A shortcut to international monetary catastrophe

When the silver price collapse in March 1980 nearly brought down the Hunt interests, the chairman of the executive committee of Citibank, America's largest, told friends, "There are so many things in the woodwork that no one can say which is going to pop out." The point was well taken and applied with a vengeance a year later. A monetary system in the penultimate stage of bankruptcy loots Peter to service Paul's deficit accounts. Whether Peter or Paul defaults first is not predictable, unless all political conditions are known in advance. Monetary crises are more likely to inspire a political free-for-all.

With this limitation in mind, analysis of the forthcoming monetary crisis is a relatively simple matter. In first approximation, it is a demonstration that the monetary system is *in deficit to itself.* In financial terms this means, simply, that the international and national accounts of the public and private sectors are so awry that no sources of income are available to cover the system's aggregate deficits, except through the sort of money-printing that quickly discredits all financial instruments. In a closer approximation, it is a political examination of the responses of policy-makers to problems that cannot possibly be solved within their narrow belief-structure. The course of the crisis does not follow the contours of the accounting problem per se, but the strange convolutions of thinking at institutions like the International Monetary Fund, the Bank for International Settlements (the "central bank for central banks,") and the Organization for Economic Cooperation and Development.

It is possible to predict with some accuracy the precise way in which a crisis will evolve, as Lyndon H. LaRouche, Jr., the founding editor of this publication, did during the years and months prior to Aug. 15, 1971. Such forensic skills depend on the analyst's ability to determine how the belief-structures of policy-makers will ultimately conjoin with the hostile reality around them. On this basis Mr. LaRouche informed *EIR*'s June 10 seminar in Washington, D.C., before an audience including 60 administration economists, that the most likely date for the outbreak of full-scale monetary crisis was October of this year.

In Federal Reserve Board Chairman Paul Volcker's belief-structure, interest rates in the 20 percent-plus range are *not* a means of reducing inflation, but an instrument of *income redistribution.* The Fed's interest-rate policy strengthens *creditor organizations* against *national governments,* diverting income flows toward the refinancing of debt service that otherwise would be unmanageable. Here, in the data made available by the International Monetary Fund, is what the global flow of funds looks like. Start with the most pressing deficit of all, that of the countries least able to manage a deficit, the non-oil-producing developing countries:

Current account payments deficit of non-oil LDCs

1972	$– 9.9 billion
1977	–31.3 billion
1980	–77.9 billion
1981 (p)	–93.0 billion

This corresponds roughly to the volume of debt service of the same group of countries:

1972	$14.0 billion
1977	30.3 billion
1980	75.2 billion
1981 (p)	96.4 billion

This close correspondence means that these countries are importing virtually nothing above their level of exports—that there is zero development effort going into their economies—and that the entire deficit on their payments accounts is due to their debt-service bill. The current account deficit is what must be financed through new capital, i.e., the amount that the commercial banks or others must lend so that their debtors can service their outstanding debt.

Although in certain ways the United States, as noted in an earlier section of this report, is worse off than the non-oil LDCs as a group, this lacuna in the world's balance sheet is cited more frequently than any other as a potential cause for a "doomsday scenario" on the financial markets. Under the headline "A New Financial Crunch," the *Far Eastern Economic Review* warned in a survey March 20 of this year, "Ayatollah Ruhollah Khomeini and Paul Volcker may make an unlikely pair. But from the developing world's point of view, the fiery

Islamic revolutionary and the rather dour chairman of the United States Federal Reserve Board have conspired, albeit unwittingly, to produce another Third World balance-of-payments crisis every bit as threatening as that brought on by OPEC seven years ago. . . . The Volcker shock of 1979 has had as great an impact on Third World payments as the OPEC crisis of 1973-1974." Morgan Guaranty Trust estimates that if the short-term Eurodollar rate averages 20 percent this year, interest payments will hit $38 billion this year. The IMF staff estimate for 1981, in any event, is $33.6 billion of interest payments alone.

Whether or not the Third World debt bubble is more vulnerable than the California real-estate market or the Italian stock exchange is not so much the point. It is an excellent place to start, working outward to other potential problems.

