EIR Economics

A Caribbean model for international credit?

by David Goldman, Economics Editor

This week's inauguration, after two years of corporate infighting, of the International Banking Zones in New York City and other U.S. money centers could mark a turning point in recent financial history. To the extent that various administration officials, including President Reagan himself Sept. 29 before the International Monetary Fund, have endorsed a "Caribbean" model for the developing sector, they have ignored the much vaster implications for the industrial heartland itself.

The world is entering a liquidity crisis of unmanageable proportions, and therefore world finance is reacting according to the classical profile of the 1930s:

1) Where liquidity is to be gotten, banks will fight for it, fair or dirty.

2) National governments will adopt financial-protectionist measures, e.g., exchange controls, currency blocs, where it protects their liquidity position.

There is nothing contradictory in these seemingly opposed types of action. The Caribbean model as such was represented at the outset by Jamaica's Prime Minister Mr. Seaga as a means of capturing the funds generated by the country's huge marijuana crop. In a liquidity crisis, cash margins of this type—the international narcotics traffic is worth over $200 billion and second only to oil as an item in international trade—can become decisive. It only need be remembered that the British "gold standard" of the last century was in fact based on the opium revenues of the British East India Company, which covered a 40 percent imbalance of imports over exports on the British trade accounts.

Where banks believe they may capitalize on such flows, e.g. the Hong Kongs, Londons, and (as of Dec. 3) the New Yorks, controls will be lifted. Where central banks fear they will be victimized by such flows, e.g. the European Monetary System, controls will be imposed. Unless the central banks find a means to generate orderly forms of liquidity at acceptable interest rates, e.g. by mobilizing their gold reserves to provide low-interest international trade credits, as *EIR* has proposed, this type of monetary disintegration will be the principal fashion in which a "Crash of '79" becomes manifest.

Should a major crack in the chain of dollar payments emerge, for example, the IBFs, as they are called, will themselves become a principal instrument of U.S. exchange controls—a means whereby international banks might "walk away" from the liabilities of Cayman Islands subsidiaries made bankrupt by default of their debtors—as New York Federal Reserve officials report in background discussions.

Most financial press discussion of the IBFs misfocus on such issues as whether the shift in reserve-free international banking operations will damage the status of London and other Eurodollar centers relative to New York, or whether they will lend unfair advantage to the New York banks relative to their continental European competition, as Bundesbank President Karl-Otto Poehl charged last September. A scan against the financial horizon shows that a movement parallel to the IBFs is taking place across the entire banking world.

Britain, as usual, anticipated the most dramatic decontrol measure yet taken in American banking a year ago, by eliminating the foreign-exchange controls that had eliminated sterling as an international lending currency by the early 1970s; but only as the countdown to the opening of the New York free zones began did the full importance of Britain's earlier turnabout become clear. During October and November London reawoke the financial dead, with a rash of sterling-denominated loans—including a spectacular £375 million acceptance facility for the Mexican national oil company Pemex—that returned sterling to a place of significance among the world lending currencies. No one would have predicted that a billion pounds would be lent in a bare six weeks earlier this year. Effectively, London has become an international banking facility unto itself, drawing strength from what most recently was considered a bankrupt national currency.

The next step for such surprises is likely to be taken in Australia, where the Campbell Commission, presided over by the country's premier real-estate operator, will shortly give judgment over the Australian system of exchange controls. Currency the Australian central bank intervenes in foreign-exchange markets to peg the Australian dollar to an (unpublished) basket of currencies of its trading partners. Part of the exchange-rate management program is a system of exchange controls preventing short-term, speculative capital inflows. The Campbell report is expected to argue that the development of Australia's natural resources, i.e., one of the world's biggest sprees in real-estate speculation, requires complete freedom of capital movement and therefore cannot brook management of exchange rates.

Brazil, meanwhile, is looking toward an offshore market—a "Rio Dollar"—to cope with the financing problems associated with a $20 billion annual foreign borrowing requirements. On Nov. 19 the President of that country's central bank, Gerardo Langoni, announced in Bahrain that Brazil would bring over a team of specialists to study its offshore money market, implying, according to Brazilian press accounts, that the government now leans toward the establishment of an offshore money center in Rio. Citibank, the Canadian Imperial Bank of Commerce, and various other international and domestic banks began to float such a proposal in 1979, as if in order to say that, because Brazil had already accumulated such great debt, it should transform itself into a debt with a country attached, as Voltaire said of Prussia.

Karl-Otto Poehl's revelations

The President of the German Federal Bank, who is now presiding over a slow but deliberate shift in German banking operations from Eurodollar borrowing and lending to German mark-based financing out of Germany's own landlocked Cayman Islands, the Grand Duchy of Luxembourg, has stated the matter in theoretical terms. Speaking before a Forex Research conference in Paris Nov. 16, he said:

"As the year is drawing to a close perhaps the only good thing we can say about it is that the 'crash of 79' has not occurred in 1981. . . . Although I believe that such a crash as described so vividly in [Paul Erdman's] book will not occur, there can be no question about the seriousness of the economic situation at present.

"I hesitate to use the word 'crisis' but I believe that what I shall have to talk about tonight is a crisis scenario if ever there was one in the postwar years. . . ."

