

## U.S. interest rates and the Ides of March

by David Goldman

The world financial system may not survive the month of March. This is as true in the political as in the economic sense.

The banking system's capacity to re-finance itself on the recycling model has come to the end of its string; the postwar agreements between Europe and the United States, and their respective private and central banks, are now in a state of full disarray.

The increase in U.S. short-term interest rates, by about half a percent between March 5 and March 9, has already put a liquidity squeeze on both foreign and domestic markets. In the midst of a record rollover of Third World debt, the U.S. Treasury must raise \$40 billion by mid-April under highly unfavorable conditions. Federal Reserve Chairman Paul Volcker has privately warned contacts prominent in the City of London that he is sure interest rates will rise by early April, and the U.S. Treasury has issued an identical forecast for internal use.

In addition, the rise in the Belgian discount rate March 9 from 11½ to 14 percent, amid speculation about a European currency realignment, indicates that wild uncertainty about currency movements will add to international interest-rate pressures. The weakness of the softer European currencies, and the collapse of the pound sterling to below \$1.50 the same week, will tend to force up all interest rates through an increase in speculative and hedging requirements for bor-

rowed currencies.

Here is the lineup for the next immediate future: perhaps \$90 billion of developing nations' short-term debts comes up for renewal in the course of the month of March, with a particularly heavy mid-month bulge. About \$40 billion of the total represents new extensions on the part of American banks since the Mexico crisis broke last Sept. 1. When Brazilian banks threatened to default on interbank obligations in late November and December, the American banks, under massive pressure from the monetary authorities, conducted a "flight forward" in the form of new interbank credits. Such lines extended by American banks to Ibero-American banks since August 1982 now total \$37.5 billion, according to secret Federal Reserve data. But a large portion of that total represents net liquidations by European banks, who began to extricate themselves from the debt sinkhole after the Mexico crisis broke.

### Transatlantic breach

Peru's March 7 freeze on repayment of \$2 billion of interbank lines demonstrates that the breach between the European and American lenders has widened as the big refinancings came through. So does Argentina's announcement that it cannot find the \$1.4 billion to repay private-sector hard currency debts which the government had earlier guaranteed; earlier, Argentina had raised funds to reshuffle such loans

through interbank borrowings, and now must call them into default. The Venezuelan banks are facing demands for repayment of interbank lines as maturities come due, and the same is true throughout most of the continent. If the crisis breaks in the course of the month, it will spring from the submerged mine of interbank lending.

As the Swiss central bank points out caustically, the reality of the situation demonstrates that the International Monetary Fund's "White Knight" role in assembling banking funds for hard-pressed debtors has been, by and large, a hoax. Brazil, the continent's biggest debtor (with well over \$100 billion in total debt outstanding) has avoided formal default, not because of the IMF package, but because American commercial banks went over their heads in new short-term debt extensions.

One leading British merchant bank has conducted a private study which demonstrates why the continental European banks have broken ranks with their American partners. According to the study, most of the major American banks have two to three times their shareholders' capital in Ibero-American debt, once short-term debt is counted in. Citibank has \$6.7 billion in total Ibero-American loans, according to the study. A bank official said, "We still think this is too low. There is a lot of short-term debt we haven't been able to find out about. But that is already double their shareholders' capital. They have more than their capital outstanding to Brazil alone. And Manufacturers Hanover and Bank of America both have \$4 billion outstanding. In the case of Manufacturers, that represents triple the shareholders' capital!"

That is to say that if even one-third of the Ibero-American debt were wiped out, Manufacturers and Citibank would be technically insolvent.

The study indicates that there is no reason to expect that European banks will continue pumping funds into the refinancing balloon, according to a British bank official. Dresdner Bank of West Germany, for example, has \$700 million of loans to Mexico and \$400 million to Brazil, a relatively small portion of its \$60 billion in assets. Although the European banks stand to lose massively, their exposure is still such that they might survive a collapse of the debt; that is not the case for the American banks, who are stuck. The data contained in the study explain, a banker added, why the Europeans have been cashing in all the Ibero-American short-term paper they can, rather than continuing to refinance along with the big American banks.

