Foreign Exchange by David Goldman

How to provoke a dollar crisis

European nations' measures to protect their currencies will crack the upward trend by next spring.

As *EIR* warned in October, the dollar has continued to rise, and the prospect is that it will continue to do so for at least the next several months. With the German mark under 2.76 to the dollar, earlier widespread European expectations of a DM 2.8 rate by Christmas are within reach.

The reason, as we have argued, is that Western Europe is both financially bankrupt and politically unstable, and the combination of capital exodus and distress sales of European currency to pay dollar debt service will continue to depress European currencies below liquidation values.

However, pushing the dollar up further (which, we reported last week, the Soviets have been doing) prepares the ground for a dollar crisis of really nasty proportions: The capital flows into the dollar undermine the health of the dollar-based banking system, and set conditions for a dollar crisis based on (or on expectations of) a credit crisis.

With Soviet help, presumably, the dollar crisis will become the battering ram that forces President Reagan to cut the defense budget. That view has become especially popular among European leaders who have or want to cut a deal with the Russians. A statement to this effect came from Helmut Schmidt in remarks delivered to a Washington executive group on Dec. 8.

Schmidt blamed the U.S. budget deficit for the current problems over the EC budget, the disunity among EC nations, and the problems in the European economy. He said that "the United States is living at the expense of the rest of the world," and that "the world outside will not continue to finance your deficit." (See *EIR*, Dec. 20.) The regime of capital inflows to finance the American deficit "cannot last. . . . Eventually the Europeans will regulate capital outflows" through controls.

That is the content of a how-to manual for a dollar crisis to appear in the next issue of *Fortune* magazine by the former chief economist at OECD, Stephen Marris, now at the Institute for International Economics. Marris writes:

"The currency goes into a nosedive, interest rates and inflation accelerate. The only way then to restore confidence is by monetary and fiscal action that halts the economic recovery and sets the stage for recession. . . . This conjunction of an unsustainable budget deficit cannot continue indefinitely. *At some point foreigners' nerves will probably crack.*"

Then, he continues, as happened in the U.K. currency-flows reverse, currency flows out, the dollar will weaken, and inflation accelerate:

"At some point along the line comes the classic symptom of the acute phase of a stabilization crisis. Interest rates will rise but the dollar will keep sinking because capital is fleeing. . . . An American stabilization crisis would be bad news for the world economy . . . if it prove severe enough to halt the U.S. recovery and set the stage for a new worldwide recession."

At what point will "foreigners' nerves crack?" The standard, and discredited, viewpoint is that a drop in American interest rates would trigger a reversal of capital flows into the dollar. The contrary is true. As we reported last week, the current pressure on interest rates derives from the need to *maintain* the level of capital flows into the dollar, and the interest rate will be forced up as capital flows become scarcer. Marris is right that the dollar and U.S. interest rates, once the flows reverse, will in fact move in opposite directions.

The provocation for a reversal of such flows would have to be a sudden, major degradation of the quality of dollar assets, including equities, bank deposits, and bonds, probably associated with the rupture of the Brazilian and Argentine debt patches. It would coincide with the first open evidence that the U.S. recovery, in fact, does not exist, and a corresponding collapse of stock-market values, possibly led by suspect bank shares.

Such a transformation is built into the evolution of the next several months. The appropriate target month is March, the point at which the Brazil mess will come unraveled in any case—if matters last that long.

With European assets at liquidation value, and American assets wildly overvalued with respect to the impact of a developing-sector debt crisis and the dissolution of the recovery myth, the argument that there is nowhere to go from the dollar sounds thin; despite the mess in Europe, the cost of physical assets and equity bought in dollars is so low as to permit a new round in bankruptcy-speculation in West Germany, France, and other European sectors.

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