REFLEXIVITY IN THE CURRENCY MARKETS

The traditional view of the currency market is that it tends toward equilibrium. An overvalued exchange rate encourages imports and discourages exports until equilibrium is reestablished. Similarly, an improvement in competitive position is reflected in an appreciating exchange rate that reduces that trade surplus so that equilibrium is again reestablished. Speculation cannot disrupt the trend toward equilibrium- if speculators anticipate the future correctly, they accelerate the trend; if they misjudge it, and they will be penalized by the underlying trend that may be delayed but will inexorably assert itself.

Experience since floating exchange rates were introduced in 1973 has disproved this view. Instead of fundamentals determining exchange rates, exchange rates have found a way of influencing the fundamentals. For instance, a strong exchange rate discourages inflation: wages remain stable and the price of imports falls. When exports have a large import component, a country can remain competitive almost indefinitely in spite of a steady appreciation of its currency, as Germany demonstrated in the 1970s.

The fact is that the relationship between the domestic inflation rate and the internal exchange rate is not unidirectional but circular. Changes in one may precede changes in the other, but it does not make sense to describe one as the cause and the other as the effect because they mutually reinforce each other. It is more appropriate to speak of a vicious circle in which the currency depreciates and inflation accelerates or of a benign circle where the opposite happens.

Vicious and benign circles are a far cry from equilibrium. Nevertheless, they could produce a state of affairs akin to equilibrium if the reflexive, mutually self reinforcing relationship could be sustained indefinitely. But that is not the case. The self reinforcing process tends to become more vulnerable the longer it lasts and eventually it is bound to reverse itself, setting in motion a self reinforcing process in the opposite direction. A complete cycle is characterized by wide fluctuations not only in the exchange rate but also in interest rates, inflation, and/or the level of economic activity.

The participant's bias introduces an element of instability into the system. If the system had an innate tendency toward equilibrium the participant's bias could not disrupt it: at worst, it could introduce some random, short term fluctuations. But when the casual connections are reflexive, the participants' bias may engender, sustain, or destroy a vicious or benign circle. Moreover, the prevailing bias takes on a life of its own as one of the constituent parts in a circular relationship. It finds expression in speculative capital movements that may serve as a counterweight to an imbalance in trade, allowing a trade surplus or deficit to exceed, both in size and in duration, the level that could have been sustained in its absence. When that happens speculation becomes a destabilizing influence.

International capital movements tend to follow a self reinforcing/self defeating pattern similar to the one we identified in the stock market. But the model we used for stock price movements cannot be applied to currency markets without substantial modifications. In the stock market we focused on the reflexive relationship between two variables: Stock prices and a single underlying trend. We were trying to build the simplest possible model and we were willing to simplify a much more complex reality to serve our purposes. In the currency market we cannot get by with tow variables; even the simplest model will need seven or eight. We have selected four rates and four quantities, namely:

e= nominal exchange rate (number of foreign currency units for one domestic currency unit
↑ e= strengthening)
i = nominal interest rate
p= domestic versus foreign price level (↑ p= increase in domestic prices faster than in foreign prices and vice versa)
v = level of economic activity
N = non speculative capital flow } ↕ = increased outflow
S = speculative capital flow } = increased inflow
T = trade balance } ↕ = surplus
B = government budget } = deficit

Our task is to establish how these variables relate to each other. We shall not attempt to explore all the relationships but only those that are necessary to build simple models. In other words, we are not aiming at a general theory, only at a partial explanation of currency movements. Our focus is the exchange rate and we bring in the other variables only when we need them. We shall bring in the other variables only when we need them. We shall not quantify any of the variables but only indicate direction **(↑, ↓)** or order or magnitude **(>, <).**

Before we start, two general observations can be made. One is that relationships tend to be circular; that is, variables can serve as both cause and effect in relation to other variables. We shall denote the casual connection by a horizontal arrow **(➡)** the other point is that the relationship of the variables need not be internally consistent. It is the inconsistencies that make that entire situation move in a certain direction, creating vicious or benign circles. Equilibrium would require internal consistency; historical change does not. Describing historical change in terms of vicious and benign circles is, of course, merely a figure of speech. A circular movement between component parts when the entire system is in motion could also be described as a spiral. Moreover, what is benign and what is vicious are in the eye of the beholder.