The next question is, who will foot the $100 billion bill of preventing the entire pack of non-oil LDCs from defaulting this year? Unfortunately for the commercial banks, they have no choice but to pick up the tab. As West Germany's Commerzbank complained in an analysis released July 24, the proportion of private debt (as opposed to loans from governments or the World Bank and International Monetary Fund) in the LDCs' total indebtedness has risen from 50 percent in 1973 to 60 percent in 1981, looking only at long-term debt. If short-term debt is factored in, which it ought to be, the proportion of private debt rises to 70 percent.

In incremental terms, the picture looks even worse. In 1980 the international organizations and governments together carried less than 20 percent of the LDCs' deficit, and will not do better this year. For all intents and purposes, the problem is dripping into the laps of the commercial banks. This circumstance has produced some unusual shrieks and howls from the financial press. Last March, the London *Economist*, in a rhetorical flourish at the end of a long demand for more official financing for the LDCs, intoned, "In the longer term bankers must ask themselves if they are fit to carry on their recycling role. They have pushed billions of dollars into Poland on the scantiest statistical information. . . . They have proved as bad at reading the political tea-leaves as at avoiding being manipulated by politically sophisticated borrowers skilled at playing highly competitive banks of different nationality off against each other." The piece bore the headline, "Banks Discredited by Their Failure to Foresee That Some Countries Cannot Pay Their Debts on Time."

By June, when the Bank for International Settlements' annual report warned that the commercial banks could not keep on lending at the present rate, *The Economist*—who can serve as well as any as fall-guy for the inanities of the international financial press—had changed its mind. When the Bank for International Settlements pointed out that the banks lent 59 percent more to developing countries during the first five months of 1981 than during the same period of 1980, *The Economist* accused the "central bank for central banks" of being "overly cautious."

The banks are stuck with the problem, and, all of a sudden, none of the usual pundits wants to complain about banks' "overexposure," just when the exposure has gotten positively indecent. Next question: where does the money come from? Last year, after the big 1979 oil price rise, most of it came from OPEC deposits into the Eurodollar market, i.e. from a tax on oil consumption worldwide, transformed into a great fund for debt-service refinancing. The OPEC cash surplus provided $154 billion in Eurodollar market deposits during 1974-1980, of which $42 billion were placed last year. Apart from this, the International Monetary Fund failed to trace some $65 billion of the $109 billion in OPEC surplus cash racked up in 1980; some of this seems to have fed indirectly into the Eurodollar market.

But this year, because of stable or weaker oil prices, OPEC's quota of lendable cash has fallen off sharply to a little more than half of last year's levels. "By the end of the year [1980]," commented Chase Manhattan's *International Finance* newsletter, "[OPEC revenues] were a negligible source of new funds. This occurred for two reasons: the OPEC members appeared to be favoring longer-term nonbank investments [rather than dump all their money into the recycling mill—D.G.]; and they were forced to increase their borrowings late in the year as their oil revenue growth came under increasing pressure."

Without the OPEC cow to milk, the Eurodollar banks and the international financial institutions, the subject of an unusual encomium from the heads of government who signed the Ottawa communiqué, needed another source of funds. At this point Fed Chairman Paul Volcker became an important player in the world financial game. Volcker's credit controls of March 1980 shut down lending in the United States, and permitted U.S. banks to shift $15 billion to their foreign branches during the third quarter of 1980. Chase commented in its July 20 newsletter, "The imposition of credit controls in the United States in the spring of 1980 caused 'tight' monetary conditions in the classic sense, as some market participants . . . were denied sources of credit even though they could and would have paid a higher price. But such tightness failed to carry over into the Euromarkets because such rationing of credit requires regulations that cannot be imposed on the Euromarkets."

Except to state that Euromarket conditions were easy while domestic U.S. conditions were tight, the statement is disingenuous. It leaves out the crucial fact that the Federal Reserve and the banks designed an outflow to the Eurodollar markets at the expense of the

U.S. economy.

