U.S. dollar's fall deepens as Bentsen waffles

by Richard Freeman

During October, like that of the autumn leaves, the fall in the value of the world's leading currency, the U.S. dollar, intensified. The dollar began 1994 at 1.735 deutschemarks. On Oct. 3, it stood at DM 1.55. By the close of trading on Oct. 26 it was DM 1.49, a two-year low against the deutschemark. Similarly, against the yen, the dollar plummeted from its Jan. 1 level of 111.8 yen, down to 100.8 yen on Oct. 10, and thence on Oct. 26 to 96.85 yen. It stands at its lowest level against the yen in 49 years.

U.S. Treasury Secretary Lloyd Bentsen indicated on Oct. 20 that he doesn't care if the dollar falls further. Bentsen said that the United States "has no plans to intervene" to support the dollar. "I would prefer that the dollar was up a little, but the market forces are going to decide." It is explained that Bentsen's thinking is that a cheaper dollar will increase U.S. exports. But this is mostly sophistry. The next day, partially in response to complaints from Japanese Finance Minister Masayoshi Takemura—the yen is rising steadily—U.S. Treasury Undersecretary for International Affairs Lawrence Summers attempted to mitigate Bentsen's statement of "benign neglect." Summers said that the United States would indeed support the dollar; but actions will have to prove his words.

There is a real physical-economic as well as political cause for the dollar's fall: the City of London-led attempt to weaken the Clinton administration. The dollar's collapse parallels the sharp decline of the U.S. bond market, particularly the U.S. government bond market. On Oct. 15, 1993, the yield on a 30-year U.S. Treasury bond was 5.78%. By Oct. 24, 1994, it stood at 8.04%. The price of a bond works inversely to its yield. Thus, over the past 12 months, the price on 30-year U.S. Treasuries fell a staggering 25.5%, according to Ryan Labs, a financial reporting group. This means that a holder of a U.S. Treasury "long bond" saw one-quarter of the price of his holdings evaporate. This caused a financial massacre among bondholders, especially on Wall Street. During the same 12-month period, the 30-year U.S. Treasury bond's "rate of return" fell by 20%. The "rate of return" differs from the "price" of a bond. In addition to the price drop, the rate of return also incorporates positive interest pay-outs to the bondholder during the 12-month period.

More broadly, on a mid-October to mid-October basis, the composite average rate of return for all U.S. Treasury instruments—from the 1-, 2-, and 3-year notes all the way up to 30-year bonds—fell a whopping 7.2%, *the largest cumulative fall ever recorded in 60 years, i.e., since the Great Depression*. Thus, when bankers say that nothing out of the ordinary is happening, that this is a normal market "bump," they are not telling the truth.

Simultaneously, the cumulative 12-month fall in the rate of return on long-term Treasury bonds for Germany, Great Britain, and Australia, ranges from 4 to above 15%.

However, during the same period, the derivatives market was also shaken out. Derivatives are highly leveraged entities, pyramided upon underlying financial instruments, that loot the physical economy. Since October 1993, there is more than $20 billion in known recorded derivatives losses—and perhaps $100 billion in unrealized, unreported losses. Not all of them are American. In October, Japan Air Lines announced a $450 million derivatives loss from a bad bet on a $3.6 billion 10-year forward currency contract undertaken in 1986.

Derivatives (more than half of which worldwide are denominated in dollars), U.S. Treasury bonds, and so forth, are all part of the web that makes up the dollar's value. If the value of these and related instruments falls, and, at the same time, if, as is occurring, the depression in the U.S. physical economy broadens, then the dollar is weak. This is the fundamental cause of the dollar's weakness. Other technical causes may be advanced, but they are tertiary at best.

Dangerous response

How is the fundamental cause of the dollar's collapse addressed? There are two sets of responses: one that is madly foolish, the other representing sanity.

The first response is an attempt to benefit from the current circumstances. The rate on federal funds (overnight, interbank money) is 4.63%; the rate on a two-year U.S. Treasury is 6.88%; the rate on the 30-year U.S. Treasury bond is 8.04%. Some banks, which borrow federal funds from America's central bank, are still trying to arbitrage the 3.41 percentage point differential between federal funds and 30-year T-bonds, which is significant.

