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European bankers dictate their debt plan to U.S.

by David Goldman

New York Fed chief Tony Solomon will assemble ranking central bank officers from industrial and developing countries in New York on May 9 for a stage-managed fight between Europeans and Americans over the Third World debt issue. U.S. and European central bank sources confirm that the Europeans—whose banks can and will write off Latin American debt—will propose a global cut in interest payments, longer maturities, and writedowns, while the Americans, whose banks can't afford the losses, will demand further short-term patchwork in order to keep accruing interest.

A New York Federal Reserve officer confirmed the planned meeting, first reported by the London *Financial Times* May 2. The French, with some European support, will propose elaborate plans for refinancing the Third World debt burden, which the Americans will reject, by pre-arrangement among the participating central banks. However, Solomon will use the fight over these plans to offer a form of concession to the European viewpoint, in the form of a "cap" on interest rates on bank debts of developing countries. This will be the first official American move toward forcing American banks to sacrifice current income and perhaps capital in the course of renegotiating Third World debt.

Debt-for-equity programs

A May 2 editorial in the *Financial Times* (see below) declared that the short-run programs were now a disaster, and that both the banks and the developing nations had to suffer as a result. By "banks," the British mean American banks. The editorial concluded with a demand that the developing nations give up sovereignty over their natural resources in a "debt-for-equity" swindle to benefit their British and Swiss creditors.

A French central bank source reported: "There will be a divergence of opinion between, on the one hand, the French and to a certain extent the Europeans, and on the other, the Americans. The French believe that the debt burden has to be lightened and that interest rates have to decrease. You have an opposition in the United States between the liberals and the 'interventionists' who want to 'intervene,' like France, but that can lead to some bad effects in the whole system. In Europe, France is getting some results in moving its partners in that direction; they are somewhat changing their position, like the Bundesbank, for instance, which now agrees a bit to support our thesis rather than the American one."

The official added that France will propose a form of "sinking fund": "It would work like an international company; capital would be gathered from different quarters and with this capital, debts would be refinanced with extremely low interest rates, which would come down to a consolidation of the debt. . . . With very low interest rates, you arrive in fact at a cancellation of the debt after a while. But it is to be feared that U.S. interest rates will remain high and together with the rise of the dollar, this makes the debt heavier. . . . Creditor banks, for instance, could cancel 5% of what they are owed, with a relaxation of interest rates and some government help, it could work."

A Solomon aide derided global debt refinancing schemes as "perpetual-motion machines" which "simply try to transfer sovereign risk from the private sector to the public sector."

However improbable the grander schemes are, Tony Sol-

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omon has already prepared the grounds for a crunch against the American banks, e.g., his proposal in congressional testimony on May 3 for a "cap" on interest rates in lending to the Third World—a formula for bank losses when Eurodollar interest rates are still rising. A source at the office of the Controller of the Currency, the Treasury bank regulator, says that banks will have to capitalize the difference, i.e., add it to the principal sum without collecting current income. The interest capitalization approach was supported last fall by German and Swiss banks as preparatory to writing down the principal. For obvious reasons, it was bitterly opposed by the big American banks.

Last month's court decision, much discussed in the press, giving Costa Rica the equivalent of Chapter 11 status with respect to American banks, also pushes banks toward significant writeoffs of both current income and principal.

Barring a change in Reagan administration policy, the best-case scenario would blow a hole in the capital positions of major American banks, as Solomon's proposals imply. This means a credit crunch in the United States. Banks expanded their loans at a 16% annual rate during the first quarter, and at a 30% annual rate during March, an ominous sign at a point where the economy has slowed. It points to rising unsold inventories and potential illiquidity.

In the worst-case scenario—worst for the European strategists—the Latin American nations could follow through the implications of the March 31 joint rescue package for Argentina, and break out of the IMF's harness on the occasion of the June 30 or Sept. 30 quarterly deadlines, causing much greater disruption of the banking system.

