

Volcker's 'controlled disintegration' begins

At England's Warwick University just a year ago, Federal Reserve Chairman Paul Volcker took "as my text" the dictum of the late British economist Fred Hirsch: "Controlled disintegration of the world economy is a legitimate objective for the 1980s." Volcker wondered if such disintegration could, in fact, be controlled. Now he has given the world financial community the chance to find out.

EIR is not privy to the deliberations at the Bank for International Settlements on the subject of controls on

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the Eurodollar market. However, such controls are now coming on line as a de facto condition of doing international business. Whether the Eurocurrency markets, bending under the strain of a 16 percent London Interbank Offered Rate for funds, will manage not to break is open to question.

Uneasy Agreement

There has been struck the following unstated deal between the American, British, West German, and Japanese central banks, according to highly reliable sources in the banking community. Mainly because of divisions at the West German central bank—misleadingly cited in the press as a fight between outgoing President Otmar Emminger and his successor, Karl-Otto Poehl—the deal is highly tentative. Nonetheless, this is what is operational: commercial lenders in the four leading countries are now subjecting major international credits to the formal or informal scrutiny of central banks.

This has gone furthest in Japan, where the finance ministry in October began case-by-case review of all Japanese bank participation in international syndications. Reportedly, the approval rate has been extremely low. As a result, Japanese participation in several major credits, including recent Mexican and Brazilian loans, has been sharply reduced. One syndication by Japanese banks on behalf of the Mexican electricity authority fell one-third short of the \$600 million goal. In addition the Japanese banks are now under finance ministry orders to fund at least 20 percent of their term loans with one-year liabilities and 10 percent of such loans with three-year liabilities. In a Euromarket where the average maturity of deposits is less than 30 days, that is a de facto prohibition.

The status of West Germany's international lending

profile is a matter of contention. Nominally, the Bundesbank is in favor of stricter oversight of the expansion of Eurocredits. However, the major political pressure in this direction has come from the Berlin-based *Aufsichtsamt fuer das Gesamt Kreditwesen*, the West German equivalent of the U.S. Controller of the Currency. The bureau's director, Ingelore Behre, is a political ally of ex-chancellor Willy Brandt and hostile to the commercial banks. Apart from attempting to rein in the commercial banks, the *Aufsichtsamt's* major demand on the banks is a reduction in gold market operations (see Gold).

However, the Bundesbank's continued pressure on liquidity has hit the West German banks as hard, in terms of their DM operations, as Fed Chairman Volcker's crunch has hurt their dollar bookings. There is no end in sight to the contraction of the West German fixed-income securities market, which has forced major cancellations over the past month, including a Commerzbank-managed DM 100m issue for Chile during October.

The interest rate on the U.S. Treasury's four-year DM bond released to the West German markets last week was 8.55 percent. That is not merely a new plateau for the West German market; it is almost as much as the U.S. Treasury was paying in dollar terms just before Paul Volcker's "Saturday Night Special" maneuver Oct. 6.

As for dollar bookings, the Dusseldorf daily *Handelsblatt* warned Nov. 6 that the 16 percent Libor rate was discouraging banks from undertaking new syndications. Worse, the newspaper reported, German banks are currently taking losses on existing six-month rollover credits (the standard Eurodollar term credit), because credits funded with less than six-month liabilities must now be funded at a loss. The borrowers' rate can only be adjusted at half-year intervals.

Volcker's cut

Volcker's share of this deal appears much meatier than that handed to the Germans or Japanese. U.S. banks are now predicting an increase in their Euromarket share, which fell drastically during the past year and a half. The current edition of Chase Manhattan's newsletter *International Finance* predicts not only a solid expansion of the Eurodollar market (although at less than the 30 percent annual rate registered at mid-year 1979), but an expansion of American bank operations. Bankers say that the top-down "lending cartel" arrangement Volcker is now putting into place guarantees

more attractive margins (the difference between the banks' cost of funds and their charge to customers), the basis for a return to the market.

European and Japanese banks undercut American and (to a lesser extent) British banks during most of 1978 and 1979, reducing spreads on prime credits to less than 0.5 percent, or barely equal to the cost of administration. German and Japanese banks did this less for book profits than to maintain foreign markets for their closely allied industrial customers.

Since the Volcker package came through, bankers have expected some form of international lending (or exchange) controls to appear—along the lines of the old Interest Equalization Tax which former Treasury Secretary George Schultz abolished in January 1974. Such controls appear to be in place, albeit not formally, and in a form attractive to dividend-watchers at the commercial banks.

To a great extent, public discussion of this process has taken the form of an ideological debate over the Eurodollar market's role in monetary expansion. At a conference sponsored by the Philadelphia World Affairs Council Oct. 31, monetary sages Robert Triffin and Guido Carli demanded formal controls on the Eurodollar market to contain world inflation. (Extracts from the Triffin and Carli speeches are appended to this report).

In the *Financial Times* Nov. 5, columnist Samuel Brittan—a conduit of leaks from Sir Geoffrey Howe's finance ministry—predicted that the "compromise" on this issue to be struck among the U.S., British, West German, and Japanese central banks would be to limit Eurocurrency expansion to the rate of growth of national currencies in each individual sector.

This is nonsense, if carefully designed nonsense. Paul Volcker is not controlling the U.S. money supply, except to the extent that it can be controlled with a blackboard eraser. The Fed's discount window is still open to the commercial banks, providing them with cheap borrowed reserves at a discount rate that still has not been raised. According to William Griggs, economist at the New York branch of Schroeder's Bank, the Fed has promised the banks a solid two more months of this.

