fifth of its imports during September 1981; however, to one extent or another, all the developing nations are under the same financial pressure that Mexico now faces in an extreme fashion.

There are also indications that the import levels of the industrial nations will fall in tandem with their more rapidly declining export levels. For the moment, the United States and Britain have represented a growing import market. American imports grew by 16 percent in August alone, largely due to the momentary pumping of domestic demand through the June tax cuts; but the import level had already fallen back in September, and must continue to fall, as the recession worsens (*EIR* projects a 7 to 10 percent range of decline for physical output of the economy between the fourth quarter of

1982 and the fourth quarter of 1983). French imports had already fallen by 20 percent during August (much more than the usual seasonal fall), and the worsening of the French trade balance by more than half between 1981 and 1982 ensures a continuing decline of French imports; Italy's payments crisis ensures a decline there, and the continued contraction of the West German economy raises few encouraging prospects for the West German market.

Fraud and chicanery

These facts, as the IMF reports them, identify the most recent round of debtor-creditor negotiations involving the major Ibero-American nations as a dangerous type of hoax. Brazil is now appealing to its creditors to provide the $3 billion it needs to meet its obligations through the end of 1982, using the following reasoning: Planning Minister Delfim Netto (see article, page 7) has used a Wharton Econometrics forecast of 2 percent world trade decline in 1982 and a 2 percent rise in world trade in 1983 to argue that Brazil, with brutal economic stringency, might produce a $6 billion trade surplus in 1983, and therefore is creditworthy.

Wharton's economists know this is a hoax, but say it in order to persuade Brazil not to collaborate with other Ibero-American nations who are also in debt negotiations with private and official creditors; Mr. Delfim Netto knows this is a fraud, but says it to squeeze as much money out of the banks while there still is money out there. As Brazil's President Figueiredo told the United Nations General Assembly in September, Brazil cannot pay its debts if world trade were to go to pieces. Brazil and the banks both know this. However, both feel themselves too weak to call the question just now.

The same aura of fraud by mutual agreement surrounds the "tentative agreement" announced by Mexico and the International Monetary Fund Nov. 10. In a press conference that day, Mexican central bank governor Carlos Tello Macias told reporters flatly that exchange controls would *not* be lifted, while the letter of intent released to the press describes the exchange controls as "temporary." Exchange controls were not the only, but were unquestionably the most important, issue between Mexico and the Fund, who have been circling around an agreement since Sept. 1. As a senior Federal Reserve official put the matter, "It's a question of precedent; the IMF can't possibly sanction the kind of controls that Mexico imposed without giving up the entire principle of the liberal world trading system, and will never bend on this point." As the *Wall Street Journal* noted Nov. 11, there appears to be "confusion" over what was actually agreed to.

The same applies to the repeated announcements of an Argentine deal with the IMF, which in each case turned out to be no deal whatsoever. One advisor to the Ibero-American delegation to the International Monetary Fund cautioned against taking any reports of deals, signings, loans, and compromises too seriously. "You know what happens when Delfim Netto and a banker go into the negotiating room," he added. "Both walk out with each other's wallet. And both the wallets turn out to be empty!"

Nothing has changed since the finance ministers of the developing world warned the industrial nations at the International Monetary Fund Annual Meeting at Toronto the first week of September that the "entire financial and trading system" of the world might break down unless the extant policies of the industrial nations were turned around; nothing, that is, except the statistical confirmation that the developing nations' means of paying their debts are falling only slight faster than the industrial nations' means to refinance these debts. The present round of "negotiations" is a *Sitzkrieg,* a phony war, which ultimately cannot favor either side, but weakens both as it postpones a resolution of the real issue.

Dangers for the industrial nations

The collapse of trade has not only thrown discussions of debt refinancing for the developing sector into the realm of fantasy, but raised the spectre of industrial nations' bankruptcy for the first time since the shock of the oil crisis in 1974. As the leading Swiss financial daily pointed out Nov. 10, the Securities and Exchange Commission's refusal to register a $150 million bond issue for the French state-owned *Caisse Nationale des Telecommunications* marked something of a turning point. The SEC demanded further information on the total quantity of French external indebtedness, a matter of fierce dispute inside France at the moment. The leading national daily *Le Monde* revealed Nov. 6 that the actual foreign indebtedness of France at reached 320 billion francs (about $52 billion), half again as much as the country's total gold and currency reserves, and considerably more than the official estimate.

Swiss commercial banks began to boycott French official loans in September. The *Neue Zürcher Zeitung* explains:

"With its present level approaching 10 percent of Gross National Product, France's foreign debt has reached the first level of alarm. The payments balance on current account, whose deficit in 1981 consumed 53.6 billion francs in reserves and will consume another 85 billion this year, has caused the monetary authorities justifiable concern. The question of whether France's international credit standing has been broken appears, at the moment, to be of limited current value indeed. However, the rise of indebtedness in the present year demonstrates that danger threatens."

