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Foreign Exchange by David Goldman

Can exchange markets be managed?

The issue is not "currency management," but who will kick in how much to bail out the American banks?

The U.S. dollar rose about 3% between June 17 and June 22 against the West German mark, in response to continued rumors of a secret central bankers' meeting to announce a new general lowering of interest rates on the part of West Germany and Japan. Lower Japanese and West German rates would, supposedly, bring more funds into dollar investments.

No such meeting transpired, and the dollar fell from DM 2.27 to about DM 2.22 in an hour's trading on the afternoon of June 23.

On the surface of things, the U.S. Treasury is warning that a new global recession may emerge, unless Europe and Japan take steps to "stimulate domestic demand," following the example of the United States. If the West Germans and Japanese "stimulate demand," by creating more money, the "supply" of other currencies will increase against the "supply" of dollars, bringing down the price of those other currencies against the dollar. That "soft landing for the dollar," in turn, will avoid what Paul Volcker most fears: a withdrawal of the $150 billion per annum of foreign inflows into the United States, and the collapse of the bubble in U.S. securities and related markets.

Superficially, it all appears to repeat the so-called "locomotive theory" made laughable by Jimmy Carter's Treasury Secretary, W. Michael Blumenthal, in 1978. But the resemblance is misleading, because the U.S. Treasury has lied bald-faced about the real terms of the discussion, while Europe and Japan have not seen fit to call the Treasury on its lie.

The problem starts from what the Treasury means when it uses the word, "currency."

Currency, or money, derives in earliest history not from precious metals, but from the transferable liabilities of deposit banks. (Metals took on a monetary character only as they were employed to settle clearing imbalances between deposit banks.)

"Cash money," i.e. currency, differs from "bank money" (checks or credit cards) only in one respect: it is the bank money of a central bank supported by the government's power to tax. When the central bank virtually guarantees the liabilities of ordinary deposit banks, by promising to bail them out in case of trouble, the distinction between cash and "bank money" blurs.

It happens that American banks have created a couple of trillion dollars of additional liabilities, the so-called "off-balance-sheet liabilities," in the last couple of years. As *EIR* has reported with some frequency, these "off-balance-sheet liabilities," which usually involve some form of direct or indirect guarantee, have become the bank regulators' nightmare. The banking system is more overextended than at any time in the 20th century.

The mushroom growth of "off-balance-sheet liabilities" culminates two decades in which the leading international banks have arrogated into their own hands, the control of money-creation (the expansion of banks' transferable liabilities). First, the offshore, or "Eurodollar," market, grew to over $2 trillion, more than the domestic banking system. With no reserves required upon bank deposits, the expansion of such low-quality bank liabilities is theoretically infinite. It was only possible with the Fed's implicit guarantee of the deposit banks, tested in 1983 when the authorities bailed out the $20 billion Continental Illinois, following a run against its offshore deposits.

Now, on top of the $2 trillion offshore market, the banks have invented another means to manufacture money, namely, "off-balance-sheet liabilities." By this means, they do not directly create credit, but make it possible for third parties to do so, by guaranteeing the repayment, or the interest-rate or other condition of repayment, of the new liabilities.

American banks have extended themselves past all reckoning; their total liabilities of $2 trillion are now more than ten times the worth of the U.S. Federal Reserve. That is to say, the requirements of a Fed bailout, in the event of the collapse of a major section of these liabilities, would preserve "confidence" in the affected banks, only by destroying "confidence" in the U.S. currency and its central bank. There would be a crash landing for the dollar.

The real debate is not, therefore, over whether economic policies will be "coordinated" to manage exchange-rate value. The issue is: Who will kick in how much to bail out the American banks? All the public talk is rubbish. As long as the Europeans and Japanese remain adamant that the United States has to pay the costs of its own folly, the idea of "currency management" is a chimera.

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