Volcker does not see the matter in the technical terms that Triffin, Carli, and Samuel Brittan present. His standpoint is the best means of "controlling disintegration," that is, deciding which sectors of the developing world will be cut off from credit, which basket-cases may be written off, and which sectors of international trade must give up the ghost. It is mainly in the hands of the West Germans, who are far from decided on collaboration with this approach, to say whether Volcker's policy will prevail.

—David Goldman

Triffin forecasting new reserve currencies

The following are excerpts from Robert Triffin's speech before the Global Interdependence Center in Philadelphia on Oct. 31:

I could tell you that the international monetary system *has no future*, because our political leaders ... may be unable to muster the lucidity and the courage required to negotiate and implement the radical, agonizing reforms indispensable to cure the world inflation, recession, balance-of-payments disequilibria, chaotic exchange rate fluctuations, creeping protectionism, etc. to which we seem condemned.

I prefer to concentrate on what should be done to reverse the process, even if the chances are that nothing of the kind will be done in the foreseeable future

My major thesis ... is that neither stable, nor floating exchange rates can function satisfactorily in the absence of any international control, and *restraints*, over the fantastic explosion of international liquidity provided to the market, in recent years, by the monetary authorities and the commercial banking system....

Gold was traditionally the major constraint on such (inflationary and reserve expansion—ed.) proclivities, but its beneficial role in this respect has been vastly exaggerated by the enthusiasts of the gold standard.... Any country determined to fight inflation would be better advised to try legal, or constitutional, ceilings on money creation (percent a year, for instance, a la Milton Friedman) than to tie money creation to gold....

The United States (after the 1971 elimination of any fixed rates or gold standard—ed.) was not restrained by gross reserve losses, because the acceptance of its own currency—which it can produce without limit—by other countries enabled it to finance enormous deficits, before and even after the dollar became inconvertible. What is less perceived so far in most of our economic debates is that the size and persistence of these deficits, together with floating exchange rates, have practically eliminated any substantial losses of reserves, even by the most inflationary countries. Significant reserve losses were experienced by about a dozen countries only in the first years following the explosion of oil prices, but gross reserves ... more than doubled on the average ... over the three years 1970 - 1972, and have nearly doubled again ... since 1972.... This does not mean, of course, that all other countries were in surplus on current account, but merely that the current account deficits of even the most inflationary ones could be financed—and indeed overfinanced—by international borrowing.

The flooding of world reserves by dollar and Eu-

rodollar creation has added new dimensions to this financing. It has increased the cash reserves of commercial banks, enabling them to expand their own foreign lending at a pace which they could not have sustained otherwise....

The most hopeful sign of possible progress toward reform, since the breakdown of the Bretton Woods System, is the breakthrough finally achieved in March of this year with the initiation of the European Monetary System (EMS)....

One of the first and most urgent problems confronting nonmember countries as well as member countries is the insertion of the EMS into the world monetary system, and particularly the uneasy relationship between the ECU (the numeraire used to record EMS currency support operations—ed.) and the dollar in international settlements.

An important feature of the EMS in this respect is highly welcome by our monetary authorities. This is the replacement—in principle at least—of the dollar by Community currencies in intra-Community interventions on the exchange market.... The first months of functioning of the EMS have been somewhat disappointing in this respect, dollar interventions have remained far larger so far than was intended. New measures are now under discussion to make possible a further reduction in the use of the dollar in market interventions and settlements....

The use of the ECU outside the Community itself, might, at first view, be more worrisome. Switches from dollars to ECU's in private and official settlements and reserve accumulation might become very tempting, if made possible by the EMS authorities, or by the imaginative Eurocurrency and Euro-bond sectors of the world economy....

A more decentralized structure of monetary cooperation than that of Bretton Woods is long overdue. It would have, to my mind, (some of the following advantages):

- To relieve the IMF of unnecessary responsibilities, and enable it to concentrate its time and attention on those which cannot be discharged as, or more, efficiently on the regional scale.

- To make wholehearted participation in the IMF more attractive and feasible to disaffected countries, such as many less developed countries, and particularly to make it possible for the Communist countries ... to adjust their mutual relations to rules and norms derived from the market....

Guido Carli: dollar is on the way out

The following are excerpts from a speech by Italian banker Guido Carli, in Philadelphia Oct. 31:

The international monetary system is going through a period of transition that will probably end with a change in the role of the dollar. But this process is slow and the dollar will remain very important during the transition period.... (There are) two institutional sources of instability, which the (world monetary) system has not yet corrected. The first lies in the fact that the process of creation of international liquidity triggered by the U.S. balance-of-payments deficit is not only due to the increase in the amount of the dollar reserves in the hands of other central banks, but also to the presence of an international banking system that multiplies U.S. liquid liabilities outside the control of any monetary authority. The problem is old: it has been ten years since I first pointed to the need for some kind of regulation of the Euromarkets....

The possibility of a repetition of the same sequence of events that followed the 1973 crisis has revived interest in Euromarket regulations. But it is perhaps too late. The volume of the international liquidity denominated in dollars has reached levels that may no longer be controllable by any one authority. The idea that the problem can be solved with the institution of a specific center of control, or with the alignment of the control responsibility of one central bank, seems inadequate.

The second institutional problem ... is that of containing the effects of reserve and portfolio diversification policies on the price of the U.S. currency. These policies increase the destabilizing consequences of the existing supply of dollars. The challenge is to create an alternative asset that satisfies the needs of dollar-holders searching for viable forms of investment for their liquid balances. You will recall that the first official discussion of the idea of a "substitution account" can be found in the IMF Executive Directors report to the Board of Governors on the "Reform of the International Monetary System" of August 1972. Yet the idea was never put into practice. The market, however, made up for the inertia of the system, finding in gold the instrument that was lacking.

...The solutions of these two institutional problems—control of Euromarkets and creation of alternative assets—are, of course, complementary....