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EIR Special Report

From dollar bankruptcy to breakdown

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If the Republican party enjoyed powers of memory of the type associated with its popular symbol, the White House would view the dicennial anniversary of Aug. 15, 1971 with brooding horror. As it is, Mr. Reagan has already been measured for Mr. Nixon's monetary casket. A new international economic crisis is immediately in view, and if every detail does not match the events of ten years ago, the situation as a whole forces up an overwhelming image of déjà vu.

Paul Volcker, the undersecretary of Treasury who ran administration monetary policy while "Big Jawn" Connâlly blustered, is now at the Federal Reserve; Milton Friedman, the ex officio White House economic adviser who lobbied for the end to fixed-exchange rates, is back at the President's ear through the President's Economics Advisory Board, along with former Chairman of the Council of Economic Advisers Paul McCracken; on the same panel is George Shultz, the "assistant President" and budget chief who moved into the Treasury slot in the aftermath of August 15; his deputy Caspar Weinberger is now at defense; then-Federal Reserve Chairman Arthur F. Burns has the crucial ambassadorship to West Germany; and Rep. Henry Reuss, the veteran of the postwar German occupation and Marshall Plan who scourged Nixon's men into the decisions of August 1971, is more a power in the House of Representatives than he was then.

Excepting Reuss, the same men gathered at Camp David during the second week of August 10 years ago to advise President Nixon that he had no options except to remove the dollar's link to gold, and unfix the parity relationship between the dollar and other leading currencies, in combination with a protectionist import surcharge and income-suppressing wage and price controls. No American President was to regain control of the monetary process during the ensuing decade.

Ten years of economic downslide cannot be blamed on a single day's blunders, but the date of the dollar's inconvertibility marked a turning point. In 1971 the offshore, uncontrolled Eurodollar market was a negligible $50 billion. It has since grown to $1.5 trillion, equalling the total size of the

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Left to right: Budget Director Weinberger, Treasury Secretary Shultz, President Nixon, Fed Chairman Burns, and CEA Chairman Stein in October 1972. Not shown: Treasury Undersecretary Volcker.

American commercial and savings banks' combined deposits, and dominating all features of the credit system. Against the major world currencies, the dollar stood at more than half again its present value. Nominally, the Dow Jones index of industrial equities stood at about its present level, but inflation has eroded the real value to some 30 percent that of 10 years ago. Capital investment in 1971 was, just barely, meeting the deterioration and obsolescence costs of American industry. Now the economy is underspending more than $50 billion per year relative to the capital outlays required merely to keep the economy's nose pointed up. Gold and oil both sold for about one-tenth of their present market price.

True, a few administration officials are cultivating Treasury Secretary John Connally's swagger, informing the world that the U.S. dollar has returned to first place among the world's currencies, and the U.S. has returned to a position of resolve, ready to employ trade, monetary, and regulatory muscle to reassert America's economic primacy. While the dollar gained about 22 percent in the first half of this year against the European currency group, Undersecretary of Treasury Beryl Sprinkel, the man in Paul Volcker's old job, announced that the United States had shifted intervention policy to permit the dollar to rise freely. Europe interpreted this as currency warfare.

Deputy Secretary of Treasury Timothy McNamar warned European nations in June that the United States would declare an "export-credit war" if its trading partners did not forbear from subsidizing export credits at lower-than-market interest rates. The U.S. side at the July 20-21 senior officials' jamboree in Ottawa, mislabeled the "economic summit," demanded that Europe and Japan submit exports of technology to the Soviet Union to review by an international body.

Gold break: unnecessary

Notwithstanding this performance, the dollar is in danger of an anniversary collapse of potentially far greater magnitude than 1971's. The great irony of this predicament is that the severing of the link to gold was far from necessary 10 years ago, as we will show below. A devaluation of the dollar against gold, urged by the late Jacques Rueff in France and by this publication's founding editor Lyndon H. LaRouche, Jr. in the United States, would have eliminated the short-term crisis of gold withdrawals from the Treasury's stockpiles, and bought time for an economic recovery package to put the economic fundamentals in order. Now the dollar is showing the same sort of tubercular blush that made the British pound seem attractive through most of 1979 and 1980, before its 25 percent drop this year against the dollar. The crisis, most financial press commentators delude themselves, has its seat in Europe rather than the United States.

