Dollar depression: Volcker takes slower kind of poison

by David Goldman

The largest-ever U.S. corporate bankruptcy, the second-largest-ever U.S. bank failure, and the second-worst quarter ever suffered by a U.S. bank were reported in the week following the Federal Reserve's July 9 reduction of its discount rate to 6%.

Apart from the worst week of financial news in U.S. history, the stock market had just fallen by a hundred points, the Fed had announced a 1% combined May-June drop in industrial production, and the Commerce Department reported falling business sales, lower housing starts, and assorted other bad news.

Within 10 days of the July 6 stock-market crash, when the Dow-Jones industrial average lost 3.2% of its total price, or $48 billion in paper values, the Reagan administration's "recovery" myth vanished in smoke.

A $220 billion deficit

The worst news, overshadowing the $8 billion failure of LTV Corporation, regarded the federal government's own finances: the Office of Management and Budget predicted a $220 billion budget deficit for the fiscal year ending next Sept. 30, $50 billion more than the previous estimate. As *EIR* warned in its July 11 issue, such an estimate could hardly be suppressed, after the Treasury showed a $39.2 billion deficit during the single month of May; the actual deficit is more likely to be in the range of $270 billion, as the financial collapse takes its toll.

These developments, known in advance to federal regulators, make transparent the pressures upon Federal Reserve chairman Paul Volcker that caused him to throw caution to the winds, and unilaterally reduce U.S. interest rates, despite the weakness of the dollar on foreign markets.

For the past year, Volcker has warned, and with reason, that a reversal of the $150 billion flow of capital into the United States each year could collapse American securities markets, raise U.S. interest rates, and shatter what is left of the U.S. economy. His post-1979 policies are responsible for this predicament, in which the United States must borrow $60 billion of Japanese export earnings, $10 billion of European trade surplus, and $80 billion of narcotics revenues or other flight capital lodged in Swiss bank accounts, in order to pay for the one-sixth of total domestic consumption which we import (net) from other nations.

With the dollar down 34% against the Japanese yen, and marginally less against the German mark, since the Group of Five met last September, Volcker's fears are well justified. A turning point of sorts occurred in May, when Wall Street bond traders re-programmed their display screens to show the Japanese yen rate, fearing that a pullout of Japanese funds in the U.S. government securities markets would produce a bond market crash. No such withdrawal of Japanese investment occurred, for the simple reason that Japan's Prime Minister Yasuhiro Nakasone, and Japan's elite in general, want nothing less than they want a destabilization of the American economy.

But another turning point occurred at the end of June, when most of the officials who prepared the May 5 Tokyo Summit meeting of industrial nations, gathered in Zurich to review the prospects for international cooperation on exchange rates, supposedly mandated by the Summit. As *EIR*'s William Engdahl reported, the shabby nature of the Tokyo declaration was painfully evident in the remarks of government officials speaking under less-formal circumstances.

The issue under debate is straightforward: Without a sharp reduction in U.S. interest rates, the financial crash will immediately spread to the overbuilt, over-leveraged real-estate market, already crumbling at its weakest points in the oil-patch.

real estate alone, more than Ibero-American nations owe to U.S. banks, is already endangered, *EIR*'s most recent *Quarterly Economic Report* estimates.

However, a sharp reduction in American interest rates, while taking pressure off U.S. financial institutions in the very short term, is precisely the stuff that currency crises are made of. The Federal Reserve's half-point reduction in the discount rate is far less than what the urgency of the domestic financial crisis demands; but even that was sufficient to push the dollar down to an all-time low of about 157 yen in Tokyo, and a five-year low of about DM 2.15 in Frankfurt.

The dollar's decline so far has been gradual rather than chaotic, but the threat of a crash is brought closer by every notch downwards.

