

Dollar Crisis Evokes Panic Among World Financial Elite

by EIR Staff

A series of international conferences, starting with the Davos World Economic Forum, and extending into the United States, has led to the open airing of panic within the international financial elite. Top on the agenda is concern over the U.S. dollar, which declined about 30% between early 2002 and early 2004, but, equally importantly, the debt-drowned condition of the U.S. economy, which an increasing number of bankers believe cannot be sustained.

While none of these bankers has been willing to openly embrace the viewpoint of economist Lyndon LaRouche, who has declared the current bankrupt system unfixable, and proposed a New Bretton Woods in the tradition of Franklin Delano Roosevelt's 1944 measures, there are stirrings in the direction of recognizing the need for a new financial system.

The dollar's problems took center stage at the Davos conference, which was held over the first weekend in February in Switzerland. Raising the alarm were former U.S. Treasury official and head of the Institute for International Economics, C. Fred Bergsten, and Morgan Stanley's chief economist Stephen Roach, both of whom warned of an imminent popping of one of the huge credit bubbles holding up the U.S. economy, not to mention the increasing U.S. budget deficit.

Most alarmist was Bergsten, who addressed the danger facing the United States in the form of its huge trade and current account deficit. "The U.S. must now import \$5 billion in foreign capital a day merely to finance the current accounts deficit," Bergsten said. In the face of this, according to the London *Financial Times*, he forecast a sharp sell-off of the dollar coming "within weeks," and a full-blown dollar crisis: a combination of dollar selling by the foreign-exchange markets, coupled with a forced abandonment of the policy, up to now, of central banks' increasing their dollar holdings.

Ten days later, Bergsten reiterated his warnings in dra-

matic terms at a meeting at the Council on Foreign Relations in New York, complete with prescriptions for draconian austerity programs crafted to "solve" the problem. (We excerpt from his remarks below.)

The Dimensions of the Crisis

Bergsten's statements about the current account deficit are much more dramatic than they might appear. The fact is that, up until a few months back, financial experts estimated that the United States needed to bring in approximately \$2-2.5 billion a day to keep U.S. accounts in balance. If Bergsten's figures are correct, that figure has *doubled!*

The reasons are not hard to find.

They start with the U.S. trade deficit, which reached new highs at the end of 2004. The annual deficit went up to \$617.7 billion last year, up a whopping 24.4% from the previous record set in 2003. Imports of food products hit a record, resulting in a deficit for the third straight year; while imports of foreign autos, industrial supplies, and consumer goods all set records, according to the Commerce Department. As all rational people know, the U.S. physical economy is shutting down.

Federal Reserve Chairman Alan Greenspan had said he expected the gap to fall, in large part due to the cheap dollar's effect on the pricing of exports. It didn't happen.

Then there's the extraordinary debt load which the U.S. economy is carrying, which includes the Federal government deficit, the corporate bond bubble, and the real estate bubble. These are, as Bergsten said, unsustainable. The corporate debt crisis is shown in its starkest form by the fact that General Motors, once the nation's premier manufacturing firm, now has its bonds rated at near-junk levels.

Also contributing to the growing gap is the decline in

purchases of U.S. assets by some of the leading holders of dollars internationally, specifically the Chinese. Net inflows of capital into U.S. assets fell from \$89 billion in November, to \$61 billion in December. While that is still enough to finance the current account deficit, the direction is negative. Treasury securities purchases were only \$8.3 billion in December, a 16-month low, with only \$7 billion net from Asia. This is from Japan, while other Asian central banks are now sitting on the sidelines.

A full-page feature in the Feb. 16 *Financial Times* expanded upon another dimension of risk, that posed by derivatives and hedge funds. These are the “crack cocaine of global finance,” author John Plender wrote, and proceeded to describe how the concentration of the banking sector into fewer and fewer institutions, the “phenomenal growth” in the number and size of hedge funds since 1998, and the “dramatic growth of derivatives markets and, especially, over-the-counter derivatives,” are leading to the exacerbation of “systemic risk.” Plender refers back to the LTCM crisis of 1998 (which nearly brought the global financial system to a standstill), and asks: “Has a newly resilient international banking system acquired near-immunity to crises? Or could a financial bolt from the blue still expose global finance to a devastating systemic shock?”