Another problem indicated by the study is the volatility of the smaller American banks' lending to Ibero-America, the official added. In the case of Chile, half of the total debt is held by 550 banks; another half is held by 50 major banks. "Virtually all of the 550 small banks want out. They are screaming. For the moment, the Treasury and the Fed have pressured them to stay in. But that's like shaking up a Coke bottle and keeping your thumb over the top. It can only hold for so long."

The European banks' reticence is not, of course, simply a matter of objective self-interest. The European central banks simply did not exert the same degree of pressure to lend that the American authorities did. *EIR* March 1 published an exclusive interview with the head of the Bank for International Settlements, Fritz Leutwiler, who is also chairman of the Swiss National Bank. Leutwiler, in remarks later repeated in the French daily *La Vie Française*, the *London Financial Times* of March 6, and numerous other daily newspapers, called the putative American recovery "wishful thinking," and warned that he did "not believe in my own ways out" of the financial crisis.

### The Swiss spoilers

In a speech at a secret conference in Saint-Paul-da-Vence in southern France on January 24, Fritz Leutwiler added, "The most obvious solution would be to do nothing at all. That would be the zero option, the Hayek option. Without going to such extremes, many bankers and *central* bankers would not be wholly unhappy to let a few debtors or a major bank go bankrupt—a sharp, brutal shock" [emphasis added].

An Italian economist who advises Leutwiler added, "All this talk about an economic upswing is nonsense. The world is turning from a cycle of deflation to a cycle of inflation. Of course, there are those in Britain and the United States who want to maintain the deflation. But there is a simple argument which demonstrates why the Anglo-American position is unstable. To have a bailout, you need an international agreement to get one. If you don't want to have a bailout, all you need do is to start not bailing out."

In response to the emerging "non-bailout," British bankers will convene under the auspices of the London-based Ditchley Foundation on March 11. Entitled "European and U.S. Relations with Latin America," the conference was described by one leading banker as a strategy session on "what to do when the bridges run out."

The conference's agenda includes the following items: 1) "To identify interests and causes which Latin American countries have in common and those which are individual"; 2) "To examine the causes of political instability in Latin America"; 3) "To discuss Latin America's role in the North-South dialogue" and to shape up European and U.S. relations to this continent, and 4) Latin American geopolitical questions.

The whole Eastern Establishment "liberal" crowd will be there, including Morgan Guaranty Trust representative John Spurdle; Nicolas Barletta, World Bank chief for Latin America and the Caribbean; the U.S. Ambassador to the Organization of American States, J. W. Middendorf; Viron Vaky, head of the Aspen Institute's Hemispheric Governance Commission; CSIS Latin expert and Henry Kissinger associate Robert S. Leiken. The Ditchley meeting leaves the Anglo-Americans talking to themselves; none of the continental European creditors will attend.

In an interview in London, the chief international officer of one of Britain's big clearing banks complained that bankers "have been discouraged by the international debt situation. It is no longer self-evident that all banks will be concerned with the health of the world banking system as a whole. Now they are likely to put their individual interest first. That leaves the Bank of England in a difficult position. It may well be forced to act unilaterally. There is no possibility of an international agreement to deal with the debt crisis.

"But the only way to prevent a crisis is for central banks to rediscount the loans of banks. That cannot be agreed upon at the international level. Therefore the Bank of England may single-handedly begin rediscounting the debt of British banks. If you ask them whether they are doing it, they will, of course, deny it. But it may be at work already. The Bank of England is very conscious of the status of the City of London, and they will do whatever they see fit to preserve it."