But by the first half of 1981, it was Europe's turn in the barrel. The Federal Reserve's monetary policy kept interest rates at the 20 percent level, provoking huge declines in the value of European currencies, and the following capital outflows from European treasuries (shown from the IMF data in annualized rates):

Current payments balance including official transfers for 1981

France	$- 7.4 billion
Germany	−12.5 billion
Italy	− 8.0 billion
Total	−27.9 billion

Not quite $30 billion this year, mostly during the first half, funnel into the deposit base of the Eurodollar market. This occurs through foreign exchange market intervention on the part of central banks. When the value of European currencies fell, because short-term money moved into dollars in pursuit of Chairman Volcker's record-breaking interest rates, the central banks attempted to slow the decline of their currencies by purchasing these currencies on the open market. Most of these purchases were made with dollars drawn from the foreign-exchange reserves of the central banks. The dollars sold in return for the European national currencies become part of the Eurodollar pool. The expanded Eurodollar pool is then capable of additional lending to the otherwise-bankrupt developing countries.

With this in mind, Chase Manhattan projections continued steady growth of the Eurodollar market as follows:

Size of Euromarket

	Gross size	Net size
1979	$1,110.7 billion	$665 billion
1980	1,323.1 billion	810 billion
1981 (p)	1,550.0 billion	950 billion

The difference between gross and net size is found by deducting deposits banks make with each other from the total deposits in the market, the remainder being banks' lending to nonbanks. The projected $140 billion growth in the net size of the market will consist mainly of new loans to those borrowers who are least likely to pay anything back. Note that the proportion of net to gross size of the market has not change substantially. This is important. Technically, the Eurodollar banks can "create money," i.e. lend the same deposits back and forth to create "new deposits," without limit. In other words, the potential Eurodollar multiplier is infinite, because no reserve requirements apply. However, the Eurodollar banks are not stupid, and will not maintain a necessary rate of lending without the continuous availability of new money from outside the market. The actual Eurodollar multiplier (the relationship between what the Fed calls monetary base and total deposits) is about 5, against less than 3 in the American banking system. Despite the large multiplier, movement of funds into the market is still a requirement for expansion.

Contrary to the halcyon portrait Chase offers of Eurodollar market growth in 1981, it is occurring at the expense of chaos in Western Europe even greater than the disruption of the American economy in the second and third quarters of 1980. West German Chancellor Helmut Schmidt's warning before the Ottawa summit that the world faced a danger of 1931-type protectionism referred to the *exchange controls* that nations adopted after the 1931 collapse of sterling and the collapse of the German banking system. That exchange controls are contemplated even in West Germany, the paragon of *Freimarktwirtschaft*, is not surprising in context. The following table prepared by the IMF shows the growth of the major European nations' budget deficits internally:

Central government deficit as percent of GNP

	West Germany	Italy	France
1979	−1.9%	−10.8%	−1.1%
1980	−1.8	−10.7	−1.3
1981	−2.2	−11.0	−1.8

Translated into American terms, a federal budget deficit equal to 2.2 percent of GNP would be $66 billion, or double what the Office of Management and Budget says is tolerable for the next fiscal year—although the actual U.S. deficit for FY 1982 will more likely be around $100 billion. Under normal circumstances Europe could finance deficits of the above magnitude, if it were not bleeding through the current account of its foreign balance of payments at the same time. Virtually all spare cash available to these countries' banking systems is parked in the Eurodollar market earning 18 percent interest, and perhaps expecting currency appreciation, because the Fed has forced Europeans to speculate against their own currencies. The domestic bond markets, i.e. the vehicle for financing the enlarged government deficits, are in shambles in all three of the major European countries.

Meanwhile, the change in the value of their currencies left Europe with the worst of all possible worlds. Even though oil prices remained stable during 1981, West Germany's oil bill has risen 30 percent, because the German mark has fallen by that amount against the dollar in which oil is priced. During 1980, the sharp rise in oil prices threw the European current accounts into deficit, but OPEC funds were freely available for at least France and Germany, which together received about $15 billion in petrodollars. Now that the Volcker "currency shock" has hit the Europeans worse than the 1979 "oil shock," the petrodollars are not available—unless a crash of the dollar persuades the Arabs to "diversify" their holdings further into the French and West German banking systems.

