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EIR Economics

Brazil's temporary surrender no solution to debt crisis

by David Goldman

For those concerned with world monetary stability, Brazilian Finance Minister Ernane Galveas's announcement July 15 (just before *EIR*'s deadline) that Brazil had come to terms with the International Monetary Fund should have been the worst news possible. It will be viewed differently in Washington and New York, to the inestimable detriment of the United States and the American banking system.

According to sources at the Basel-based Bank for International Settlements, Brazil's acquiescence to a range of International Monetary Fund austerity demands will make it possible for the IMF to disburse about $400 million to Brazil, such that Brazil may make its payment to the BIS just under the deadline. The BIS will not "extend" the July 15 deadline, as Swiss National Bank President Fritz Leutwiler, in his capacity as BIS chairman, had announced the preceding Monday; the IMF-Brazil agreement appears timely enough to avoid the threatened default crisis.

For the moment, crisis has been postponed, once again, and once again at the cost of disturbances in the world political and financial system which may not be containable. Analysts with access to the sordid behind-the-scenes drama leading to Galveas's reluctant capitulation will shudder at the implications.

Here is the transcript of a discussion with an administration official familiar with the American government's role in this business:

Q: How do you read the Brazilian situation?

A: Brazil got beaten up to the point of making an agreement with the IMF.

Q: Does the IMF agreement include the demands for reduction of state-sector subsidies as well as the indexation cuts?

A: I presume it must.

Q: Was there any communication between the U.S. government and the Brazilian government on this matter?

A: There has been continuous communication.

Q: Was any special message delivered during the past several days?

A: What the Brazilians were told is that if they did not come to an agreement with the IMF, the BIS won't renew the loan, they might declare you in default, and then you'll be in big trouble—the usual arguments.

Q: The usual Treasury arguments?

A: Yes.

Q: Can this be repeated with Venezuela and the other countries?

A: Well, it's resolved for the moment, but the others are going to come up in quick succession.

Q: What is next?

A: This is very hard to time; I would say Venezuela in about six weeks, but it's difficult to be precise.

The U.S. Treasury conducted a fair imitation of a terrorist who hijacks an airplane by threatening to blow up the plane, himself with it. Had the Treasury backed up Leutwiler's threat, and forced Brazil into default, the top nine American banks would have immediately lost assets in the amount of double or triple their shareholders' capital; if other countries followed the Brazilian lead, the American banking system's equity would sink to the status of 1922 Reichmarks. Worst of all, the Treasury was not bluffing; the ideologues who

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flank Secretary Donald Regan would likely have done it. Under threat of total economic war, the Brazilians broke.

According to the New York *Journal of Commerce*, Brazil's options expired when its foreign exchange ran out—including the billion dollars' worth of gold it has sold over the past year—and the country was left with two weeks' supply of crude oil. Galveas spent part of the week prior to July 15 in Caracas, attempting to secure oil supplies from Venezuela in sufficient volume to withstand the threat from the Treasury, and apparently failed.

For a third time, the Ibero-American continent failed to hold together against an external threat. Brazil's inability to secure oil supplies from Mexico and Venezuela recalls Argentina's inability to persuade Brazil and Mexico to join in a common debt moratorium during the Spring 1982 Malvinas War, as well as Lopez Portillo's inability to secure agreement on the same subject from Brazil and Argentina last September, when his administration vainly sought the means to reject the International Monetary Fund program.

The Treasury has achieved nothing, of course; Brazil can implement the IMF program now less than ever. Sections of the Brazilian government were active in the organization of the mass strike movement now in progress in Brazil, leading towards a June 21 general strike. Brazil has mobilized, like Russia in 1914, and the fact of its mobilization constitutes the act of war. Either the Brazilians will repudiate their IMF agreement once sufficient lines of oil supply are in place, or Brazil will de-mobilize; but the latter option will destroy the institutions that hold the nation together. As at the outbreak of World War I, when the European nations chose war rather than the devastating consequences of shutting down mobilization at midpoint, the Ibero-Americans must either choose economic war, or crumble internally.

The threatened disintegration of institutions will not merely guarantee that not a cent of the continent's $350 billion foreign debt will ever be paid, but that no political forces will remain to preside over the aftermath.

Cui bono—who benefits?