Eurodollar market in jeopardy

As *EIR* has reported, American banks borrowed net $13 billion from the Eurodollar market in the third quarter of last year, $20 billion in the fourth quarter, and probably over $40 billion (including the big oil-merger loans) during the first quarter. (See table.) Eurodollar loans to U.S. borrowers have replaced buildup of official reserves, Ibero-American flight capital, and portfolio shifts as the principal source of funding for the American deficit and other credit demands.

Disruption of these flows, either through upheavals in the Eurodollar market itself, or damage to the capital base of the American banks, implies a credit crunch, possibly on the scale of the March 1980 massacre.

In the very short term, continued fears concerning Western Europe could continue to buoy the dollar and alleviate U.S. conditions by bringing in additional portfolio funds. The sharp decline of the dollar on May 3-4 (coincident with a rise in Eurodollar 6-to-12-month interest rates) does not necessarily spell the end of dollar strength, but the above line of development implies a major dollar decline.

The Anglo-Swiss view was made more explicit in an editorial in the Swiss journal *Neue Zürcher Zeitung* of May 1 entitled "Dual Priorities in Debt Management," which underscores sharply the difference in views between U.S. and European banks: "The different interests of the banks on this and that side of the Atlantic are quite inappropriate to contribute to stabilizing the situation." After cooperation has prevented a collapse, *NZZ* writes, "the task is now to use the time gained and what has been achieved for a consolidation."

The American banks, the Swiss say, have a problem: Their interests favor "securing interest payments even though this means the extension of further dubious loans." Under the subhead "Short-Sighted View," the *NZZ* continues with the example of Argentina and its arrears, amounting to de facto default. Even though formal default was narrowly averted, "few observers would be surprised if within two months we did not arrive at a similar drama. . . . The international banks—if they were united—have something to contribute

Flows between the reporting banks and outside area* countries, 1981-83
(billions of dollars)

	End 1980 to end June 1982	End June 1982 to end June 1983
Gross borrowings		
OPEC	9.1	13.0
Non-OPEC LDCs	55.3	16.8
of which Latin American	42.3	9.0
other	13.0	7.8
Developed countries	26.0	14.2
Eastern Europe	1.7	−2.7
Total	92.1	41.3
Gross deposits		
OPEC	−3.4	−25.2
Non-OPEC LDCs	13.0	11.8
of which Latin American	4.4	4.7
other	8.6	7.1
Developed countries	3.5	1.7
Eastern Europe	−2.3	7.3
Total	10.8	−4.4
Net borrowings		
OPEC	12.5	38.2
Non-OPEC LDCs	42.3	5.0
of which Latin American	37.9	4.3
other	4.4	0.7
Developed countries	22.5	12.5
Eastern Europe	4.0	−10.0
Total	81.3	45.7

*Group of 10 industrialized nations plus Switzerland.

Source: *Bank for International Settlements Quarterly Report.*

in order to attenuate the bottlenecks or at least to spare the monetary system unnecessary shocks. At the same time, they would make themselves less vulnerable to the attempted blackmail of individual debtors."

In short, U.S. banks which are hysterically fixated on their quarterly results, have not provisioned their loss accounts, and are creating an immense risk. "Things go much differently in Europe. In Switzerland, West Germany, or Britain, the banks are far less subjected to short-term pressures and short-sighted quarterly profit maximization. . . ." The task is to "restore the solvency of the debtors," i.e., to prevent the formation of a debtors' cartel, but "The policy of American banks goes exactly counter to such aims. Instead of contributing to long-term securing of the capital value of their assets, they concentrate on short-term securing of debt-service. The U.S. banks will have to accept restructuring, for some of the creditor banks are not prepared any longer to throw good money after the bad. And this group is not only recruited among European banks, but also among those American banks which feel beaten over the head by the *diktat* of their big brothers in New York." The warning is clear.