Italy has already undergone a brutal shakeout of the internal markets, starting with the July crash of the Milan stock market. For the first time since 1917 the government—in consultation with the International Monetary Fund—shut down the stock market for several days. It appears that the large commercial banks themselves began the crash, in order to clear ground for even more shocking measures by the central bank and government. At the end of July, while the heads of state met at Ottawa, the Bank of Italy stopped rediscounting Treasury bills, i.e. put an absolute stop to internal credit expansion. Since inflation in Italy is at 21 percent, this translates into a 21 percent cutback in credit in real terms. Meanwhile the new Spadolini government declared a reduction in its budget outlays from the 50 trillion lira ($42.5 billion) per year annual rate then prevailing, to 37 trillion lira—a 25 percent cutback across-the-board, something OMB honcho David Stockman would never have dreamed of. Such a measure was, in any event, implied by the earlier action of the Bank of Italy. It means the virtual end of health and sanitation services in most Italian municipalities.

Even West Germany will not be much better off if the present environment persists. Its whole credit system is based on long-term, fixed-interest securities, whose marketability collapses if interest rates rise. Both the big commercial banks, and the *Landesbanken*, the regional central banks for savings institutions who do commercial banking business, are crippled by the paper devaluation of their bond holdings. The Bundesbank's Volckerish monetary stance has virtually shut down commercial lending, with the result that the rate of bankruptcy has doubled from 1980 to 1981. On another anniversary, the July 10 semi-centenary of the collapse of the Danat Bank in 1931, the German financial press asked in all seriousness whether the German banking system would not repeat the debacle that brought in, first, Hjalmar Schacht as the enforcer for the Bank for International Settlements and, two years later, Adolf Hitler. Since the *Landesbanken* as a whole have been operating at a loss during 1981, and the third largest commercial bank, Commerzbank, reduced its dividend this year for the first time in decades, this speculation is not unmotivated.

British disease

All Europe is staring at its near-term future across the English Channel, where Prime Minister Margaret Thatcher's government has doubled unemployment to 11.8 percent of the workforce, or 3 million individuals, while proposing to reduce unemployment pay to $71 per week from $100 per week for a worker with a family. The 20 percent peak-to-trough production drop in Great Britain since Thatcher took office in April 1979 is half again as bad as the worst of the 1930s. The riots in British cities this year so far, involving mainly Asian and Caribbean immigrants, are perhaps only the beginning; under 1930s conditions not so gruesome as what archmonetarist Thatcher has prepared, British workers rioted 50 years ago. Only this time there is no Royal Navy to fall victim to a sailors' strike.

Monetarism in Europe, the inverse side of the "efficiency and ease" of Euromarket conditions in Chase Manhattan's description, means the spread of Britain's economic, social, and political chaos to the Continent. Just at the point of breakdown for several of Europe's economic sectors, however, their ability to provide a continuing flow of funds into the Euromarket has virtually ended. They are sucked dry.

Banking sources close to Fed Chairman Volcker explain that this does not represent a real problem; it is merely necessary that the United States take its turn in the barrel again. After the second and third quarter 1980 shambles, when industrial production in the United States dropped by 8 percent, and $15 billion flowed off to the Eurodollar market, the outflow stopped. In fact, the United States was the beneficiary of a substantial net inflow during the first quarter of 1981, when Eurodollars entering the American banking system accounted for most of the 12 percent per annum rate of expansion of money supply in that quarter. That is, since the Federal Reserve restricted banks' capacity to lend at home, American corporations borrowed abroad and brought the proceeds of the loans home, expanding money supply. During the second quarter the Federal Reserve accommodated a 32 percent annual rate of expansion of domestic credit, and the inflow stopped. It is important to note that the first-quarter inflow was not a drain on the monetary base of the Eurodollar market, but rather importation of loans spun off the monetary base. Had the actual base of the Eurodollar market decamped, the banks could not have financed the developing-sector deficit on the markets, and sanitation crews would still be scraping off the sidewalks around Wall Street.