The Treasury has made no excuses concerning its intention to push "adjustment" to the point of economic war; Secretary Regan told *EIR* in late June that if the Ibero-Americans formed a debtors' cartel, "they would never get another loan again." From discussions with Treasury officials involved in negotiations with the Bank for International Settlements, it appears that the two-week extension represented not so much a compromise as a tactical detour. Open Treasury support for a default declaration June 30 might have triggered a response at the Defense Department, the CIA, the National Security Council, and other agencies who are warning the President of grave national security complications should the U.S. take the role of George III against a rebelling South American continent. The July 15 deadline represented a "compromise" that served the Treasury's factional purposes.

Switzerland may have more than a merely ideological hold on the American side of the negotiations. The Federal Reserve governor chiefly resonsible for international affairs, Dr. Henry Wallich, is the scion of an old and nasty German-Swiss banking family; he maintains close ties to the German-speaking central banks, and attends the monthly BIS meetings on behalf of the Federal Reserve. Wallich is a faithful conduit for *Mitteleuropäische* views (including his post-January advocacy for a tighter American monetary policy, coinciding with Leutwiler's). Fed Chairman Volcker, the New York banks' man, is the ideal meeting chairman, but not an initiator of ideas, and must lean heavily on Wallich. The Treasury's chief international officer, Assistant Secretary Marc Leland, is the former personal lawyer of Swiss banker Edmond de Rothschild (and son-in-law of Guy de Rothschild); his superior, Undersecretary Beryl Sprinkel, is an ideological clone of Milton Friedman, close to the Karl Brunner monetarist circuit in Washington.

Sources close to Fritz Leutwiler insist that a political change occurred over the two weeks prior to July 15, permitting the Swiss National Bank chairman to stick to his deadline. Much depended upon the internal situation in the United Kingdom. Mrs. Thatcher is committed to a strong American defense policy, and, in that sense, is one of Mr. Reagan's few close allies among foreign leaders. Nonetheless, she began the war projected against Ibero-America one year ago (thanks especially to Lord Carrington), which hardly suited Britain's interests. Her economics also have much to do with seminars in 1975 under Berne University professor Karl Brunner, a Swiss National Bank consultant and Leutwiler confidant also prominent in conservative monetarist circles in the United States. Mrs. Thatcher's chief advisor Alan Walters is also a monetarist of the Brunner stripe.

As reported by the *London Observer* July 10 (and not denied by 10 Downing Street), Mrs. Thatcher's response to a last-minute Brazilian plea for help that weekend was to urge that Brazil be taught a lesson in austerity. Such outrage over this gaffe emerged in the City of London, especially among the clearing banks heavily committed in Ibero-America, that the London *Daily Telegraph* editorially attacked Mrs. Thatcher July 14 for the first time since she became Prime Minister.

A hidden, but perhaps critical, element in 10 Downing Street's hostility towards Brazil may be Brazil's refusal to give British military aircraft access to airfields; this display of Brazilian solidarity with Argentina may have set Mrs. Thatcher on her ear.

As sources close to Leutwiler emphasized, the British "tough line" towards Brazil was a significant factor in Leutwiler's emphasis on the July 15 payments deadline; "major forces were at work" strengthening Leutwiler's hand, a source close to the BIS chief reported, citing the British development.

Continued monetary deterioration

The global consequences of continued financial deterioration in Ibero-America are a principal element in Swiss calculations. Brazil has paid no interest and principal since June 1, and ran up considerable arrears before June 1. Bra-

zil's arrearages began with the attrition of interbank lines made available by the major American banks as of May; earlier, American banks had extended at least $12 billion in such lines to Brazil starting during the fourth quarter of 1982, partly to replace lines withdrawn by continental European banks. The entire continent built up $37.5 billion in such interbank lines between August 1982 and February 1983. The IMF agreement does not begin to deal with Brazil's $2 billion of arrears to the banks; as IMF officials emphasize, the March IMF program for Brazil cannot be resumed without guarantees from the banks that Brazil will be funded. These guarantees are not yet in sight.

