

## The Fed's inflationary Eurodollar bailout

by David Goldman, Economics Editor

To the surprise of International Monetary Fund officials and, perhaps, those of other industrial nations, the United States will make the principal issue at the Sept. 4 meeting of the IMF's Interim Committee the *transformation of the IMF into an instrument for bailing out bankrupt developing-sector debtors*. U.S. Treasury Secretary Donald Regan will insist that the Fund be given powers to borrow very large amounts of money on the private capital markets and re-lend this money to countries in a position similar to that of Mexico, a cabinet-level meeting including Regan, Secretary of State Shultz, and Commerce Secretary Malcolm Baldrige decided the week of Aug. 16.

Although the United States, and most emphatically the Reagan administration, had opposed such expansion of IMF resources in the past, recognition that "the international monetary situation is unraveling" has changed the administration's viewpoint, according to senior officials familiar with the policy change, which took IMF staffers by surprise. The United States will maintain its "hard-line" posture towards increased financing for the Third World by opposing an increase in IMF quotas, i.e. member country contributions to the Fund, strongly urged in the IMF's Annual Report; however, the funds lent for "emergency purposes" through the new facility the United States proposes to create will be lent with the single condition that the recipient country subject itself to a Fund economic program.

### Hyperinflation to save the banks

Administration officials insisted that the new plan represented no largesse toward Third World nations, but only a

means of covering their payments to banks who might otherwise founder, as appeared likely when Mexico announced Aug. 15 that it had run flat out of cash. The model for the administration action, officials said, is the present Mexican formula: the \$2 billion in new credits and advance oil payments given Mexico by the United States and the \$1.68 billion emergency short-term loan issued through the Bank for International Settlements were made on the condition that Mexico accept IMF reorganization of its economy, including the elimination of all subsidies on domestic food and fuel prices, and a lowering of annual economic growth targets that will permanently put an end to Mexico's once-ambitious industrial development plans.

The Treasury will support the IMF's tough stance toward Mexico without reservations, officials said, even though the National Security Council will not rule out the likelihood of political violence in response to such brutal measures.

In summary, the United States will conduct a *monetary* program with hyperinflationary implications in a (vain) effort to hold the international banking system together, while pursuing an *economic* program which will ruin developing-sector economies. As *EIR* demonstrated in a June 29 survey, since 70 percent of the Mexican workforce is now employed assembling parts imported mainly from the United States, a shock-reduction of Mexican imports (which the banks have already enforced) will throw much of the industrial labor force out of work; add to this the elimination of basic subsidies, and the internal economy will disintegrate within months.

### The worst of all possible worlds

Carried past the first stage of implementation, the effort to bail out the \$1.7-trillion Eurodollar market with the \$153-billion balance sheet of the Federal Reserve System leads to classical hyperinflation. Not merely the still-forthcoming proposals of the Treasury before the IMF's Interim Committee, but the behavior of the Federal Reserve in the last month, suggests the worst of all possible worlds.

As we have repeatedly explained, the basis of the Euro-dollar market is reserve-free multiplications of a relatively narrow base of initial deposits. Under conditions of feared collapse, lenders and depositors in the market unwind the chain-letter game by pulling out deposits and stopping loans. To prevent the collapse of scores, if not hundreds, of institutions on the model of the Banco Ambrosiano of Luxembourg, which defaulted on \$400 million of "interbank" debt, the Federal Reserve would have to substitute its own obligations for the lowest-quality, unbacked "bank money" in which the loans were made. More on this below.

The Fed, as Manufacturers Hanover Trust reported in a commentary Aug. 23, has already turned the pump on full. Entitled, "Concern Over the Financial Structure Prompts the Fed to Ease," the commentary read, in part:

"Despite widespread expectations that interest rates would rise in the second half of 1982, so far, at least, precisely the opposite has occurred. Fueled by a five and one-half percentage point drop in the Federal funds rate since late June, powerful financial market rallies have reduced interest rates across the entire maturity spectrum. But while undoubtedly welcome, these interest-rate declines have served to mask a continued deterioration in the business outlook. Faced with an economy yet to exhibit signs of recovery and well-publicized problems in the financial system—not to mention the soaring credit needs of the Treasury—the Federal Reserve has loosened the monetary reins. In so doing, bank reserve pressures have been eased, thereby pushing interest rates lower. . . .

"The central bank has also been generously providing reserves to the banking system. During the month ending August 11, these building blocks of the money supply expanded at a torrid 26.5 percent seasonally adjusted annual rate. This is an abrupt turnaround compared with the almost one percent seasonally adjusted annual rate of decline posted during the month ending June 30."

Manufacturers Hanover analysts guess that the Fed's behavior is prompted by the succession of financial bankruptcies—Penn Square Bank, Drysdale Securities, Lombard-Wall—that shuddered the market during the past three months. Federal Reserve officials, however, say that their principal job is to "worry about the whole financial system," which means, above all, the vulnerable Eurodollar market.

When a country like Mexico is unable to pay its bankers, that means, stripped of euphemism, that the bankers are unwilling to lend Mexico the wherewithal to pay its current interest installments, for fear of Mexican bankruptcy at some near future date. The entire Third World (with few excep-

tions) is in the same position, including Brazil with \$80 billion in debt, Argentina, with \$40 billion in debt, and Venezuela, with \$30 billion in debt. Since the entire sum of payments in question is interest—bookkeeping transactions within the financial system—it means that the banks are unwilling to generate the new bookkeeping entities required to lend Mexico the required interest through one window, and take it back through the other. All the "dollars" involved are deposit-entries at commercial banks representing a multiple of 6 to 10 times the original deposits into the Eurodollar system.