Exchange rates are determined by the demand and supply of currencies. For present purposes, we can group the various factors that constiute demand and supply under three headings; trade, nonspeculative capital transactions, and speculative capital transactions. This gives us the simplest model of a freely floating exchange rate system:

(↓ T + ↑ N + ↑ S) → ↓ e

In other words, the sum of the currency transactions under th three headings determines the direction of the exchange rate. Our primary interest is in investingating the role that the participants bias plas in exchage rate movements. To facilitate the investigation, we shall assume that the beas finds expression only in speculative capital transactions **(S)**, while trade **(T)** and non speculative capital flows **(N)** are independent of expectations: they constitute the 'fundamentals.' In reality, the 'fundamentals' are also influenced by the participants expectations about the future course of exchange rates. The figures are notoriously distorted by leads and lags in payment, not to mention the effect of expectations on the inventory policy of exporters and importers. As far as capital movements are concerned, perhaps the only transaction that is totally independent of expectationsis the payment of interest on acccumulated debt; the reinvestment of interest receipts already qualifies as a speculative transaction. The repatriation of bannk debt from less developed countries is probably best described as nonspeculative, although speculative considerations come into play if and when the assets are redeployed. What about direct investment? If managments were interested only in the total rate of return, it ought to be classified as

speculative, but often there are overriding industrial considerations. It can be seen that there are many gradations between speculative and non speculative transactions; but we do not do any great violence to reality by putting them into these two broad categories.

We shall focus on speculative capital transactions because that is where the participants bias finds expression. Speculative capital moves in search of the highest total return. Total return has three elements: the interest rate differential, the exchange rate differential, and the capital appreciation in local currency. Since the third element varies from case to case we can propose the following general rule: speculative capital is attracted by rising exchange rates and rising interest rates.

↑**(e + i)** →↓**S**

Of the two, exchange rates are by far the more important. It does not take much of a decline in the currency to render the total return negative. By the same token, when an appreciating currency also offers an interest rate advantage, the total return exceeds anything that a holder of financial assets could expect in the normal course of events.

There are times when relative interest rates seem to be a major influence; at other times they are totally disregarded. For instance, from 1982 to 1986 capital was attracted to the currency with the highest interest rate, namely, the dollar, but in the late 1970's Switzerland could not arrest the influx of capital even by imposing negative interest rates. Moreover, perceptions about the importance of interest rates are often wrong. For instance, until November 1984 the strength of the dollar was widely attributed to high interest rates in the United States. When interest rates declined without the dollar weakening this view was discredited and the dollar went through the roof. Expectations about exchange rates play the same role in currency markets as expectations about stock prices do in the stock market: they constitute the paramount consideration for those who are motivated by the total rate of return. In the stock market this covers practically all investors, in currency markets all speculative transactions.

Conditions prevail in currency markets; expectations about future exchange rates constitute the main motivation in speculative capital transactions. The major difference between the stock market and the currency markets seems to be the role played by the fundamentals. We have seen that the 'fundamentals' were rather nebulous even in the case of stocks but at least we had no reason to doubt that stock prices were somehow connected to the fundamentals. In the case of currencies the trade balance is clearly the most important fundamental factor, yet the dollar strengthened between 1982 and 1985 while the trade balance of the United States was deteriorating. It would seem that the fundamentals are even less relevant in determining price trends than in the stock market. We do not need to look far afield for an explanation: it is to be found in the relative importance of speculative capital movements. As we have seen, speculative capital is motivated primarily by expectations about future exchange rates. To the extent that exchange rates are dominated by speculative capital transfers, they are purely reflexive: expectations relate to expectations and the prevailing bias can validate itself almost indefinitely. The situation is highly unstable: if the opposite bias prevailed, it could also validate itself. The greater the relative importance of speculation, the more unstable the system becomes: the total rate of return can flip-flop with every change in the prevailing bias.