Brazil's immediate problem is only the closest to the surface of many similar ones. The sharp rise of Eurodollar rates (to 10.75 percent for six-month money) since early May reflects not Federal Reserve tightening, but growing illiquidity on the Eurodollar market itself. Continued, perhaps accelerating attrition of OPEC deposits in the primary market following the $6 billion drawdown reported for the first quarter is sufficient to produce substantial interest-rate pressure on the market. More dangerous is the heavy dependence of France, Italy, Belgium, Spain, and other European nations upon the Eurodollar interbank market to fund balance of payments deficits.

Europe's financial crisis is indissolubly linked to the Ibero-American crisis through the mechanism of the global interbank market. In financial terms, France, Italy, and Spain are moving rapidly into the position of Ibero-America now, except with a six-month delay. The other difference is that these three worst-off countries may not go to the IMF; between them, they can legally demand over $25 billion in loans under the "enlarged access" formula, at a time when the IMF is already struggling to reduce its commitments.

France, with close to $100 billion in external debt, is rapidly becoming another Brazil, but with perhaps fewer resources respecting the world market with which to postpone its crisis. Internally, the French government is nearly bankrupt; the most recent "jumbo" Eurobond issue arranged for France via the European Community served mainly to pay the current salaries of the French civil service. An internal French Treasury study now says that by a year from now, France will have to borrow as rapidly as it is borrowing now merely to pay interest on the existing debt. Italy, if possible, is in even worse condition; Spain is on the verge of major political as well as economic dislocation.

Federal Reserve specialists view the interbank market as the most visible fuse with respect to the European debt bomb; the abandonment of the foreign branches of Italy's Banco Ambrosiano last spring and summer by its bankrupt parent office might repeat itself on the grand scale. An indication of the danger is the increase of "tiering," i.e., differential rates applied to weaker borrowers in the interbank market, as well as the rise of Eurodollar interest rates themselves.

As *EIR* will document in more depth in our Quarterly Economic Report, the American economy bought time from the economic grave by means which are rapidly exhausting themselves—as the present rise in interest rates makes clear. Wittingly, the Treasury boosted its actual borrowing requirement to $350 billion per year, in order to include close to $100 billion of "agency" bonds supporting the mortgage market; the Federal Reserve maintained the fastest rate of peacetime reserve-creation in history to enable the banks to buy Treasury securities at a $100 billion annual rate. This extraordinary chain-letter operation failed to produce a collapse of the dollar and rising interest rates for one overriding reason: the United States has been the recipient of a $50 billion per annum flow of flight capital from the rest of the world, principally from Ibero-America, sufficient to stabilize the dollar and temporarily hold interest rates down. Despite Volcker's attempts to oppose them, the forces driving interest rates upward have almost crossed that tripwire which will knock out the housing and auto consumer-credit flows which sustained the so-called "recovery" this far.

In the most basic sense, therefore, the international debt crisis is not an exogenous threat to an otherwise-sound American economic situation. The debt crisis, triggered in its present phase by flight capital more than by any other factor, is the immediate and direct result of the means which Paul Volcker and Donald Regan chose to rig their "recovery."

The view from *Mitteleuropa*

At some point in the process of unraveling, American banks themselves will repeat their actions of September 1982, shutting down commitments to weaker banks abroad, with potentially disastrous consequences for the funding position of both the rest of Ibero-America (Venezuela and Chile in particular), and Western Europe. It is impossible to say where the chain will break, once yanked sharply. The probable rupture will be among Ibero-American and European third-tier banks, who will be unable to meet Eurodollar interbank obligations, turning into a chain-reaction of contraction of interbank lines.

We earlier reported the growing conviction among central European, particularly Swiss, banking circles that a financial crash was not only inevitable, but from their standpoint, desireable. A strategic perspective in the German-speaking European countries has become evident during the past month without which vantage point the wrangling over the Ibero-American debt is incomprehensible.

Soviet planners hope to include much of Western Europe in the basin of resources which the sclerotic Soviet economy may loot. Any major problem on the interbank market will bring down French finances and plunge the rest of Europe deeper into depression; under these conditions, the stays that have held Europe inside NATO may break. That, in summary, is what the Swiss axis counts on.

The signals from Washington are not encouraging. President Reagan does not have his Administration under control in a matter that may determine whether the country survives. Unless the White House shuts down the economic warfare ministry masquerading as the American Treasury, it is difficult to see what will interfere with *Mitteleuropa*'s plans.