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International Credit by William Engdahl

Are we repeating October 1987?

The trends in world interest rates bear an uncanny resemblance to events of one year ago, and for similar reasons.

When U.S. Federal Reserve chairman Alan Greenspan announced Aug. 9 that the U.S. central bank's discount rate was rising by ½% to 6½%, financial market analysts around the world began speculating on whether a repeat of 1987 was in the making. In 1987, Greenspan, newly installed as Fed chairman, acted early in September to raise the U.S. discount rate by a similar ½%, from 5½ to 6%, and there appeared to be a worldwide competition among Japan, West Germany, and the United States to outbid each other in further rate increases right up to the Oct. 19 stock market crack, as investors scrambled to dump inflated stock values for more profitable bond yields.

The global interest rate issue has become a central policy issue more than at any time since the Aug. 15, 1971 U.S. decision to abandon the convertibility of the dollar, then the world reserve currency, into gold. President Nixon's move opened the door of "floating exchange rates." Since Sept. 22, 1985, when finance ministers of the world's seven most important trading nations met in New York to coordinate policy to ensure a tight range of dollar fluctuation, world interest rates have been one of the few tools to control inflationary consequences of German or Japanese or other support for the dollar's stability.

Since the 1971 dollar decoupling, world financial market deregulation has led to world financial market "globalization." New York led the way to this financial "free market" in the late 1970s, followed by London's "Big Bang" in October 1986. As a result, huge volumes of "hot money" slosh from London to Tokyo back to New York and possibly briefly into Frankfurt, as short-term speculative gains, not long-term industrial investment, drive financial profits.

According to a 1987 study by the Morgan Guaranty Bank of New York, in September 1987, the size of the Eurocurrency market (dollars on deposit in foreign banks, Eurodollars, Euroyen, Euromarks, etc.) had soared to an alarming 160% of the volume of total world trade. That is, for every dollar of real goods traded that year, $1.60 of paper traded outside national borders in the Eurocurrency markets.

According to senior City of London economists and informed financial market traders, the most worrisome problem in the past three months for Greenspan and the Washington monetary authorities has been how to protect this U.S. bond market, at least until the November elections. With global inflation already on the rise, the expected catastrophic impact of the record U.S. drought has devastated U.S. government price calculations since June. If various indices of inflation begin rising, bond traders simply demand higher interest rates, or what amounts to the same thing, lower bond prices to compensate, otherwise speculative fund managers simply begin dumping bonds.

In 1987, the U.S. depended to an unprecedented degree on foreign financial flows to finance its huge budget and trade deficits, some $140 billion. Most of this money came from cash-rich Japanese banks and brokerage houses. Beginning last summer, though, the inflated domestic Japanese financial markets began to explode. Interest rates on Japanese bonds skyrocketed on Tokyo financial markets. Between August 1987 and the end of September, interest on Japanese government long-term bonds jumped an alarming 1.3%, to 5.6%, following several years of steady decline. At the same time, for many of the same reasons, rates in the German bond market began to rise slowly in order to stem the exodus of capital to New York, and the collapse of the German bond market.

Today, while we are not yet at the alarming levels of last summer's collapsing Tokyo bond market, all eyes are nervously on what the Bank of Japan says and does about raising its interest rate. From June to July, Japanese bond rates inched up from 4½% to about 5%. Since then they have inched below 5%, as Washington and Tokyo "discussions" have led Tokyo to increase preferential support for a Bush presidency by controlling Japanese financial policy for the short term. West Germany's Bundesbank has been far less willing or able to do the same.

German bond markets have been disastrously weak over the summer, while the Bundesbank has refused to increase its various Lombard or "Repo" discount rates to correct the problem, largely for fear of triggering a repeat of October 1987. By early July, the pressure became unbearable and the Bundesbank began tiny ¼% rises in the "Repo" or middle rate which the central bank uses to control overall domestic interest rates in the banking system. German bond rates as a result have climbed to 6.55% by Aug. 13, from 6.35% in June, the first rise since Black Monday.

Japan is so far holding back. If Tokyo is forced to raise its rates in the coming days, as many expect, the "race" will be on in dead earnest.

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