In a system of freely fluctuating exchange rates reflexivity constitutes the rule. Of course, there is no such thing as a purely reflexive situation. Speculation is only one of the factors that determine exchange rates and the other factors must also be taken into account in formulating one's expectations. Thus, expectations cannot be totally capricious: they must be rooted in something other than themselves. How a prevailing bias becomes established and, even more important, how it is reversed are the most important questions confronting us.

There are no universally valid answers. Reflexive processes tend to follow a certain pattern. In the early stages, the trend has to be self- reinforcing, otherwise the process aborts. As the trend extends, it becomes increasingly vulnerable because the fundamentals such as trade and interest payments move against the trend, in accordance with the precepts of classical analysis, and the trend becomes increasingly dependent on the prevailing bias. Eventually a turning point is reached and, in a full fledged sequence, a self reinforcing process starts operating in the opposite direction.

Within this general pattern each sequence is unique. It is the characteristic feature of a reflexive process that neither the participants' perceptions nor the situation to which they relate remain unaffected by it. It follows that no sequence can repeat itself. Not even the variables that interact in a circular fashion need be the same; certainly they will not carry the same weight on different occasions.

We have had two major reflexive moves in the dollar since the breakdown of the Bretton Woods system and at least that many in sterling. It is instructive to compare the two big moves in the dollar because the interaction between the trade balance and capital movements was radically different in the two instances.
In the late 1970's the dollar got progressively weaker, especially against the continental currencies, while in the 1980's it got progressively stronger. We shall call the first move Carter's Vicious circle and the second Regan's benign circle. We can build simple models to show how different the two trends were.

In the case of Germany in the late 1970's the German mark was strong (↑ **e**). Speculative purchases played a major role in making it stronger (↓ **S**) and sustaining the benign circle. Germany started with a trade surplus and the strength of the currency helped to keep the price level down. Since exports had large import content the real exchange rate, as opposed to the nominal, remained more or less stable (↕ **ep**) and the effect on the trade balance was negligible (↕ **T**). With the speculative inflow predominating (↓ **S** > ↕ **T**), the benign circle was self-reinforcing:

↑ **E** ➡ ↓ **p** ➡ ↕ **(ep)** ➡ (↕ **T** < ↓ **S)** ➡ ↑ **e**

The fact that the rate of currency appreciation exceeded the interest rate differential made it very profitable to hold German marks, so that the speculative inflow was both self-reinforcing and self-validating.

What was a benign circle for Germany was a vicious circle for the United States. As the exchange rate depreciated, inflation accelerated. Despite rising nominal interest rates, real rates remained very low, in not negative. Various measures were tried to compensate for the outflow of capital, of which the issue of so called Carter bonds denominated in German marks and Swiss francs was the most dramatic, but nothing seemed to work until the Federal Reserve embraced a strict monetarist policy. Then came the election of Ronald Regan to the presidency and the dollar embarked on a sustained rise.

During Reagan's benign circle the strong dollar caused a sharp deterioration in the trade balance of the United States. In contrast to Germany in the late 1970s' the United States did not have a trade surplus to start with. Moreover, the appreciation in the currency was not matched by inflation rate differentials. The inflation rate declined in the United States but it remained low in other countries as well. As a consequence, the United States developed an unprecedented trade deficit as well as an unprecedented interest rate differential in favor of the dollar. It was extremely attractive to hold dollars as long as the dollar remained firm, and the dollar remained firm as long as the deficit on current account was fully matched by a surplus on capital account. In our notation:

(↑ e +↑ i) ➡ (↓S >↓ T) ➡ ↑ e ➡ (↓S >↓T)

The models are obviously oversimplified. We shall explore Regan's benign circle in greater depth later. The point we are trying to make here is that different sequences have totally different structures. In the case of Germany in the late 1970s the appreciation of the currency was sustained by the inflation rate differential and the balance of trade was largely unaffected. Regan's benign circle was sustained by the differential in interest rates rather than inflation rates and there was an ever growing trade deficit which was matched by and ever growing inflow of capital. While in the first case it was possible to claim some kind of equilibrium, in the second case the disequilibrium was palpable. The inflow of capital depended on a strong dollar and a strong dollar depended on an ever rising inflow of capital which carried with it ever rising interest and repayment obligations **(↑ N).** It was obvious that the benign circle could not be sustained indefinitely. Yet, while it lasted, any currency speculator who dared to fight the trend had to pay dearly for it. Speculation did not serve to reestablish equilibrium. On the contrary, it reinforced the trend and thereby increased the disequilibrium, which would eventually have to be corrected.

