U.S. interest rates a bid for petrodollars

by Alice Roth

Federal Reserve chairman Paul Volcker's decision to jack up the U.S. discount rate to an all-time high of 13 percent has triggered a new round of interest rate hikes in the major Western European economies.

Leading West German bankers are seething about what they characterize as the Fed's turn to international financial warfare. Essentially, the Carter administration has opted to use higher interest rates to finance an otherwise unmanageable budget deficit—pulling tens of billions into U.S. Treasuries at the expense of the rest of the world.

The carnage on foreign capital markets has been severe. On Feb. 28, the Bundesbank announced a one percentage point hike in its discount rate to 7 percent and a 1.5 increase in its Lombard rate to 8.5 percent. The Swiss central bank announced a hike in its discount rate from 2 to 3 percent that same day. The French government reported a tightening in its controls on bank credit expansion effective April 1 and Italy, Britain, and the Netherlands are expected to follow with similar measures in the near future.

Volcker's gambit apears to have worked for the moment. Although U.S. consumer price inflation is running at 18 percent and the Carter budget (favoring military buildup and energy boondoggles) could push that rate toward Weimar levels, the dollar has performed surprisingly well on international currency markets.

Since the beginning of 1980, the dollar has risen by 4.5 percent against the West German mark, 8.2 percent against the Swiss franc, and 4.0 percent against the Japanese yen. The dollar has continued to appreciate even in the wake of the West German and Swiss tightening because traders anticipate *still another* competitive discount rate boost by the Fed. The entire confidence game could break down at the point that foreign money managers do a few simple calculations and discover what the Fed's rate hikes are doing to the interest component of the Federal budget!

In reality, the Schachtian budget advocated by Carter's Trilateral Commission advisors (with or without the proposed cutbacks in transfer payments and social programs) can only be financed if the U.S. Treasury receives a sizeable portion of this year's OPEC petrodollar surplus.

This fact was addressed openly by Lazard Freres investment banker Felix Rohatyn in a speech before a New York meeting of the Conference Board on Feb. 28. Rohatyn declared that the U.S. was in a state of "national bankruptcy" comparable to that of New York City in 1975 and proposed a global equivalent of "Big MAC" to solve the crisis. According to Rohatyn, OPEC should be compelled to accept long-term bonds from the U.S. in payment for oil, "the proceeds of which would be limited to purchases of American goods and services." (For excerpts of Rohatyn's speech, see page 19).

In the aftermath of the Iranian asset freeze, however, OPEC governments are understandably reluctant to deploy new funds into U.S. markets. The question of how the major Middle East dollar holders will invest their petroearnings this year is the most important question facing international financial policy-makers—and no one appears to have any firm answers.

One possible option, mooted by the *Financial Times* in its March 4 editorial, "A Neighborly Adjustment," is that the just-arranged central bank bail-out of the Japanese yen will be used to finance the U.S. deficit "through the back door." According to the "Financial Times, Japan is attempting "to make Japanese assets more attractive to OPEC investors" by such measures as raising the rates payable to foreigners on yen deposits and permitting Japanese companies to float yen-denominated bonds abroad. Since oil payments to OPEC continue to be made in dollars, OPEC governments seeking to diversify into yen assets would first have to sell these dollars to the Bank of Japan. The *Times* hopes that the Japanese will end up recycling the monies into U.S. Treasury bills, "providing an outlet for the investment of (the OPEC) surplus" which "should help to reduce strain in the financial markets generally."

The urgency of such a back-door recycling arrangement was underscored early in the week ending March 7 when the Japanese government (using the Fed as an intermediary) was forced to unload $2 billion worth of U.S. Treasury bills on U.S. credit markets in order to raise cash for foreign exchange intervention. As a result, three-month Treasury bill rates reached a new record high of 15.4 percent.

Will they go along?

It is still far from clear whether either Japan or the OPEC countries will cooperate with the Rohatyn proposal to throw the petrodollars down the Carter budget sinkhole. West Germany, the other major potential beneficiary of OPEC diversification, is even less likely to go along. In his Feb. 29 Lombard column, *Financial Times* columnist Jonathan Carr objected to the Bundesbank's decision to raise its rates on the grounds that this move would attract more capital into West Germany. The implication was that if West Germany gained control over the petrodollar funds, it might put them to other uses than propping up the U.S. and British treasuries. One suggestion which has been voiced increasingly in the French capital is that the European central banks or a proposed European Monetary Fund (EMF) should systematically recycle the petrodollars into Third World industrial development projects.

Of course, if Washington's interest rate war compels the Bundesbank to bid for OPEC's funds at ever higher rates, this effort to recycle the funds into productive channels will quickly bog down. As the U.S. case shows, higher interest rates simply raise the costs of long-term investment to prohibitive levels, so that short-term "get rich quick" speculations appear as the only profitable investment outlets. Western Europe's only remaining option is to offer OPEC *gold guarantees*—so that the petrofunds can be recycled at interest rates far below the prevailing Eurodollar rates.

France makes its bid for petrodollars

Just this may have been an unofficial item on the agenda of French president Giscard d'Estaing during his tour of the Persian Gulf this week. In fact, what has Washington scared is that the French president now so popular in the Middle East is the same man who has promised to propose a well-thought out plan to return the world monetary system to the gold-standard at the forthcoming economic summit in Vienna. Giscard's tour of the Gulf states, including petrodollar giant Saudi Arabia, has been most successful to date. He arrives in Saudi Arabia next week.

According to Saudi sources, Giscard will unveil a "surprise" of some kind that will be the crowning point of his trip. It is thought that one feature of the talks in Riyadh will be state-to-state oil supplies for France bypassing the multinational concerns, but much more is going on.

Politically, Giscard is seeking an alliance of Europe, Africa and the Middle East oil-producers for the immediate creation of a Palestinian state and prevention of an "outside military presence"—read U.S. or British—in the region (see INTERNATIONAL). In an interview Giscard laid out a concept of this "trialogue" whose basis will be the agreement among the three parties on political and security issues. That lays the groundwork for lasting economic cooperation.

Economically, Giscard has been basing his diplomacy on massive nuclear energy technology transfer and "trialogue" development of the Arab and African economies. The French press is already saying that Giscard is trying to "out-de Gaulle" de Gaulle, while the effete British are simply screaming "unfair."

A diplomatic coup

As a result of the French president's diplomacy, France has moved the European Monetary System nations, including West Germany, much closer to the petrodollars than anyone else right now. Giscard has pulled off a virtual diplomatic coup d'etat internationally—aided not a little by President Carter's "apology" to Israel and the U.S. Zionist lobby for a pro-Palestinian vote in the United Nations this week, leading the Saudis to dub the U.S. leader a coward.

What may well decide whether gold guarantees for petrodollars, petrodollars to be used for Third World development, can defeat the objectives behind Paul Volcker's interest rate war are the discussions to occur in Saudi Arabia next week. As of now, France is virtually assured of the friendship and financial cooperation of the Arab world for years to come, and observers say that if Giscard proposes economic agreements of mutual benefit, the Saudi Arabians are entirely prepared to state their readiness to finance the program.