Now, apparently, the Federal Reserve, not satisfied with the gradual but ominous decline of U.S. economic activity, has determined to give the United States a short sharp shock. In this case, the enforced collapse (perhaps through lending controls of the type Volcker used in the second and third quarters of 1980) of internal lending activity will free additional funds to feed the ravenous Eurodollar pool, and the global deficits will presumably be financed.

Not only the murderous interest-rate regime, but the capital movements of the first half of 1981, have already had a disastrous impact on the American economy. When European central banks sell their dollars to buy their own currencies off the floor of the foreign-exchange market, they convert their reserve holdings of U.S. government securities into ready cash. This involves presenting the securities to the Federal Reserve for sale on the U.S. market. For the American credit markets, the effect is the same as if the federal government spent more, and had to raise additional funds on the market. Someone must buy the securities. In practice, savings that would otherwise go into the savings banks and similar institutions, i.e. into the domestic housing market, buy up the additional bonds. What occurs is a net transfer of American savings from the mortgage and other long-term credit markets at home, to the monetary base of the Eurodollar market, through the liquidation of foreign holdings of U.S. government debt.

Another turn in the barrel for the United States economy will only buy time, in the view of the crisis managers. If the deficits of the Third World cannot be made up through the funds available through the international institutions, and the commercial banks must end their drunken-sailor lending pattern sometime, what must give is the internal economies of the Third World.

"Such countries," the IMF commented in its June 1981 *World Economic Outlook*, "will incur substantial increases in their debt service ratios even if they are successful, as assumed here, in implementing comprehensive programs of adjustment." Comprehensive programs of adjustment mean, in IMF euphemistic language, doubling or trebling of food prices through the elimination of internal subsidies, reductions in energy and capital goods imports, the abandonment of large capital-intensive development projects, cuts in government spending, and other measures that push developing economies under the threshold of survival. Under a 1979-1980 "adjustment program," Jamaica suffered a 20 percent drop in real wages, a staggering blow for a nation most of whose population lives at the margin of existence, and took to producing marijuana as a primary cash crop. What the IMF is saying here is that even such programs will *not* contain the explosion of their deficits. "A major cause is the persistence of interest rates at levels much higher than during the 1970s, tending to increase the outflow of investment income from countries with large external debt and, therefore, to limit the improvement in their current account deficits stemming from the adoption of adjustment programs. . . . It is difficult to see how these developing countries could sustain their debt burden without further reducing their growth rates."

Since the firm's accountant has been at work selling off the firm's assets to stay current with the creditors, it is time to look into the shop and see what is left. It was one thing to juggle the world's accounts during 1979, when world trade grew in real terms by 6½ percent, and quite another in 1980, when world trade grew by only 1½ percent. As a result of the Federal Reserve's juggling in collaboration with the International Monetary Fund and Bank for International Settlements, world trade volume is falling this year in absolute terms, for the first time since 1975. Every national sector of economic importance is either going through significant short-term reductions in output, as in the United States, or remaining stagnant after a major drop in output, e.g West Germany, or stagnating, as in Japan.


Chairman Paul Volcker

Cracked façade

Here is the point at which the seemingly cool half-smile of the central banker is recognizable as the expression of a paranoid axe-murderer. To manage deficits of crisis proportions during the past two years, the Bank for International Settlements has put every national economic sector among the OECD group into recession and the grave immediate danger of general collapse, and pushed large sections of the developing sector population to the edge of extinction. Extinction is, in fact, the next step. The U.S. State Department reckons the signal accomplishment of the Ottawa summit July 21 to have been the inclusion in the heads of governments' final communiqué of a Paragraph 12 devoted to population control. It means, as the State Department wants to tell next October's North-South meeting in Mexico, the introduction of population control programs as a condition for further credits. Since, according to the IMF, the developing sector cannot afford to sustain large sections of its population, it must eliminate part of them.