Although each self reinforcing circle is unique, we can make some universally valid generalizations about freely fluctuating exchange rates. First, the relative importance of speculative transactions tends to increase during the lifetime of a self reinforcing trend. Second, the prevailing bias is a trend following one and the longer the trend persists, the stronger the bias becomes. The third is simply that once a trend is established it tends to persist and to run its full course: when the turn finally comes, it tends to set into motion a self reinforcing process in the opposite direction. In other words, currencies tend to move in large waves, with each move lasting several years.

These three tendencies are mutually self validating. It is the growth in speculative capital flows moving in a trend following fashion that makes the trend so persistent; it is the persistence of the trend that makes a trend following bias so rewarding; and it is the rewards reaped by speculation that attract increasing amounts of capital.

The longer a benign circle lasts, the more attractive it is to hold financial assets in the appreciating currency and the more important the exchange rate becomes in calculating total return. Those who are inclined to fight the trend are progressively eliminated and in the end only trend followers survive as active participants. As speculation gains in importance, other factors lose their influence. There is nothing to guide speculators but the market itself, and the market is dominated by trend followers. These considerations explain how the dollar could continue to appreciate in the face of an ever rising trade deficit. Eventually, a crossover point would have been reached, even without the intervention of the authorities, when the inflow of speculative funds could not keep pace with the trade deficit and with rising interest obligations, and the trend would have been reversed. Since the predominating bias is

trend following, speculative capital would then have started moving in the opposite direction. If and when that happened, the reversal could easily have accelerated into a free fall. For one thing, speculation and 'fundamental' flows would then have worked in the same direction. Even more important, when a change in trend is recognized, the volume of speculative transactions is likely to undergo a dramatic, not to say catastrophic, increase. While a trend persists, speculative flows are incremental; but a reversal involves not only the current flow but also the accumulated stock of speculative capital. The longer the trend has persisted, the larger the accumulation. There are, of course, mitigating circumstances. One is that market participants are likely to recognize a change in trend only gradually. The other is that the authorities are bound to be aware of the danger and do something to prevent a crash. How the drama actually unfolded will be the subject of a later chapter. Here we are trying to establish a general proposition. Taking the three generalizations together, it can be asserted that speculation is progressively destabilizing. The destabilizing effect arises not because the speculative capital flows must be eventually reversed buy exactly because they need not be revered until much later. If they had to be reversed in short order, capital transaction would provide a welcome cushion for making the adjustment process less painful. If they need not be reversed, the participants get to depend on them so that eventually when the turn comes the adjustment becomes that much more painful.

It is quite likely that the generalization about the progressive accumulation of hot money holds true not only within a cycle but also from one cycle to another, although the history of fluctuating exchange rates is too short to provide reliable evidence. It has certainly been true so far- the size of speculative capital movements was far greater in Regan's benign circle than it was during Carter's vicious circle. Empirical studies of the 1930s also showed a cumulative growth in 'hot money' movements, although circumstances were somewhat different because currencies were not freely floating.

We can see why hot money should continue to accumulate as long as real interest rates are high and the return on physical investments low: keeping capital in liquid form in an appreciating currency is more rewarding than investing it in physical assets. What is needed to give the generalization universal validity is an argument that would show that fluctuating exchange rates are associated with high returns on financial assets and low returns on physical investments. Let me try. We have seen that hot money can earn exceptional returns if it gets the trend right; since it sets the trend that is likely to be the case. Physical assets represent the opposite side of the coin; they cannot move to take advantage of the trend. The tradable goods sector is bound to suffer when a currency appreciates. Of course, a depreciating currency brings windfall profits to exporters, but having been hurt before, exporters are loath to invest on the basis of a temporary advantage: they prefer to hold their profits in financial assets, contributing to the growth of hot money. The process can be most clearly observed in the UK, where exporters refused to expand when sterling fell below $1.10 in 1985, despite record profits. How right they were! Sterling rose above $1.50 by April 1986. Thus, both an appreciating currency and a depreciating currency discourage physical investment and foster the accumulation of 'hot money.'