"I will readily admit that the European Monetary System has performed a good deal better than I expected at the outset. But I would have to add that I cannot applaud all the reasons why it has functioned better than expected [including] the Bundesbank's fears that its monetary policies might be endangered by too large a volume of intervention. . . . The EMS will remain a shell that is in constant danger of cracking under the pressures from inside, without the promise of a viable organism emerging from it. . . . We cannot be satisfied with a 'zone of monetary stability in Europe' merely in terms of more stable exchange rates supported by intervention obligations, by settlement mechanisms based on a precarious European Monetary Unit, by credit lines involving considerable liquidity creation. . . .

"One subject of heated debate among EMS partners over recent months has been that of a 'common attitude vis-à-vis third currencies,' meaning especially a 'common dollar policy.' My own reaction to the various pressures deriving from developments and policies across the Atlantic [stems from] the poor chances of any intervention on our part with the U.S. authorities. . . . We may not have lived through the phase of repeated strains and instability yet. The short-term outlook for U.S. inflation is clouded more than anything else by the size of the federal budget deficit now projected. The immediate outlook is clouded also by the prospect of economic slowdown which may yet go deeper than intended as part of the fight against inflation."

Poehl, who should (and sometimes does) know better, formulated a classy equivalent to "every man for himslef," with the proviso that the salvation, in the form of life-raft sorts of currency arrangements, requires increasingly brutal austerity approaches to credit issuance, along the lines proposed during the last International Monetary Fund meeting by Poehl's Dutch colleague, the outgoing President of the Bank for International Settlements, Jelle Zijlstra.

Far from representing an increment to American power, the International Banking Facilities betray the yawning weakness in the dollar credit structure, and in particular the collapse of the Federal Reserve's ability to manage dollar liquidity. It is to be emphasized above all that the world is in a liquidity crisis brought on in part by the $140 billion annual foreign borrowing requirement (almost all to refinance debt service) of the developing sector, and what Karl-Otto Poehl euphemistically called "a crisis scenario if ever there was one in the postwar period."

ence, the chief economist of the Bank for International Settlements, Belgian Alexandre de Lamfalussy, put it this way: "Expenditure-restraining monetary policies are unavoidable if we want to put an end to inflation and so are its costly effects in terms of lost employment and real income. . . . [Government must] defuse inflationary expectations by sending more signals about interest rates and credit shortages."

During fiscal 1981, Manufacturers Hanover Trust pointed out in their Nov. 23 *Financial Digest,* the sum of federal borrowings already equalled net private savings, and this year's deficit threatens to be half again as high as last year's; broadly speaking, the deficits of leading industrial-nation governments due to the consequences of two years' of Paul Volcker's "expenditure-restraining monetary policy" are greater than the world sum of advanced-sector savings, and can only be financed through the intervention of savings pools like the OPEC investment funds. This means the advanced-sector governments are not much better off than those of the Third World.

Professor Mundell on his gold proposal

Professor Robert Mundell, formerly at the International Monetary Fund and University of Chicago, is the acknowledged creator of the "supply-side economics" promoted by his graduate student Arthur Laffer and former Wall Street Journal *editor Jude Wanniski.*

In this Dec. 3 discussion with EIR*'s David Goldman, Professor Mundell shows how his gold plan would prevent excess money manipulation in the Euromarkets from draining U.S. gold reserves, but acknowledges that speculative capital inflows from the Eurodollar market might turn into a squeeze on American banking resources.*

In addition, he warns of a possible credit crack and argues for a gold price high enough to generate international liquidity sufficient to prevent this.

Goldman: Professor Mundell, in 1971 you warned that "we have moved into a system where what is ordinary money in the United States—bank money, low-powered money so to speak—becomes essentially high-powered money in Europe, so that ordinary deposits in Chase Manhattan or First National City Bank in the United States form not only part of the money supply in that country, but also the base of a potentially explosive money supply in Europe." Could your gold proposal work under these circumstances? Wouldn't explosive money growth in Eurodollars drain away American gold?

Mundell: It's possible for it to operate, yes. The problem is that all U.S. liabilities aren't liabilities of the Fed.

The Federal Reserve cannot be liable for Eurodollars, only for base money in the United States. To get gold from the United States you wouldn't be able to take a check from a foreign bank and present it at the Treasury.

Goldman: Let's say that U.S. Steel borrows $1 billion abroad to buy Marathon Oil, and Marathon stockholders get that $1 billion in the form of checking accounts at U.S. banks. Could they use these dollars to buy gold from the Treasury?

Mundell: No, they would have to pay for gold in base money, in cash.

That way the dollars coming into the Treasury would cut the reserve base of the U.S. monetary system, and would eventually create a squeeze on the Eurobanks. If the Fed doesn't replace those dollars, total reserves will be lower in New York, and this will have an effect throughout the financial markets.

Any reduction in the monetary base will create a multiple contraction in the volume of quasi-dollars in the Euromarket. The Fed would only give gold in return for real dollars, forcing a withdrawal of cash from the banking system.

Eurodollars are not real dollars, but bank debts. To buy gold people would have to take vault cash out of the banking system [which forms part of banks' reserves—D.G.], and that tightens the system.

Goldman: With the introduction of International Banking Facilities, Federal Reserve officials are pointing to the factor of country risk—that IBFs are safer for depositors than bank foreign subsidiaries that might be abandoned in case of a series of defaults on the international market, after which dollar liabilities would be frozen. How does your proposal address this problem?

Mundell: This is a danger. That is why gold must be remonetized at a comfortable price.

It would be a great mistake to set the gold price at a low level. There would be serious risks in putting the price of gold too low in a completely convertible gold standard system. For example, a level of $200 to $300 would be too low, but a level of $400 to $500 would be comfortable.