While the leading British commercial banks, who are almost as heavily exposed in Ibero-America as their American counterparts, fret about who will pick up their bad loans, some of the British merchant banks are "leaning in the Swiss direction," according to City of London sources. Morgan Grenfell, which only recently ended its longstanding shareholding relationship to New York's Morgan Guaranty Trust, S. G. Warburg's, and others among the City merchant banks are now bracing for the worst, rather than attempting to avoid it.

### **Central bankers fall out**

Meanwhile, a significant rift in policy as well as personalities has emerged between the two most influential European central banks, the Bank of England and the Swiss National Bank. Bank of England senior civil servant Christopher MacMahon has stopped talking to Leutwiler, while SNB officers ridicule the English position.

Both, however, agree that the present stance of the Federal Reserve is pointed towards disaster.

A Bank of England analyst warns that there will be a sharp rise in interest rates before the end of March: "The negative atmosphere is starting to have an effect. Volcker is just accommodating whatever section of the market currently appears most nervous, and that section now happens to be the Shadow Open Market Committee," the group of monetarists led by two close Leutwiler associates, Prof. Karl Brunner and Alan Meltzer, which held a press conference in Washington March 7 to denounce excessive money supply growth and the administration's proposed bailout of the banking system. "That is a disastrous route. All the pressures I see are now negative. The market believes there is a strong recovery—which there isn't—but it believes it, while all the comments about monetary policy are negative, like the Shadow Open Market Committee. This means the Fed will be standing still. But the Fed would have to lean heavily against

the tendency to push rates up in the short-term markets. It would take direct action to prevent it, and I don't see the Fed doing that."

The British official said contemptuously of the Swiss attitude, "They're just saying let the people who have taken the risks take the losses, and let the rest of us get on with it. If they think things are so bad, they should not be against a global increase in liquidity!"

The most worrying indication of short-term problems noted by the Bank of England is a "flight to quality" that has erupted on the Euromarkets; Morgan, Citibank, or Chase are obtaining funds at less than the London interbank overnight rate, while secondary banks are paying 1 or 2 percent more. That is to say that major depositors are so concerned about safety that they will sacrifice more than 2 percentage points of interest to maintain funds in large American banks with direct access to the Federal Reserve's discount window. "Tiering" of interest rates in the Eurodollar market had threatened to topple the banking structure in late September in the wake of the outbreak of the Mexico crisis, and evaporated after the Mexicans appeared to come to heel, and after the Federal Reserve conducted the fastest re-liquefaction of the banking system in its history. Under conditions in which the Federal Reserve is apparently unable to expand the growth of funds to the banking system—as Federal Reserve Chairman Volcker suggested to the House Banking Committee in testimony March 8—"tiering" is viewed as an ominous sign in London.

### **Final solutions**

The sudden appearance of pre-crisis conditions on the markets has sent a submerged shock wave through Washington policy circles. Secretary of State George Shultz, the grandfather of a family of schemes to reorganize the world banking system on a supranational basis, has told friends that no discussion on the subject of grand plans to deal with the crisis is required; on the contrary, the "economic recovery" will permit the situation to heal on its own, as developing countries earn more foreign exchange through additional exports. However, Shultz has a team at work reviewing plans to bail out the banking system on the model of the 1920s "Young Plan" for German war reparations, e.g., those offered by Lazard Frères partner Felix Rohatyn and Princeton University Professor Peter Kenen. Both plans, the subjects of major recent financial press attention, would create a supranational agency to buy up the bad loans of commercial banks at a discount, giving the banks government-guaranteed long term bonds instead.

At the Council of Economic Advisers, economists are looking into the Rohatyn plan in detail; however, CEA staff officials caution that this is far from an immediate option, if only because the administration fears an "America First" reaction on the part of Congress should reports leak out that the administration was considering any such thing. The detail

work at the level of the Treasury's bank examiner, the Controller of the Currency, and the Department of Justice, has not yet been done.

National Security Council economist Norman Bailey has also offered a more complex scheme involving "exchange participation notes." The plan would give creditors notes guaranteeing a fixed percentage of debtor countries' export earnings in exchange for the medium-term portion of the outstanding debt.