We can attempt yet another tentative generalization. When a long-term loses its momentum, short-term volatility tends to rise. It is easy to see why that should be so: the trend-following crowd is disoriented. The generalization is tentative because it is based on inadequate evidence. It certainly was true when the dollar reversed its trend in 1985. If these generalizations are indeed valid, the eventual demise of a system of freely fluctuating exchange rates is inevitable. Fluctuations become so wild that either they system has to be modified by some kind of government intervention or it is bound to break down. Currency markets thus provide the best support for my contention that financial markets are inherently unstable. There is no built-in tendency toward equilibrium: to the extent that we need

stability we must introduce it by deliberate policy measures. These conclusions may not strike the reader as particularly revolutionary at the present time they were written in April/May 1985. There are widespread malaises about the instability of exchange rates, but belief in the magic of the market was still running strong, and the famous Plaza agreement in September 1985 came as something of a shock to market participants. Even today, there is no theoretical underpinning for the contention that a freely floating exchange rate system is cumulatively destabilizing. That is what I hope to have provided here.

I have been speculating in currencies ever since they started floating, but I have failed to make money on a consistent basis. On balance I traded profitably through 1980 and then chalked up losses between 1981 and 1985. My approach has been tentative, based more on intuition than on conviction. By temperament, I have always been more interested in picking the turning point than in following a trend. I managed to catch both the rise and fall of European currencies against the dollar until 1981, but I traded myself out of my positions too soon. Having lost the trend, I found it too demeaning to start following the trend followers. I tried to pick the reversal point instead- needless to say, without success. I had some temporary profits in the early part of 1984, but I have them all back. I was again engaged in a speculation against the dollar at the time I wrote this chapter (April/May 1985). Writing it has undoubtedly helped to clarify my thoughts. The real-time experiment recorded in Part III may be regarded as a practical test of the theory propounded here. Admittedly the theory is far too abstract to be of much use in making concrete predictions. Specifically, the turning point cannot be determined until it has actually occurred. But, as we shall see, theory can be very useful in interpreting events as they unfold.

REAGAN'S IMPERIAL CIRCLE*

At the time of the international debt crisis I was working with a rather crude and inarticulate model of credit expansion and credit contraction similar to a boom/bust sequence in the stock market. I thought that 1982 was the end of a period of worldwide credit expansion and failed to anticipate the emergence of the United States as the 'borrower of the last resort.'

The large and growing US budget deficit emerged as the unintended consequence of conflicting policy objectives. On the one hand, President Reagan sought to reduce the role of the federal government in the economy by reducing taxes; on the other, he wanted to assume a strong military posture in confronting what he considered the Communist menace. These two objectives could not be pursued within the constraints of a balanced budget. To make matters worse, fiscal and monetary policies were dominated by two conflicting schools of thought. Fiscal policy was influenced by 'supply side' economics, whereas monetary policy was guided by the precepts of monetarism.

The supply-siders believed that a tax cut would have such a stimulating effect both on output and on willingness to pay taxes that the economy could grow at a rapid rate without exacerbating inflation and the budget would be brought back into balance by higher tax receipts. It was a thoroughly reflexive line of reasoning, and it contained serious flaws, as such reasoning usually does. The dollar strengthened and a strengthening currency combined with a positive interest rate differential made the move into the dollar irresistible. The strong dollar attracted imports, which helped to satisfy excess demand and to keep down the price level. A self reinforcing process was set into motion in which a strong economy, a strong currency, a large budget deficit, and a large trade deficit mutually reinforced each other to produce noninflationary growth. I have called this circular relationship Reagan's Imperial Circle because it finances a strong military posture by attracting both goods and capital from abroad. It can be seen

that the Imperial Circle was built on an internal contradiction between monetarism and supply side economics. The outcome was not intended or even anticipated. Many momentous historical developments occur without the participants fully realizing what is happening

