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City of London by Stephen Lewis

Why the central bankers are worried

Short of recreating the U.S. industrial base, there are no solutions to the world financial crisis.

The International Monetary Fund holds its annual conference in Washington on Sept. 29. Central bankers assembling for this meeting know that the world financial order is closer to destruction than at any time since the Second World War.

The economic policies of successive United States administrations, which have weakened the U.S. industrial base, are the chief reason for the problems which are now emerging.

United States manufacturing industry has been in decline since the 1950s. Then the U.S.A. could claim 28% of total world exports. By 1986, this proportion had fallen to only 12%.

By contrast, U.S. imports represented 20% of world trade in the 1950s but were still around that level in 1986.

This is the root-cause of the huge U.S. trade deficit which has mounted from $40 billion in 1981 to $166 billion in 1986 and, even on the calculations of United States Special Trade Representative, Mr. Clayton Yeutter, looks as if it will be as wide again this year.

The size and persistence of the U.S. trade deficit has left the whole world monetary system vulnerable to external shocks, such as hostilities in the Persian Gulf or the collapse of private commercial banks.

It has done this because a trade deficit requires for its financing a matching surplus of capital inflows, that is, inflows of "hot" money.

When the United States trade deficit was relatively narrow, these "hot" money flows were small. But now that the trade deficit has grown, the "hot" money flows have to be on a substantially larger scale.

The financial intermediaries that form the channels through which the "hot" money enters the U.S.A. have expanded.

Their prosperity has been a direct counterpart of the decline of the U.S. manufacturing sector.

As the U.S. trade deficits have piled up in recent years, so the U.S.A., as a nation, has moved into heavy debt with the rest of the world.

From being the largest net creditor nation in the world in 1981, the U.S.A. became the largest net debtor by the end of 1986, with external debts exceeding assets by $250 billion, according to U.S. Commerce Department statistics.

This compares with Brazil's external debt of $110 billion and Mexico's of $100 billion. By 1987, the U.S.A.'s net external debt will have risen to $400 billion and will probably pass the $500-billion level in the course of next year.

These figures, it is true, have been challenged by economists working in the East Coast banking establishment. They claim that the official figures underestimate the dollar value of U.S. asset holdings in foreign currencies.

This dollar value has been boosted as a result of the decline in the United States currency on the foreign exchanges. When a dollar was worth Deutschemark 3, the dollar value of DM 100 worth of assets held in West Germany was a little over $33.

Now, with the dollar trading at DM 1.80, the same German assets are worth more than $55.

There is no reassurance in this, however. The argument merely illustrates the consequence of the persistent United States trade deficits, namely, persistent dollar depreciation to wipe out the effective debt burden on the United States economy.

So far, the foreign holders of "hot" dollars have been willing to suffer the loss in the value of their holdings for the sake of the high interest rates they can earn on dollar deposits and bonds.

With the dollar continuing to fall, however, they are now growing restive. If these holdings begin to be switched out of dollars, the decline in the U.S. currency will accelerate and there will be a rush for the exits.

That will spell the end for the world's reserve system which is based primarily on the United States dollar.

This is why the central bankers are worried. Nor are they likely to come up with any solutions at their Washington meeting.

Short of recreating the U.S. industrial base, there are no solutions. Even so, policymakers will probably seek to delay the day when the monetary order becomes unstitched, by patching together an agreement to act together in unspecified ways to maintain currency stability.

An agreement of this kind, reached in Paris in February, was for a time successful in persuading investors to stick with the dollar. It will not be so easy to instill confidence this time.

The central banks look like they'll be having their bluff called well before the end of this year.

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