Leutwiler's friends in Washington and in the financial press, who have raised a drumbeat against "bailing out the banks" in the editorial pages of the *Wall Street Journal* and the *Washington Times*, have upset the planners' calculations concerning the U.S. Congress. Whereas the passage of the \$8.4 billion U.S. contribution to the IMF seemed trouble-free at the end of February, the activities of the "Shadow Open Market Committee," joined by former Reagan administration officials Paul Craig Roberts and Michele Frattiani, have cancelled all bets on this topic.

Most fundamental is the speed at which the crisis may break. A senior Federal Reserve official commented, "All central banks are always thinking about this sort of question. I just spent two hours discussing this over lunch with someone from the Bank of England. The problem with Rohatyn's plan or with any of these ideas is that you can't do them fast enough to help when you need them. What would happen in the case of major defaults? A variety of things would be proposed and done simultaneously. The central banks would move immediately to try to control a liquidity brushfire which might otherwise turn into a firestorm. It's relatively easy to anticipate central bank actions. But you can't pre-specify everything in advance. It depends on what banks have what problems."

Princeton's Kenen, the author of one of the most widely-quoted refinancing plans, say, "The problem is that we [who propose to refinance the developing sector] are not up against conventional monetarism. We are up against the old von Hayek view. We are facing Austrian business cycle theory *circa* 1930, the view that the only way to get rid of inflation is to purge the system of all its excesses. The problem is that anything less than unanimity favors the 'let it all go down' approach. That has been my fear for some time, a fear which I have been reluctant to express publicly until now. We have the following paradox: we may offer the only rational plan to save the system, but it is impossible to attempt to negotiate it before the crisis strikes. But when the crisis strikes, it is too late."

That is by no means to say that the efforts of Secretary of State Shultz et al. to emerge from the crisis with a set of supranational controls over the world economy are null. On the contrary, lack of a coherent policy on the part of the administration leaves the United States vulnerable to a plan which would turn over American national sovereignty to the International Monetary Fund.

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## DOCUMENTATION

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# The LaRouche proposal for gold-based credit

This document lays out the program for a gold-backed world monetary system developed by economist Lyndon H. LaRouche, Jr., a leading figure in the Democratic Party and the chairman of the advisory board of the National Democratic Policy Committee. This gold proposal presents the unique mechanism for reorganizing the world financial system to the end of expanding world industrial production and trade and creating the basis for Third World countries to develop economies capable of producing wealth—the only competent solution to the mammoth crisis of unpayable Third World debt now hanging over the world. LaRouche's gold policy is therefore diametrically opposed to the restrictive, credit-strangling gold plan being brought forward by the Bank for International Settlements and its propagandizers in the United States, such as Rep. Jack Kemp of New York.

The immediacy of this issue is dictated by the debt crisis and the crisis of the international financial system. The world is months, perhaps days, from the biggest financial collapse since the 14th-century collapse of the Bardi and Peruzzi banking houses of Europe, which bankrupted every European government then in existence and ushered in one of the darkest ages in world history.

At the New Delhi meeting of Non-Aligned nations that began March 1, the governments of the debtor nations have the opportunity to adopt the LaRouche plan and jettison the present unworkable system in favor of a world economy premised on growth; again at the end of March, the governments of the Group of 77 meeting in Buenos Aires have this central issue before them; the heads of state of the industrialized countries, meeting in Williamsburg, Virginia at the end of May, have the same issue posed to them.

LaRouche's gold proposal works like this.

President Ronald Reagan should announce on national television that the United States will take the unilateral step of remonetizing its gold reserves at \$500 per ounce, as part of a coordinated effort with other major Western and developing-sector governments to create a new gold-based world monetary system.

At this moment, the world network of banking and financial systems is bankrupt. No amount of austerity or other International Monetary Fund conditionalities can make the