This is the Republic of France; consider the position of Spain, Italy, or Greece.

Although no such figures are readily available, it is likely that the United States itself has been the major foreign borrower during 1982, as a number of economic advisors to the President (e.g., former Council of Economic Advisers economist Michele Frattiani) advocated as a matter of principle. The flight of capital from Eurodollar deposits to ultra-safe Treasury securities (and, to a limited extent, into the stock market bubble) financed perhaps $40 billion of the $217 billion borrowing requirement of the United States Treasury (including all items—see Domestic Credit, page 19). Treasury and Federal Reserve officials complain that they do not have the apparatus to determine what portion of securities transactions involve foreign funds, and therefore cannot estimate the precise amount.

The irony is that the principal funding source for the Treasury was not portfolio shifts from Europe and Japan to the United States, but a change in "preference" among different types of dollar assets, Treasury bills rather than Eurodollar market deposits. The Treasury funded itself at the expense of the developing sector, producing the collapse of international trade, and, within the few weeks or few months it requires, the international banking system.

The dollar has been buoyed, artificially, by the same factors that threaten to destroy it in the relative short run. As the denominator of the world's debt, it benefits from the deflation cycle, in which the earnings ability of debtors falls, and dollars to pay debt service become relatively scarce. The continued inflow into the dollar is less a matter of investor preference than of compulsion: the requirement to convert other currencies into dollars in order to meet dollar-denominated payments obligations. As this situation worsens in the short-run, a sharp rise in the dollar remains possible; it is not to be excluded that the dollar could rise from about DM 2.58 to DM 3.00 by the end of the year, despite the rising American trade deficit, despite the fact that the American current account balance has finally fallen into deficit, and despite the fact that a large portion of dollar obligations is ultimately worthless.

Once the domestic credit market bubble bursts, either through major commercial bankruptcies (and the Canadian situation, e.g., the Chrysler strike, is a point to be watched closely), or through a retreat of the major institutions who rigged the stock market rally, or through a political crisis in Washington, the decline of the dollar would be startling. The immense network of hedging and futures-market devices that grew in the wake of floating exchange rates during the past decade guarantee that the pendulum must swing dramatically in the direction of dollar *undervaluation*. The Institute for International Economics' director C. Fred Bergsten told a Philadelphia conference Nov. 9, the process could produce a "world slump"; but Bergsten, as usual, has got matters backwards. The dollar collapse will be the *result* of a world depression that has been in progress for three years, since Paul Volcker went monetarist, and finally ran out of control through the contraction of international credit during the third quarter of 1982.

Within a few months, if not weeks, the monetary issue that dropped out of public discussion will resurface with a vengeance: gold. If the American authorities are compelled to resort to a return to gold payments on the wrong sort of terms, the type that Bank for International Settlements former President Jelle Zjilstra proposed a year ago, the victors will be big gold hoarders among the European *fondi*, who dominate private holdings of above-ground gold, and the United States will be restored, de facto, to its pre-1776 owners.

Chile crisis could be a debt bomb fuse

by David Goldman

Chile's fascist government, installed in 1973 as a model debt-collectors' dictatorship, has become the unwilling fuse for the Ibero-American debt bomb. The collapse of Chile's currency, banking sources fear, could push the dangerously balanced Ibero-American debt situation over the edge, even before Mexico's confrontation with the International Monetary Fund goes into its next phase during the first week of December.

Although Chile's $20 billion in outstanding foreign debt is small compared to Mexico's or Brazil's $90 billion, a financial collapse in the country most willing to butcher its own population in favor of creditors would have devastating political repercussions for the rest of the continent, bankers fear. Chile's creditors shut down basic industry after the bloody overthrow of the Allende government in 1973, leaving the country dependent on copper exports for foreign debt service payments. Now, the world depression has pushed the copper price down to about half of its peak price, destroying Chile's international payments position.

Chicago boys run out

After losing $1 billion of its $3 billion in foreign exchange reserves, setting the country on track for total bankruptcy, the Chilean government this summer purged the "Chicago boys," the students of Milton Friedman, who had put the country through the meatgrinder following the 1973 coup. Milton Friedman turned out to be the only man who could make fascist dictator Augusto Pinochet throw up.

As hundreds of millions of dollars of flight capital fled the country, worsening the drain on Chile's cash reserves, new Economics Minister Rolf Luders dumped the "Chicago boys" free-markets program and imposed exchange controls Sept. 30, demanding postponement of debt-principal payments from Chile's nervous creditors. At the same time, Luders applied to the IMF for a $900 million loan.

Despite the controls, banking sources report, huge amounts of capital are still leaving the country—up to $45 million per day, according to one estimate. "We hadn't heard it was that big," said a source in the Latin American delegation to the International Monetary Fund, "but we knew it was really bad."