Sharp Warnings

For the most part, the press excludes the statements of those who recognize the breakdown crisis in process. In printing the following statements, we are giving you a glimpse of some of the discussions “behind closed doors.”

Robert Rubin: President Clinton’s Treasury Secretary was one of the commentators on the speech of Fed Chairman Greenspan at the Feb. 4 Advancing Enterprise 2005 conference convened by British Chancellor of the Exchequer Gordon Brown in London. After Greenspan expressed hope that the U.S. situation was about to improve, Rubin said: “The U.S. imbalances can have bond market effects and raise complex questions about our currency. . . . There is a fairly good chance the dollar could decline.” It “will not be fixed by tinkering around the edges. The U.S. is at a critical juncture.”

Paul Volcker: “Below the favorable surface [of the economy], there are as dangerous and intractable circumstances as I can remember. . . . Nothing in our experience is comparable,” warned the former Federal Reserve chairman in a Feb. 11 speech at the Stanford University Center for Economic Research conference. Volcker was referring primarily to “wild fluctuations in currency values,” which he said, however, were overwhelmingly dangerous to “small and emerging economies” in the Third World.

C. Fred Bergsten: The following excerpt comes from Bergsten’s remarks at a Council on Foreign Relations briefing on “America and the World Economy,” in New York City on Feb. 10.

“But we focus [in our book] also on a series of immediate

problems, to which we would attach a great degree of urgency, of which two are at the forefront—one which you mentioned, the current account deficit, and a possible sharp fall of the dollar; and the other of the new sharp rise in energy prices. We think energy prices can easily go back up to \$60 or \$70 a barrel. If that combines with the sharp fall of the dollar, you could have a vicious scenario of a sharp spike in inflation, a rapid rise in interest rates, and a sharp turndown in the economy. It was a combination of those two things—and you will remember it well—higher oil prices and a falling dollar—that led to the term ‘stagflation’ in the 1970s, and in the late 1970s produced the worst period for the American economy since the 1930s—double-digit inflation, 20% interest rates, sharpest recession since the Great Depression. I hasten to say I don’t think things will get that bad this time, but the combination of those two immediate risks implies moving in that direction, which we saw not so long ago, and clearly do not want to repeat.

“The most urgent of the problems, I think, is the one you address, the risk of a sharp fall in the dollar. The latest numbers suggest the U.S. current account deficit has now risen to about 7% of our GDP, well over \$700 billion a year at an annual rate. . . . The previous peak, which led to a decline of the dollar by 50% in two years in the middle ’80s, was just under 4% of GDP. Now we’re at 7%. And, even more importantly than the level, rising by about \$100 billion a year. We are on a trajectory that is not only unsustainable and unprecedented territory now, but is rising even more into terra incognita. Catherine Mann in our institute—who has been very accurate on this, and she wrote the book on it five years ago—has recently updated her projections, and suggests another \$100 billion per year into the foreseeable future. In short, when Chairman Greenspan tried to paint a rosier picture on this last Friday—I understand why he did it—do not believe it. The outlook is not for a turnaround or even a leveling off; it’s for getting worse.

“As a result of that huge external deficit, the United States has to borrow \$5 billion every working day from the rest of the world. That’s to finance the current account deficit and our own foreign investments. And if we don’t get that \$5 billion inflow every working day happily invested by foreigners here at existing interest rates, exchange rates and other prices, then something has to adjust. And the main thing that adjusts is of course the exchange rate of the dollar goes down.

“When the dollar hit its peak three years ago, we at the institute calculated, it would have to come down by at least 30% on a trade-weighted average in order to restore at least a semblance of sustainability of the U.S. external position—not meaning elimination of the current account deficit—that would be implausible and impossible—but cutting it in half, cutting it from the current level to maybe 3% of GDP. That would take something like a 30% fall of the dollar from its peak three years ago. Over that period, the dollar has come down about 15%. So it’s gone about halfway.”