

## Foreign Exchange by David Goldman

### Consequences of the dollar blowout

*Treasury Secretary Jim Baker's crash of the stock market has set up a crash of the bond market.*

**P**recisely as *EIR* warned, Treasury Secretary James Baker chose Scylla over Charybdis the week of Nov. 2, and triggered a run on the dollar that brought the U.S. currency's rate down to only 1.67 German marks and 135 Japanese yen Nov. 6. Baker's assertion that the United States "will not have a recession," even if it means an uncontrolled fall of the dollar, guarantees a much higher level of U.S. interest rates, former Federal Reserve official Scott Pardee warned in a Nov. 2 interview.

Pardee, now at Yamaichi Securities, warned, "The danger now is drastically higher interest rates here" in the United States, "by which the banks and securities houses will suffer."

Alan Greenspan's Federal Reserve is driving down short-term U.S. interest rates. That strategy will blow up in his face, for the simple reason that America borrows close to \$200 billion per year from creditors whom it already owes \$400 billion net. In effect, the United States is devaluing its existing obligations, while trying to borrow more.

America's payments imbalance now approximates the foreign-exchange burden on Germany after World War I. Unable to earn or borrow sufficient foreign exchange to meet its obligations, Weimar Germany printed money to buy foreign currency on the markets. That, and not domestic policy criteria, produced the famous hyperinflation. The difference between Weimar and Washington rests in the willingness of America's allies to continue to fund the U.S. deficits,

as opposed to the hostility of Germany's adversaries.

Our allies are merely reluctant to maintain the level of subsidy; what is occurring, therefore, is a milder version of the Weimar disease, but sufficient to trigger disastrous consequences for American debt markets.

Despite the momentary enthusiasm for long-term Treasury debt, as a refuge from the collapsing stock market, astute observers note that the section of the fixed-income dollar bond market which best reflects foreign-exchange risk, namely, Eurobonds, virtually stopped trading during the week of Oct. 26. Overseas investors who must weigh their repayment in hard currencies won't touch dollar paper. The preceding week, Eurobond issues with equity or other conversion features stopped trading; the paralysis has spread to the entire market.

Baker has set up the worst bond-market crash in history, to surpass the 1930s bond-market slide that followed the stock-market debacle. For the moment, the volume of dollar purchases by foreign central banks required merely to maintain orderly markets, as opposed to propping the dollar's value, has flooded liquidity into the U.S. markets. During the week of Oct. 26, the Bundesbank alone bought DM 8 billion worth of U.S. dollars (about \$3.5 billion). On Nov. 5, the Bank of Japan bought an estimated \$1.4 billion.

Thus, the rate of foreign central banks' dollar purchases, which turn into purchases of U.S. Treasury securities, continues to maintain the incredible \$160 billion p.a. rate regis-

tered during the first half of 1987. It was the central banks' decision to slow their rate of support for the dollar that produced the August-September bond-market collapse in the United States, which in turn triggered the stock-market collapse.

When the collapse will begin in earnest depends, in the days ahead, upon dickering among the central banks. On Nov. 5, Makoto Utsumi, the director of the Japanese finance ministry's international finance bureau, said the Bank of Japan will continue its intervention in support of the dollar. However, foreign central banks, faced with the collapse of their own securities markets, cannot hyperinflate their own monetary systems for long in support of a futile American effort to put a bandaid on the Wall Street bubble.

Nov. 5 represented a turning point of sorts, according to foreign exchange traders who noted that the German Bundesbank's interest-rate reduction that day affected only a little-used central bank discount rate, while the bank's principal discount rate remained unchanged. That half-hearted signal of "cooperation" with Washington spoke for itself.

The central banks, i.e., the creditors' committee for American foreign debt, issued numerous private warnings to the same effect as British Chancellor of the Exchequer Nigel Lawson's Nov. 4 formulation. Lawson said that if Washington imposes sizeable reductions in the American budget deficit, West Germany and Japan will cut their interest rates as part of a new and "wider international accord." Lawson knows perfectly well that such reductions are politically and economically impossible; such statements merely pass the onus for the next financial shocks back to Washington.