### **'High-powered money'**

When the Bank for International Settlements handed Mexico \$1.68 billion (of which \$750 million came from the Fed) to hand over, in turn, to its bankers, it substituted *central bank money*, also called "reserve money" or "high-powered money," for fictitious bookkeeping money. All central bank bailouts, including the one proposed via the International Monetary Fund cited earlier, have the identical effect: they transform the lowest-quality obligations of private banks into obligations of central banks, in this case, of the Federal Reserve.

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*The United States will conduct a hyperinflationary monetary policy to try to hold the world banking system together, while pursuing an economic program which will ruin developing countries. Banks hand a debtor the funds to pay their interest, and take it back through another window, generating a multiple of Eurodollar paper. When does the bubble burst?*

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According to Bank for International Settlements and Swiss National Bank internal estimates of the total required funds to tide the banking system over the present crisis, the central banks would have to create \$100 to \$200 billion in new "high-powered money" to cover "debt reschedulings" during the next year or so. Measured against total Federal Reserve credit, or \$153 billion as of Aug. 11, that amount is large enough to blow out the Fed's balance sheet.

That does not tell the whole story. About \$800 billion of the \$1.7 trillion in Eurodollar deposits represent loans be-

tween banks, much of it re-lending of the same original loans, but ultimately lent out to non-bank borrowers who cannot repay the principal value of those loans on demand. An informal boycott of suspect banks began with the Luxembourg-Ambrosiano affair; many foreign banks, as well as Canadian banks, are now surviving by borrowing funds from American banks at exorbitant spreads. Typically, big American banks will issue holding-company commercial paper, to re-lend the proceeds at half a percentage more interest. "We are far from the point where this banking arbitrage has reached its limits, but we are monitoring the situation daily," reports a worried Fed official. Despite the temporary solution of the Mexico program, the situation for the suspect banks is getting worse, not better. Mexico might tell the IMF, "We may not survive this crisis, but neither will you," at any moment, and there are Argentina and Brazil still to be dealt with. Even Chase Manhattan, Bank of America, and other large banks had trouble marketing their certificates of deposit upon the breaking of the Mexico crisis.

The default of a major bank, following the Ambrosiano-Luxembourg model, is perhaps even more dangerous for the market than a default of a major country, since its example would cause a general run against banks deemed similarly weak. At this point the demands against the fire brigade at the Federal Reserve would run out of all proportions, and the Euromarkets would disintegrate.

### 'Pushing on a string'

"It is impossible to tell how long we can go on creating high-powered money under conditions of debt-deflation," a senior Fed staffer commented. "Modern economic theory has no tools to deal with this; you have to move into 'catastrophe theory' to ask, 'When does the bubble burst?'" The problem is known in economic jargon as "pushing on a string," i.e. what the Fed was reduced to during the 1929-33 period: When lenders are convinced that their debtors are past saving, they will not lend no matter how much new high-powered money the Federal Reserve injects into the banking system, or how far interest rates fall.

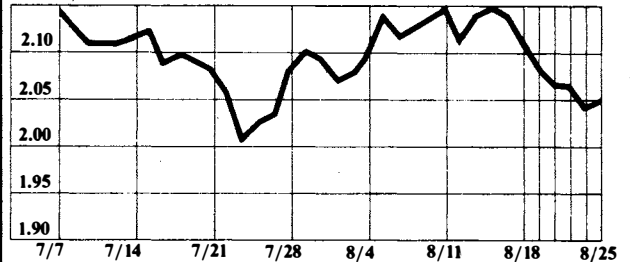
History-minded observers will not, therefore, take the central banks' commitment to "bail out the Euromarket" at face value. There is no way to stabilize the financial system without measures to revive world trade and investment, the opposite of the austerity program associated with the supposed bailout. The final step of the program would put the Fed, its balance sheet ballooned out of proportion, in the same position as Mexico, beholden to the International Monetary Fund for financial aid.

Since advisers to Secretary of State Shultz speak frankly about a change in the Mexican constitutional system, the inference is not hard to make that the authors of the bailout proposal have few illusions that it will succeed on its own terms: They expect, however, that it will give them time to flatten whatever opposition now exists to their hopes for picking up the pieces when it fails.

## Currency Rates

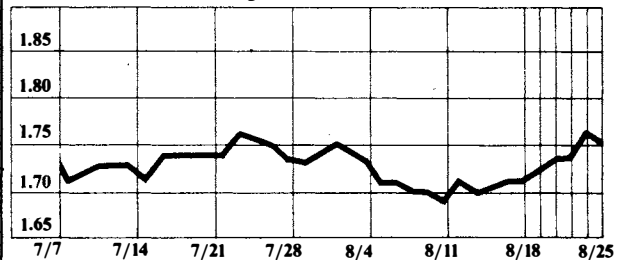
### The dollar in Swiss francs

New York late afternoon fixing



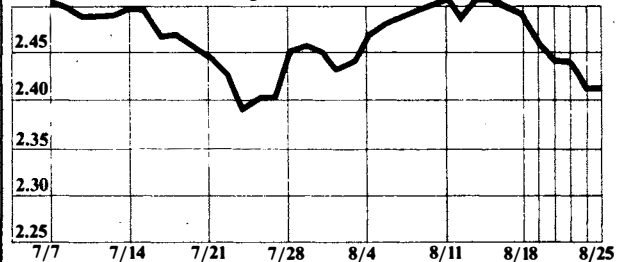
### The British pound in dollars

New York late afternoon fixing



### The dollar in deutschemarks

New York late afternoon fixing



### The dollar in yen

New York late afternoon fixing