A parallel line is expressed in a London *Times* feature May 1 on the upcoming Group of 10 economic summit which compares the growth of "a kind of Euro-nationalism" to that of "neo-isolationist trends in the United States," after having expressed "nagging doubts about the nature of the U.S. recovery and growing differences over the handling of the global debt crisis." This all "sows the seeds of discontent" among allies. European governments, it is asserted, "want the agenda . . . to include proposals to create a new mechanism for restructuring debts of the Third World countries at a time when more are expected to follow the lead of Argentina in seeking stretched-out payments for short-term obligations. But the U.S. is adamantly opposed to that. . . .

"Critics of that policy contend that a pattern appears to be developing among debtor nations, particularly Latin American nations, which cannot be ignored. . . ." Even Chile recently defied IMF orders and went on an "expansionary economic policy" which was "regarded as a harbinger of Third World discontent." If additionally U.S. interest rates, "as is widely expected," climb from today's 12% to 15% and more by year's end, "the debt problems in NICs [newly industrialized countries] and LDCs [less-developed countries] can only grow worse. This explains the European push for a more coherent policy on Third World debt" and the probable confrontation at the summit around that.

Then there was a *Financial Times* piece by British Treasury/Bank of England loudspeaker Samuel Brittan May 1, "Freeing the Fed from LDC Straitjacket," which argues that the United States, rather the Fed, should not let itself be impressed by arguments that interest rate hikes jeopardize LDC debt repayment; given the fact that U.S. inflation is powerfully rebounding and should be expected to soar to "well over 7%" this year, it is urgent to tighten the screws in the United States, and give some unspecified "special help" to LDCs to get by for the duration—which he hints should be in the form of forcing commercial banks to lend more. By November, the propaganda mills would thus be in full "out-of-control-inflation-must-be-corrected" swing, gearing the United States into a wild deflation, and administering the coup de grâce to the LDCs.

'Equity to consolidate debt'

London Financial Times, *May 2, editorial, "When Evasion Has to Stop":*

The news that the Federal Reserve Bank of New York has invited a high-powered group of central bankers from creditor and debtor countries, and some commercial bankers, to take part in a three-day seminar on international debt is welcome news, as far as it goes. At last those in authority are willing to think in semi-public what they have confided so far to each other and their pillows: The hand-to-mouth process of re-scheduling the adjustment packages which has occupied the last two years is an inadequate answer to the debt problem. . . .

It would be naive, though, to expect very much of this meeting; three days is far too short a time to get to grips with the whole range of problems involved, and at the outset the motivation still looks wrong. The operations so far have been widely and not too unfairly caricatured as a process designed to rescue banks rather than debtors. In recent weeks, this has become clearer: the sudden softening of the IMF terms offered to Peru, and the general conspiracy to overlook the fact that Argentina is making virtually no actual payments to meet its obligations, shows that sheer evasion still has a high priority. . . .

The new effort to seek more solid and longer-term solutions seems to have arisen not so much from dissatisfaction with this charade as from the problems faced by the Federal Reserve. . . . [T]he fear of the consequences of any sharp rise in short-term dollar interest rates has compelled the Fed to take the pressure off the U.S. banking system and fund longer, in British style. The Fed now needs its own rescue package to restore its freedom of action.

This is certainly a serious problem, but it does reflect an underlying economic reality: if debts which cannot be serviced at the real interest rates now prevailing cannot be written down either, then eroding through inflation is the only solution left. The "solution" which now appears to be popular among the U.S. authorities, to capitalise some or all of the interest payments due from debtor countries, is simply an attempt to evade this reality by postponing the day of settlement—a view which the U.S. authorities themselves preached more loudly than anyone until recently.

Unless any time bought in this way is used to address the fundamentals, delay will only make matters worse. The meeting will be really useful if it rejects the Micawberish approach of buying time. . . .

The trouble is that the fundamental problems are pregnant with acute discomfort for everyone concerned. The commercial lenders, for example, have to face the question whether it would not be better to sell some of their claims at a loss and so regain commercial freedom. They naturally prefer to hope for an official Fairy Godmother.

