

## Falling dollar may pop the speculators' bubble

by William Engdahl

Over Nov. 7-8, the dollar dropped almost 3% in value against the Japanese yen; this, after a spectacular 18-month rise of more than 40%. According to first-hand accounts from foreign exchange traders, the fact that the sharp reverse in the dollar came less than 48 hours after the re-election of President William Clinton, and that it apparently was triggered by remarks from a senior Japanese government official, gave speculators cause for alarm. Within hours, the German mark also rose against the dollar by almost 4% in less than one week.

The dollar's fall came only days after the Bank of England, on Oct. 29, became the first Group of Seven central bank to raise interest rates. There had been a worldwide concerted effort by central banks since July 1995, to dramatically lower interest rates, reflate their economies, and attempt to prevent a global financial catastrophe. Informed estimates are that the Bank of England rate reversal is but the first of a series of upward moves by European and Japanese central banks and the U.S. Federal Reserve System in coming months. Indeed, on Nov. 13, the Organization for Economic Cooperation and Development issued a report calling on the U.S. Federal Reserve to raise U.S. interest rates.

The question is whether, after months of rising, the U.S. dollar, still the reserve currency of the world payments system, is about to go into a free fall. Such an event at the present critical juncture of the world financial system, would start a chain-reaction leading to a financial meltdown. The U.S. stock and bond markets, some 10 trillions of dollars in paper assets, have been supported since April 1995 by unprecedented inflows of cheap money from Japan. Investors had bet that there was no risk of dollar fall.

"What has dollar traders alarmed is the possibility that the

Japanese government will no longer push the yen lower, now that U.S. elections are past," a senior European banker, close to Japanese financial developments, told *EIR*. "The 45% fall in the yen since the peak of April 1995, has reached a point where it becomes counterproductive for the overall Japanese economy to let it fall further. That Sakakibara made even vague hints in this direction, was enough to panic traders in the last days."

On Nov. 7, Eisuke Sakakibara, head of the Japanese Ministry of Finance's International Finance Bureau, responsible for currency policy, told reporters in Tokyo that it was "time for the yen to end its fall against the dollar." That comment unleashed a landslide of dollar selling and yen buying, by speculators who had calculated that such a turn was impossible so long as Japan's weak economy and banking crisis continued.

For the time being, the dollar appears to have stabilized, at yen 111.50 and mark 1.50, following "corrective" comments by Sakakibara, that he also did not seek a "weak" dollar, and an unusual intervention by German Bundesbank President Hans Tietmeyer, who said that the dollar was "fine" just where it was. As one trader characterized the situation, "It's a temporary cease-fire between traders and central banks. But the first new shock, and the dollar will resume its downslide. All eyes are on dollar risk for the first time in months."

Why a big fuss over a 2 or 3% fluctuation of the dollar? After all, since the U.S. suspended gold convertibility of the dollar in August 1971, the currency has gyrated down and up many times, often by as much as 40 to 60%. To understand what is uniquely alarming to financial market insiders about the danger of a dollar collapse now, a bit of history is necessary.

## **Bush-leaguers inflate the bubble**

On Dec. 7, 1990, a closed-door meeting was called by President George Bush, on the advice of Treasury Secretary Nicholas Brady and Federal Reserve Chairman Alan Greenspan. Reportedly, Senate Majority Leader Bob Dole was also present. According to information made available to *EIR* at the time, the group reviewed the state of the U.S. economy, which was dismal. But the real focus of concern was the report that the largest American banks, beginning with Citicorp, were technically bankrupt. If radical measures were not immediately taken, a chain-reaction banking collapse would plunge the United States and the world into the greatest systemic financial crisis in history.

Within days of that meeting, the Federal Reserve began the most concerted monetary reflation effort in its history. Between December 1990 and December 1993, the U.S. core money supply, M-1, was expanded by almost 50%; short-term Fed Funds interest rates were pushed down to an historic low of 3%, and kept there for months, until early 1994. At the same time, the Fed permitted major banks to lower Fed reserves to zero, freeing up more bank funds to buy no-risk U.S. Treasury bonds and bills. By borrowing at 3% from the Fed and investing in Treasuries at 6-7%, banks were able to make enormous risk-free profits, and write off tens of billions of dollars worth of their bad real estate and other loans.