For the rest, the debtor nations have been laboring under high real interest rates and very unfavorable terms of trade. Dollars are cheap when they are borrowed, but expensive when the interest has to be paid. The scramble to export depresses the prices of the commodities exported. Although the external performance of the debtor countries has exceeded most expectations, the internal performance is much less satisfactory. There are some that have shown practically no recovery, and even among the more successful ones per capita income has been lagging; now that it has begun to rise the trade surplus is beginning to deteriorate. Some of the weakest countries have endured a downward spiral in which both their domestic economies and their abilities to service their debts have deteriorated to the vanishing point. This group comprises a large part of Africa and some Latin American and Caribbean countries like Peru and the Dominican Republic.

Let us try to analyze Reagans Imperial Circle with the help of the analytical tools we have developed so far. We shall use the notation adopted in Chapter 3. The four key elements are a strong economy **(↑v),** a strong currency (**↑e)**, a growing budget deficit (**↓B),** and a growing trade deficit (**↓T).** At first sight, there are some obvious contradictions between these four variables. Conventional economics tells us that a growing trade deficit tends to depress both the exchange rate and the level of domestic activity. But the Imperial Circle managed to overcome these casual relationships with the help of two other variables: The budget deficit and capital inflows. The economy strengthened because the stimulus of the budget deficit outweighed the drag of the trade deficit. Economic activity is, of course, influenced by many other factors. To bring them all into the picture would complicate the argument unduly. What matters is the end result: a strong economy. To keep the picture simple, we shall denote the net effect of all other factors with a questions market giving us the formula

(2) **(↓B +?) > (↓T +?) ➡ ↑v**

Similarly, the dollar appreciated because capital inflows-
↓(N + S)- exceeded the trade deficit:

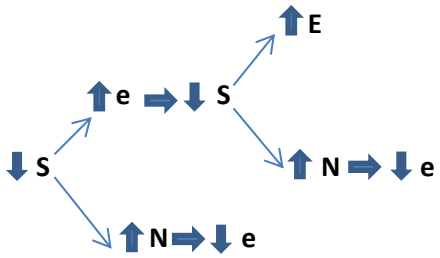
(3) **↓T < ↓(N + S) ➡ ↑ e**

These two relationships are the mainstays of the Imperial Circle. There are many other relationships at work, so many that it would be onerous to list them all. Some reinforce the Imperial Circle; others work against it; yet others reinforce it in the short run but cannot be sustained in the long run. The most important self reinforcing connection is between the exchange rate and speculative capital inflows.

(4) **↑ e ➡ ↓ S ➡ ↑ e ➡ ↓ S**

We have already identified two connections that work against the Imperial Circle (*Equation 1), and here we can mention two connection that are self reinforcing in the short run, but unsustainable in the long run. First, while speculative capital inflows are self reinforcing in the short run, they also generate interest and repayment obligations that are cumulative and work in the opposite direction.

(5)

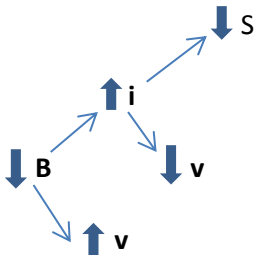


Eventually the growing debt service (**N)** is bound to undermine the relationship on which the Imperial Circle rests and the trend of the exchange rate is going to be reversed