The Fed's only hope of postponing a crisis has been, since the beginning of the year, to persuade the Germans and Japanese to inflate their currencies along with the dollar, through so-called coordinated reductions in interest rates. In effect, the Fed has asked America's major trading partners to mortgage their own national currencies to bail out the U.S. banking system.

The Germans and Japanese agreed to one round of interest-rate reductions in March, but balked at the second. The American delegation to the Tokyo Summit in May came back to them with an astonishing scheme: to authorize the International Monetary Fund to fix a set of indicators which would compel national monetary authorities to alter their policies. Drawn from the most egregious of the Trilateral Commission's "world central banking" plans of the early 1970s, the Treasury scheme met with restrained outrage at Tokyo: Certainly, replied the Germans, we would like to see such a set of indicators, but it will take years to determine what they might be.

Meanwhile, German Treasury spokesman Hans Tietmeyer warned (according to his handwritten notes on the title page of his written presentation at Tokyo) the United States that the problem was not currency instability, i.e., the dollar's looming collapse, but the fact that the United States chose to run impossibly large budget and current-account deficits.

Germany's anger at the Treasury's outrageous suggestion has two components. In truth, there is no reason why West Germany should mortgage its national currency to pay for the blunders of American bankers. More ominously, control of the West German Bundesbank has shifted to the Munich-Venice financial axis, which favors political decoupling of Western Europe from the United States. When Germany's largest insurance company, Munich's Allianz Versicherung, bought control of the Venetian insurance giant Riunione Adriatica di Sicurta (RAS) in 1985, a line of financial power was drawn from the Deutsche Bank in Frankfurt, through the dominant Munich insurance companies, through the major Swiss reinsurance firms, down to the Trieste-Venice insurance cartel.

As *EIR* has emphasized for some years, this financier alliance brings together Europe's largest and oldest private fortunes, at the helm of the largest compact banking and insurance group in the world. Their spokesmen favor a neutralized *Mitteleuropa,* or Central Europe, in which this financier faction presumably would do viceregal duty for the Soviet Empire.

The Fed's Hobbesian choice

In sum, the international arrangements which permitted the Federal Reserve to stage the vast swindle known as the "post-1983 economic recovery" are finished, and Chairman Volcker has no choice but to put out the fires closest to his desk. U.S. bank regulators knew three weeks before the First National Bank of Oklahoma closed its doors July 13 that the $1.5 billion institution was unsalvageable. With oil hovering around the $10 mark, only one of the major Oklahoma and Texas banks has a chance of surviving. The depressed American economy has failed to show signs of the usual rise in summertime gasoline consumption, eliminating the oil industry's last hope for a respite.

"According to our information, the Fed lowered rates, rather than raise them as they had wanted, largely because of their worries over the fact that the problems of the debt crisis are starting to get out of hand. You just have to look at exposure to oil loans of U.S. banks to get an idea why. The fact that they both lowered rates while increasing money supply shows the pressure that exists," commented a partner at one London merchant bank.

The danger threshold for American banks' oil-loan exposure is already far behind the falling oil price. "Since the first breakout of LDC [Less Developed Countries] debt crisis and lower oil prices in 1982-83," an analyst at a leading London financial house stated, "the banks have moved to consolidate their loan exposure. Right now, the price of $15/barrel oil is the critical one. If world price falls below this for a sustained period, then all the Western banks, not just U.S. banks, are in trouble. They hope to somehow get through the next two years avoiding a major default crisis. Then, if they can do that, they think they can even handle it if Mexico goes 'belly up.' The next two years are critical. But if oil stays below say at $5 to $10, the banks couldn't write that off." North Sea Brent for August delivery dropped to $9 per barrel, the lowest since North Sea oil came on stream in the mid-1970s.

Between Scylla and Charybdis, Volcker has chosen to steer towards Charybdis, namely, the danger of a crashing dollar. Had Volcker not lowered rates, it is likely that a general collapse of securities values would already be out of control; but it is not clear how long such a collapse may be postponed, as deflation of oil and other prices continues unabated.