The problem, as the Fed soon realized, was that, while the banks appeared to return to profitability, the cheap money reflation of the Fed had also inadvertently created the greatest speculative bubble in U.S. history. Hedge Funds, such as George Soros's Quantum Fund, had joined in the party, borrowing from banks at the low interest rates to speculate in U.S. government bonds. Using financial derivatives, they leveraged their loans as much as 50 times. Soon, the speculation was also going into European bonds, in which interest rates were even higher than in the United States.

On Feb. 2, 1994, in a desperate effort to "gradually deflate" that dangerous speculative bubble, the Federal Reserve raised Fed funds rate for the first time since December 1990, by a mere 0.25%. But, because of the leveraging by Hedge Funds on borrowed money, that tiny rate rise set off the greatest world bond market collapse since World War II. By the time the Fed signalled an end to its round of rate rises in late 1994, a number of funds had failed, bond valuations had sunk dramatically, and a Mexican peso crisis was in full swing.

By early 1995, the focus of world financial system fragility had shifted to Japan. There, the yen was climbing to new highs, damaging Japanese export earnings and pushing the economy into a fifth year of depression, following the collapse of Japan's stock and real estate "bubble economy" in 1990. The rising yen was largely a consequence of a falling U.S. dollar since 1990, which, in turn, was the result of Greenspan's low interest rates used to bail out the bankrupt U.S. banking system.

By April 1995, the yen hit a postwar high of 79.75 yen to

the dollar, a rise of 45% from January 1990. A Japanese bank crisis threatened, along with a deflationary implosion of the financial system and a collapse of the stock market below 15,000 yen. The political system seemed paralyzed to act, despite a direct urging from Greenspan some months before to take action similar to the U.S. Fed's, to prevent a Japanese banking crisis.

By July 6, 1995, the Japanese Ministry of Finance and Bank of Japan decided to act in concert with Washington, to prevent the meltdown of the Japanese financial system. The crisis inside Japan also threatened the United States, because Japanese banks were on the verge of liquidating tens of billions of dollars' worth of their U.S. Treasuries to cover losses in Japan. U.S. Treasury Secretary Robert Rubin and Greenspan worked out the now-famous Washington-Tokyo agreement. The Fed announced that it had agreed to make an emergency credit line available, "up to \$500 billion," if necessary, to aid any large Japanese bank in a payments crisis. This was intended to calm interbank lenders, who were then blacklisting Japanese banks on the credit markets for fear of bank failures (see *EIR*, Nov. 15, p. 4).

That monetarist solution to yet another financial crisis, predictably, solved nothing in the bloated international financial system. It in no way dealt with the physical-economic rot and lack of long-term investment in basic infrastructure, which had been aggravated worldwide over the past two decades by such wild and unpredictable currency gyrations. It merely bought a little more time for the monetary system.

## **It's all hot money**

By August 1995, the Japanese government, as part of the strategy of reflating and averting a banking meltdown, removed key restrictions on foreign investment. The Bank of Japan lowered its lending rate to an incredibly low 0.5%, where it remains today, and began injecting liquidity into the banking system at a record pace. Japanese banks were able to borrow for almost nothing, sell the borrowed yen for dollars, go abroad and buy U.S. Treasuries, to earn as much as 7%, all risk-free, so long as they were certain the policy of both governments was to force an ever-lower yen. The outflow from yen to dollar was part of the planned lowering of the yen.

"We have had a replay of 1993-94," a source at a large European bank told *EIR*. "Once the market speculators were convinced that Japan could not raise rates again for some time, their yen-to-dollar speculation became a one-way bet. Soon, Hedge Funds again came in with their high leverage. George Soros, for example, could go to a Japanese bank, borrow yen at close to 0.5%, then buy U.S. Treasury bonds or bills.

"And, since July, when it seemed certain that the European single currency would be pushed through, the risk to invest in high-interest-rate Italian or Spanish bonds was deemed also minimal. The funds began to go into Europe as well, all tied to the Japanese reflation process. This is the

source of a huge inflow of funds into Europe over the past several months. It has allowed interest rates to fall, easing government debt costs, and giving the depressed economies a boost. It has also sent stock markets to new records, despite the grim economy. The Bundesbank knows it's hot money, tied to the liquidity being created in Japan. That has many policymakers concerned."