Meanwhile, since the start of 1994, while investors have yanked $30 billion out of mutual funds that buy Treasury bonds and mortgage-backed securities (because of the sharp fall in the bond market), they have poured $93.4 billion into stock funds. Of this amount, $35.9 billion, or nearly 40% of the total, has gone into stock funds that invest in stocks outside the United States, especially in the Third World. Thus, the attempt to keep the bubble going has by no means been abandoned.

Moreover, there is an attempt to exploit the dollar's weakness for political-strategic reasons. The excuse is that higher U.S. interest rates are now required to halt the slide of the dollar and also to stop inflation. "If the Federal Reserve doesn't raise U.S. interest rates, the markets will force the rise," a European banking source reported on Oct. 18. He continued, "The dollar dumping started from the big New York hedge funds [on Oct. 16], as soon as the German election was clear. The overall aim of these speculative funds is . . . to force the Fed to raise interest rates on or before the Nov. 15 Federal Open Market Committee meeting." Were the Fed to raise interest rates by another half-point, for example, that would help blow out the economy.

The loser, and thus target of this attack, is U.S. President Bill Clinton. Recognizing that their entire financial edifice is about to fall, the British are frantic that America not have an unfettered chief executive, with strong powers, who could introduce, both in the United States and abroad, emergency, Hamiltonian economic measures to restart the economy.

Sanity

In Europe, proposals for a sane approach, which would strengthen all currencies, are now circulating.

On Oct. 16, Italy's vice minister on budget, Antonio Parlato, told the Italian press agency AGI that Italy's central bank, the Banca d'Italia, "must intervene to put the brakes on the worrying weight of derivatives finance, which is taking an enormous mass of resources from investment savings, such as stocks and bonds, and moving it into speculative finance." Parlato said that speculation moves the equivalent in Italian currency of DM 2 trillion, which is the size of the Italian public debt outstanding. Parlato indicated that he will soon present a public document, on how to deal with this, which could also include legislation.

On Oct. 22, the Munich, Germany-based IFO institute published a report entitled "Defects of the World Currency System and Alternatives for Their Replacement," which concludes with a call to "dry out" the foreign exchange markets. The study states that the period 1945-71, when exchange rates were fixed, was a "Golden Age." The main defect in today's world currency system, the IFO says, is the extraordinarily high fluctuation among the three leading currencies, the dollar, deutschemark, and yen. As an example, the DM/dollar fluctuations from Feb. 1 to July 31 of this year were almost six times higher than the DM/franc fluctuations. Therefore, even a new European Monetary System, i.e., a modified fixed exchange rate system, with its broadened ranges, is much better than no system at all.

The IFO states that only 2% of today's foreign exchange transactions are devoted to the trade of goods (see p. 6). Most transactions are speculative, it asserts, producing "short-term foreign exchange fluctuations." In turn, these fluctuations both "damage wealth," and have a negative effect on investment decisions. The foreign exchange market must be "dried out." The IFO proposes "a tax on foreign exchange transactions" and "capial flow limitations." Such a foreign exchange transaction tax, which apparently Italy's Vice Minister Parlato also supports, was raised by Britain's former Chancellor of the Exchequer Denis Healey at a conference on Sept. 10-11 in Bürgenstock, Switzerland. It is highly significant, that within the last 40 days, three sources (from Germany, Britain, and Italy) have raised a variant of this proposal. This indicates some understanding of the danger.

In the United States, House Banking Committee Chairman Henry Gonzalez (D-Tex.) has proposed a "one-tenth of one-percent tax on derivatives transactions," which echoes the proposal by *EIR* founder and economist Lyndon LaRouche in March 1993. Most of all, the variants of the proposals are a way to gain some control over the financial markets; as a vital first step, they will create a valuable dynamic. But in and of themselves, they are woefully insufficient. The world financial system is bankrupt. The derivatives market is bankrupt. As LaRouche stated on Oct. 19, "it is the objective of every government, which has the guts to admit it . . . to declare anything bankrupt that *is* bankrupt." In the case of the United States, the President and Congress must use constitutionally granted emergency powers to generate credit to initiate the vast hard- and soft-infrastructure projects to get the economy functioning again. This must be done on a global scale, requiring tens of trillions of dollars worth of infrastructure and industrial projects.

Such an approach, not "benign neglect" or raised interest rates, is the answer to the dollar's weakness.