EIR Economics

U.S. bond markets: weak link for world financial system?

by David Goldman, Economics Editor

After a more than 40 percent appreciation of the price of top-quality U.S. long-term securities since June, it seems paradoxical to speak of the American bond (and stock) markets as a potential weak point in the world financial system. Nonetheless, the vulnerability of America's status as the world's biggest foreign borrower during 1982 is the secret of the Federal Reserve's inability to bring down real interest rates, and reverse or even slow the present course toward international trade contraction and financial disaster.

Qualified financial observers are now convinced that the problem is no longer a matter of whether Mexico or Argentina, for example, reaches agreement with their bankers and with the International Monetary Fund, but that an entire list of countries, including Brazil, France, Canada, Yugoslavia, and Rumania, among others, will be unable to finance their deficits and meet their international obligations during the coming year. The contraction of world trade (discussed in this space last issue), means that "the issue is no longer financing, but whether the industrial countries will have the courage to reflate," according to one of the leading economists associated with the Group of 30, the bankers' ginger group organized by former International Monetary Fund managing director Johannes Witteveen.

However, despite all expectations, the Federal Reserve is *not* continuing to reflate the U.S. economy, not so much because it is disinclined to, but because it is not possible—a point that the chief economist of GATT, Jan Tumlir, made before a Philadelphia audience Nov. 9. The Federal Reserve has made the United States the principal beneficiary of flight capital leaving the Eurodollar market, and has financed perhaps 20 percent of the estimated $217 billion total net federal borrowing requirement with foreign funds over the course of 1982 so far. Except for the foreign inflows, the numbers would not have added: the present federal borrowing requirement is just below 100 percent of total domestic savings (even with the highest savings rate in the past five years), and federal borrowing, prompted largely by reductions in revenues, would have virtually eliminated all long-term financing. The Federal government's ability to finance $50 billion in net borrowing per quarter at the prevailing interest rate (adjusted for inflation, interest rates are unchanged for the past 12 months) depended on an unprecedented volume of foreign purchases of securities. Because the Treasury reporting system is so miserably inadequate (under-reporting foreign equity holdings by at least 60 percent, for example), the precise volume is not known, but well-informed government and private analysts believe it was decisive.

The inflow is also believed to be the basis for the more than 20 percent rate of increase in money supply during the month of October, because foreign purchases of U.S. securities add to domestic checking accounts. Because the total volume of commercial and industrial loans, the normal domestic generator of money supply, shrank during October, it seems difficult to attribute the rapid rate of growth to domestic causes.

Contrary to the standard accounts of the problem (e.g. the Morgan Bank's in November's *World Financial Markets*), the hot money that moved into the American markets is motivated less by interest-rate differentials than by safety and speculative considerations. During the worst of the post-nationalization crisis in Mexico, the interest differential between short-term Treasury bills and short-term bank deposits at the lower-half top 100 Eurodollar market banks reached 5 or 6 percent, an unprecedented situation, reflecting the near-panic conditions in the Eurocurrency market.

How long can the boom last?

Now, the money that has already moved into the American market must consider whether the bond market might march down the same hill that it just climbed, following the sawtooth pattern of the past two years. Should the Federal Reserve seek to avert a crisis by permitting the monetary situation to run out of control, the market unquestionably would blow up. To the extent that the Fed appears to respond to demands for global reflation, from the Institute for International Economics, the Brandt Commission circuit and others, the likelihood of an out-of-control situation appears greater, and the fuse under the bond market shortens noticeably.

For this reason, the signal from the Federal Open Market Committee meeting on Tuesday, Nov. 15, was the contrary of what most market sources expected, i.e. a rise rather than a fall in interest rates. The Fed "showed flag" indirectly, through Chemical Bank's increase in its prime lending rate from 11½ to 12 percent, the first increase in five months.

What makes the American market's vulnerability so diabolical is that the *potential* crisis dictates the Fed's actions, even if the threat never emerge. Nothing short of a reduction in interest rates to approximately the rate of inflation would have much impact on the current economic disaster. The continuing decline of the American economy pushes the rest of the world toward financial crisis in the meantime.

The Commerce Department itself has now pushed its recovery projection off until the first half of 1983, in imitation of all the recovery predictions it has made since July of 1981, while the Office of Management and Budget, in a Nov. 14 background briefing at the White House, suggested that failure to reduce the present Federal borrowing requirement would lead to higher unemployment, higher interest rates, and higher inflation all at once during the first half of 1983.

Fragmentary economic news merely reinforces *EIR*'s confidence in the accuracy of our most recent quarterly forecast (*EIR*, Nov. 2). The .8 percent October drop in industrial production, and the record-low 68.4 percent capacity utilization figure for the same month, did not manage to diminish the inventory-to-sales ratio of corporations, which remains as high as it was in April. The short-term prognosis for industrial production is that still-high inventory levels (relative to very low sales) will continue to depress output, as will the collapse of corporate capital-investment plans.

Unemployment claims on a weekly basis have remained above 600,000 (or enough to ensure a continuing rise in the official unemployment rate), although not as high as the 700,000 level exceeded during the week ending Sept. 18. However, the most important short-term indication of the likely future behavior of unemployment is that hours worked in most of the goods-producing industries fell by much more than total employment during October, which usually means that more layoffs will follow.

This represents, on the international plane, the "locomotive theory" operating in reverse. Industrial production will fall in the advanced sector as a whole for the first time since 1974, the Organization for Economic Cooperation and Development now officially believes, and the extraordinary decline in world trade during July and August (the 20 percent decline in industrial nations' exports) will continue. If the U.S. economy does not recover, the senior officials of all the international organizations admit, the prospects for the financial system will become nil by the first quarter of 1983.

Who will solve the crisis?

Despite the tentative agreement between the International Monetary Fund and Mexico and Argentina, the refinancing and debt-rescheduling process has become bogged down, while its relevancy to the international crisis diminishes. The International Monetary Fund has told leading banks, according to sources close to Managing Director de Larosière, that it will not lend to countries unless the banks also put up funds "in lockstep" with new IMF credits; otherwise the IMF will not lend. The banks, meanwhile, are refusing to lend until the IMF has put up money.

The punch line of the story is that the IMF does not have sufficient funds to make substantial loans to the potential borrowers who will desperately need them, while the banks cannot raise sufficient funds on the international markets to increase their rate of lending, either. This is the principal result of the inflow of Euromarket funds into the United States.

It is up to the central banks to break the logjam, and the Federal Reserve above all; but should the Fed attempt to reflate, the break in the logjam might have disastrous consequences on the American markets, as noted earlier.

As a number of international financial specialists are now arguing, the situation may only be remedied in a way that defuses the speculative character of the markets, starting with a global exchange of illiquid developing-sector debt for long-term, low-interest bonds, and a policy of directing credit toward enhanced trade and production afterward. To the extent that this would force the major governments to suppress the Malthusian prejudices of their own finance ministries, as well as the International Monetary Fund, the suggested approach appears far from realization. But the other options have been discredited even in the eyes of the small circle who have promoted them.