### Enormous asset inflation

According to informed Washington reports, to further ensure calm in the financial markets before the U.S. 1996 elections, the White House reached an "understanding" with Federal Reserve Chairman Greenspan. In return for confirmation of Greenspan for a new Fed term, Greenspan would use his influence to prevent any Fed rate rise before the elections that might trigger a market crash and hurt Clinton's prospects. On June 20, 1996, Senate Democrats allowed Greenspan's confirmation to be approved. There are further reports, that the Hashimoto government in Japan decided it to be in Japan's best interest, not to rock the boat of Clinton's re-election.

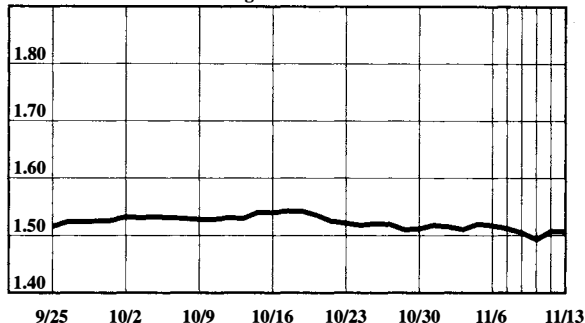
On Nov. 13, the Federal Reserve held its first Federal Open Market Committee meeting since the election. No apparent decision to raise U.S. interest rates, to "preempt inflation growth in the economy," was taken. But, the inflation that concerns the Federal Reserve, today, as in 1994, is the enormous asset inflation, which has again been created, on an even greater scale, by the last 18 months of Japanese reflation. The total paper market value, of all stocks traded in the U.S. stock exchanges today is well beyond \$6 trillion. The Dow is over 6,200; two years ago, it was 3,800. As well, the Bank of Japan over that time has invested over \$100 billion in trying to push the yen down against the dollar. But those dollars it buys are in the form of U.S. Treasury bills. That, in turn, has pushed U.S. interest rates lower and stimulated a burst in the consumer economy in the run-up to the election. Foreign central banks today hold a record \$600 billion in U.S. Treasuries, an increase of 45% since July 1995, most of it Japanese.

Now, both Japan and the United States have had elections. In Japan, the government is alarmed by the accelerating outflow of funds. That outflow is becoming so large that it is preventing a rise in Japanese stock investment, urgently needed to reduce the danger of a new round of bankruptcies in regional banks and credit unions which still have hundreds of billions dollars in bad debts. This concern was reportedly what motivated Sakakibara's remarks on Nov. 7. What alarms speculators is that very soon, Sakakibara will be forced to follow up his words with deeds, including a rise in Japanese interest rates. At that point, the colossal worldwide financial bubble which has inflated since July 1995, will implode. What no one can say at present, is where the next "Japan," that will print enough money to reflate that bubble, may be. The end of monetarist manipulations on a global scale may be nearer than most believe.

## Currency Rates

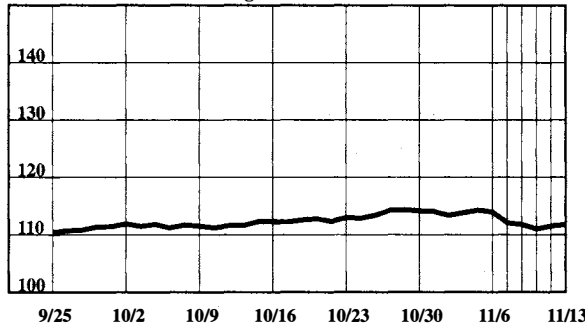
### The dollar in deutschemarks

New York late afternoon fixing



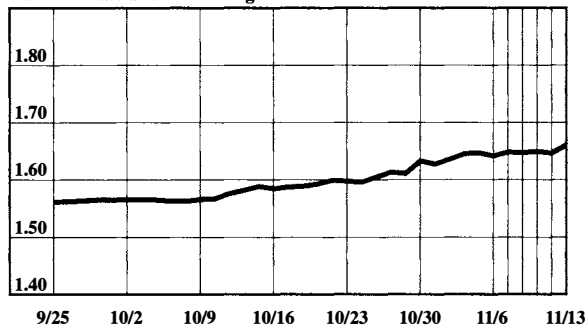
### The dollar in yen

New York late afternoon fixing



### The British pound in dollars

New York late afternoon fixing



### The dollar in Swiss francs

New York late afternoon fixing