For governments the questions are still more painful because they are political. The U.S. could help immeasurably by substituting some fiscal for monetary restraint; but higher taxes are unpopular. All developed countries could help debtors (and consumers) by a more open market for developing-country exports; but it is protection which wins votes. The banks may have some reason for their obstinate hope that in the end some form of subsidy will be less politically painful.

The debtor countries also have some questions to face—not so much on adjustment policies but on economic nationalism. Foreign equity investment would not leave a debt problem behind. And the monetary authorities have yet to display any imagination in seeking ways to consolidate debt in forms which would insulate debtors from the short-term twists of U.S. monetary policy, using not only bonds but equity, and perhaps commodity indexation. We hope that some at least of these topics will be put on the agenda in New York; in three days we can hardly hope for more.

The New York Times, *May 4, column by Leonard Silk, "The Dangers in Debt Crisis":*

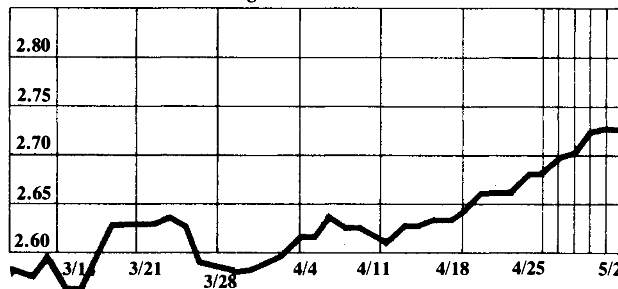
Robert V. Roosa, a former Undersecretary of the Treasury for Monetary Affairs who is now a managing director of Brown Brothers Harriman . . . sees a growing need for the United States and other countries to help raise a great deal of money—$100 billion for openers—to convert short-term debt into long-term debt and ease the burdens of the debtor countries. . . . Peter Kenen, professor of economics at Princeton University, has proposed that private banks trade in their risky loans to developing countries for 10- to 15-year bonds to be issued by a new international organization. . . .

At the New York conference next week, Henry C. Wallich, a governor at the Federal Reserve Board who is its top international expert, will suggest splitting the interest that developing countries pay into real and inflationary components, with the latter being added to the principal of the debt outstanding . . . thereby scaling down their payments without wiping out the debt. Mr. Wallich will also discuss a plan for insuring private bank loans to the debtor countries. . . . [T]he insurance plan or rescue operation will have to be done by governments operating through international agencies and central banks. . . .

Currency Rates

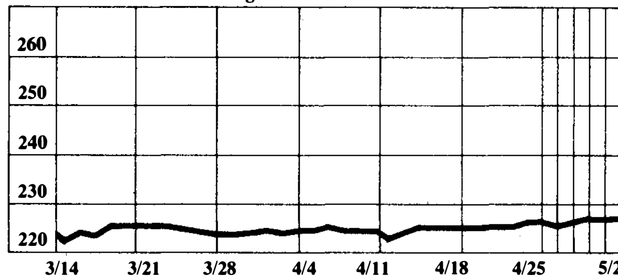
The dollar in deutschemarks

New York late afternoon fixing



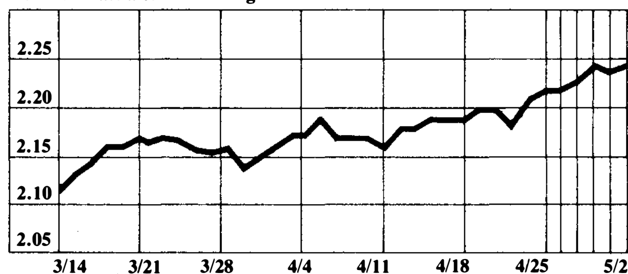
The dollar in yen

New York late afternoon fixing



The dollar in Swiss francs

New York late afternoon fixing



The British pound in dollars

New York late afternoon fixing