Real-world standards of any standard accounting approach, however, put the dollar in a different light. Since 1971 the size of the Eurodollar market, whose one real-economic activity is the financing of world trade, has grown *seven times faster* than world trade. Counted as liabilities of the United States, the $1.2 trillion dollar component of the Eurocurrency market, plus the $150

billion in official liabilities of the United States, in the form of Treasury obligations held by foreigners, run to a figure almost eight times the annual export volume of the United States. By another measure, the external liabilities of the United States are roughly half of gross national product. This stacks up unfavorably with comparable measures for the supposed worst trouble spot in the world economy, the non-oil-producing Less Developed Countries (LDCs).

Why has the dollar remained so strong? The debt of every participant in world trade is counted in dollars, and rising debt services forces demand for dollars. Between 1978 and the end of 1981, the debt service of the non-oil-producing developing countries will rise from $44 billion to $100 billion per year, a jump of about 250 percent, according to the International Monetary Fund. The debt service of the U.S. Treasury will rise by a similar amount, along with the debt service of the American private sector. In an American economy where half of the trillion dollars of public debt is short term, every 1 percent rise in interest charges costs the government $5 billion—and Treasury bill rates are up 7 percent on the year. In the Eurodollar market where about two-fifths of the debt of the non-oil LDCs is "interest sensitive," every on percent rise in the London Interbank Offered Rate on short-term funds costs the world's worst-off borrowers $2 billion a year.

Floating exchange rate gamble

Nothing helped push the United States to this edge more than the 1971 bungle. Junking the dollar standard put the London and, later, Caribbean and Hong Kong-based offshore market on the map. The single biggest user of credit in the world is not the U.S. mortgage market, or the U.S. Treasury, or even developing countries, who will have to borrow $100 billion in 1981 merely to service their existing debts. Foreign-exchange hedging consumes about $200 billion in short-term credit at any given moment. Without a reliable standard for international transactions, every market participant whose income depends on currency conversion must hedge against possible currency fluctuations, while speculators hedge against the hedges.

"Floating exchange rates" made the Eurodollar market—a source of extremely short-term credit available without the inconvenience of reserve requirements—an apparent necessity of doing international business. Even before the 1973 oil crisis, the explosion of Eurocurrency credit, whose volume tripled in the two years following August 1971, pushed the world economy in the direction later confirmed by the oil crisis. Fed by the Eurodollar market deposit base, commodity prices rose by 53 percent in 1973—before the big rise in oil prices. A few journals, e.g., the London *Banker,* warned in the summer of 1973, before the storm clouds appeared over the Middle East, that the commodity-price spiral, fed by and feeding Eurodollar market growth and Third World indebtedness, had already created the conditions for chain-reaction defaults. The next eight years merely allowed the international dollar credit system more rope.

History is rarely so precise, but it is not an overstatement to cite this 10th anniversary of Nixon's folly as the end of an era—the change from *de facto* to *de jure* bankruptcy of the American dollar. What different paths lead out of this conjuncture are discussed later in this Special Report. It is less important to speculate on the available scenarios, than to face the cumulative effect of 10 years' economic mismanagement. Ultimate control of our national affairs depends, as Alexander Hamilton told this country's second Congress in 1793, on the defense of the public credit. By pushing the public credit into the mouths of the offshore market's scavenger-dogs—when the remedy of gold revaluation would have stemmed the crisis—the Nixon administration set up a chain-reaction to which every succeeding Treasury secretary and Federal Reserve chairman contributed.

Same choices

Apart from chaos, the options are now not much different than they were when Jacques Rueff, six years before the storm broke in 1971, urged the United States to devalue the dollar against gold, in order to gain time to expand its vast industrial power in the interest of a powerful export surplus. If the dollar's value cannot be sustained by forcing the world to scramble to pay more debt service in dollars, the residual capacity of the United States to bring its industrial base to bear on the capital-intensive development needs of the southern hemisphere constitutes a potential real grounding for the dollar's value.

In 1971, a devaluation of the dollar against gold to perhaps $50 per ounce, instead of $42, might have been sufficient to buy the time we needed. Now the minimum price of gold that will make this country's foreign liabilities manageable, assuming the best graces of our creditors, is $500 per ounce, or about 10 times as much. The $500 per ounce target reflects both the marginal cost of bringing new capital-intensive gold mines into production in most of the world plus a small seignorage, and the minimum gold price required to put America's international reserves into the status required to stabilize the value of foreign liabilities.

America's cash, except for the inactive gold reserve, went 10 years ago, and the circulability of our unsecured IOUs will go before the end of the year. Finding the path out will not be easy in any event. But it will not be possible without retracing our steps to the point we took the wrong track.