Having successfully "managed" the critical deficits by reducing the world's real output and trade, the BIS and IMF propose to repeat what has evidently been such a successful procedure. This is the policy commitment evident after President Reagan was sufficiently duped as to deny the Europeans their plea for monetary sanity at the Ottawa summit.

Once real output drops off at the rate the crisis managers have ordained, the deficits of nations and private firms that earlier seemed to grow dangerously but containably will explode out of control.

For the United States, it means a gap in the balance sheets of the savings and loan industry between $45 and $75 billion, according to different official estimates; auto industry profits changing from a negligible positive figure in the second quarter, made possible by creative accounting, into massive third- and fourth-quarter losses; regional commercial bank insolvencies; and a federal government budget deficit rising over $100 billion, due to higher interest costs, higher unemployment benefits, and lower revenues.

At this point, Citibank officer Edward Palmer's judgment is accurate. One at a time, the bankruptcy of firms and even nations can be "managed," as we have seen during the past year and a half. But it doesn't work that way. Financial institutions react to the prospect of insolvency after the fashion of the individual sucker who can't meet his mortgage payments, and blows his last $500 at the roulette table in a desperate splurge to come up with the cash. The gigantic shifts in currency values, securities prices, and other basic parameters of financial life have left the crushingly indebted private sector also exposed to the neck in the speculative markets.

The first sign of real trouble is less likely to be the final bankruptcy of a Chrysler or Pan Am, but the discovery that the Bahamas manager of a Midwest bank is short of $5 billion of cocoa—at which point every player in the game considers cashing in his chips and hiding under the bed. But this is not the most dangerous feature of the situation. Volcker and his associates have created economic circumstances that no national government and no population can live with.

Should Chancellor Schmidt, for example, tire of playing Atlas to the world market, and impose defensive exchange controls—which the German central bank is now considering—the entire weight of the crisis would be thrown back onto its managers. Should Mexican President José López Portillo carry through on his threat to "fight like a dog to defend the peso," under speculative attack now, and adopt similar defense controls, what will Brazil do, or other nations in the same spot? Such events would transform what is now a de facto military occupation of the world economy by the supranational institutions into open, and uncontrolled, warfare.

Even if Schmidt, López Portillo, and other world leaders ultimately follow orders on the example of Spadolini and Mitterrand, the world is likely to take a course different from the one expected by the International Monetary Fund, i.e. the supranational institutions and their tributary commercial banks squatting like vultures over the carcasses of national economies. The tenuous nature of their position is evident in the last weeks' negotiations over the Polish debt. With $5.3 billion to pay this year, and $23 billion in external debt, Poland is the worst potential crisis-trigger in the system at the moment. The American commercial banks have, incredibly enough, decided to play chicken with the harried Polish political leadership. Since the West German banks are the most vulnerable to Polish insolvency, the U.S. banks have delayed rescheduling the debt, as the Germans want, in order to press an additional condition on the negotiations: that Poland join the International Monetary Fund.

This action gives the Soviet leadership a direct stake in undermining the *economic* crisis-management efforts of the Western leadership, even if it were disposed to play games with strategic crisis management. Every national sector the International Monetary Fund has touched has, in direct consequence, tumbled into domestic political chaos. Argentina or Zaire may have no one to mourn the convulsions of their internal political structure. But they are not dependencies of the Soviet Union.

Where the fantasies of the crisis managers will crash into bedrock reality is impossible to say. The most immediately submerged rocks are:

1) a collapse in U.S. real-estate values, associated with major commercial bank losses; combined with

2) panic withdrawal of large deposits from savings and loans after one or two big failures; both above associated with

3) a sudden turnaround of foreign-investor interest in the dollar, and a flight of capital into gold and safer currencies; combined with

4) exchange controls imposed by European governments who would have little other choice; and

5) pullout of dollar deposits by OPEC countries seeking refuge in safer assets; leading to

6) a breakdown of debt recycling on the Eurodollar market.

Of course, any number of other possibilities are evident, and the above hypothetical sequence could occur with the same events in different *apparent* order of causality. What is of overriding importance is that the short-term success of comprehensive crisis management has left every vertex of the financial system vulnerable to crisis.