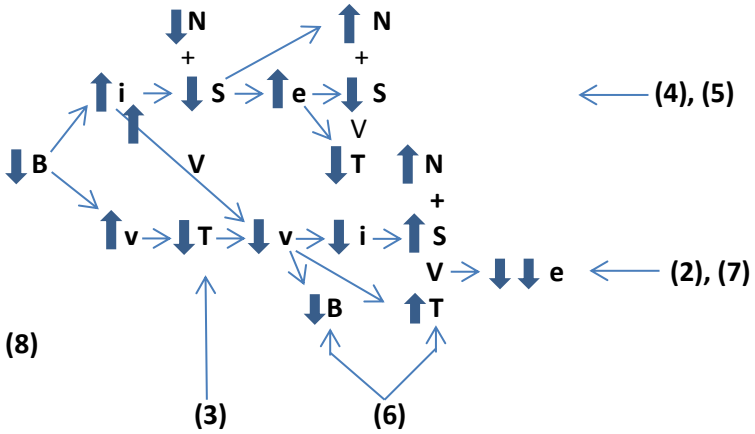
(6) **(↓T + ↑N) > ↓S ⇒ ↓e ⇒ (↑S + ↓T + ↑N) ⇒ ↓↓e**

At that time, debt service and the flight of speculative capital may combine with the trade deficit to generate a catastrophic collapse of the dollar: central bank officials, Volcker foremost among them, are aware of the danger and are publicly warning against it. To put matters in perspective, it should be pointed out that it would take many years for interest charges to accumulate to a point where they would reverse the balance. The likelihood is that the Imperial Circle will be reversed or at least be brought to a halt long before that. Volcker and other responsible government officials are certainly working toward that end. The crucial question confronting the world is whether the Imperial Circle can be arrested without precipitating a catastrophic collapse of the dollar. The longer it lasts, and the higher the dollar climbs, the greater the danger of a fall. The problem is that a clear cut reversal in the trend of the dollar could, even at this stage, cause a shift not only in the ongoing flow of investment but also in the accumulated stock or speculative capital. The stock is, of course many times larger than the ongoing flow. The problem is widely recognized, making the holders of dollar assets very nervous. That is why foreign holdings of marketable assets are aptly described as hot money.

The second example is the budget deficit, which is simulative in the short run buy may be counterproductive in the long run because it diverts resources from more productive uses through the interest rate mechanism:



As long as high interest rates suck in capital from abroad, the problems remain latent. With the help of foreign savings, the domestic economy can consume more than it produces. Only when the capital inflows cease to match the budget deficit does the problem become acute. Interest rates must rise in order to generate the domestic savings necessary to finance the budget deficit. The consequent decline in consumption depresses the economy making foreigners all the less willing to hold dollar assets. This may give rise to a ‘disaster scenario’ in which a weak economy and a large budget deficit combine to produce high interest rates and a weak dollar. W can combine these relationships to create an integrated model of the Imperial Circle:



In this model on of the mainstays of the Imperial Circle, Equation 2, is shown horizontally and the other, Equation 2, is shown horizontally and the other, Equation 3, vertically. It will be seen that the model is not stable: some connections reinforce it while others undermine it. The factors best reinforced are the speculative inflows and the trade deficit; the factor most endangered is the level of economic activity. The main threats to the stability of the Imperial Circle come from the trade deficit and the budget deficit. The twin pillars of the arrangement are a strong dollar and a strong economy; but a strong dollar leads to a rising trade deficit that weakens the economy and the budget deficit keeps interest rates higher than they would be otherwise, which also weakens the economy. These are the internal inconsistencies that are likely to destroy the Imperial Circle long before the accumulation of debt service obligations would do so.

Needless to say, the model is incomplete. There are many connections that are not shown; the illustration is complicated enough as it is. Perhaps some connection that has been ignored here will come to the rescue of the Imperial Circle when the need arises. We have already witnessed such occasions. For instance, until the middle of 1984 banks were active in expanding credit at home and attracting funds from abroad. When they stopped functioning as the main conduit, for reasons that will be explained in Chapter 8, the Treasury took their place: The withholding tax was abolished, and a large portion of the government debt was sold directly to foreigners.

It would be interesting to construct a more complete model and endow the variables with numerical values. I believe it would be possible to simulate the evolution of the US economy since 1982, but I am equipped to carry out such an operation. I have to confine myself to an impressionistic presentation.

We are dealing with a system that is not stable, but constantly evolving. What will succeed the Imperial Circle? That is the question that needs to be answered. Before I attempt to do so, let me complete the picture by taking a closer look at the banking system and the corporate restructuring that is currently sweeping the country.