EIR Economics

The Federal Reserve and the debtors' cartel

by David Goldman

A warning by the West German central bank president Karl-Otto Pöhl April 5 set the context for the Federal Reserve's tightening of credit during the week of April 2. Pöhl predicted a monetary crisis should the United States fail to reduce its budget and current account deficits, saying, "Whatever one considers possible, it is certain that a correction of the current misdirection is inevitable and that the price to be paid by all of us increases the longer the misdirection is allowed to continue."

As Pöhl is aware, the juxtaposition of the emergence of an Ibero-American debtors' cartel March 31 with the announcement of a five-nation bridge credit to Argentina with America's foreign-capital dependency defines the conditions for a murderous international monetary crisis around the June 30 payments period. The West German central bank chief's strong language on the matter reflects a decision taken in London and Zürich, in the wake of the Argentina developments, to force a monetary squeeze that will break the Ibero-American governments as well as the Washington administration.

The mood in London and Zürich is bitter: The leading banks want to crack the final objections of Ibero-American governments to generalized looting of their natural and other resources, sometimes advertised as a "debt-for-equity exchange." U.S. monetary policy, now dictated from abroad, is a blunt instrument in the hands of the European financial oligarchy to crack open Ibero-America.

Pöhl noted that the financing of U.S. government deficits depended upon foreign capital inflows, which had damaged the economies of other countries, a point frequently cited by anti-American critics of U.S. policy. However, he drew attention to two features of world monetary flows that demonstrate the fragile condition of the American banking system: first, the fact that the United States had shut off lending to the developing sector, and secondly, the fact that American banks last year became net borrowers from the Eurodollar market for the first time in history. Previously, American banks had been the principal net providers of funds to the Eurodollar market.

The dollar must fall

U.S. Federal Reserve Governor Henry Wallich, in a little-noticed address March 24, had hit the same point, and Presidential economic adviser Martin Feldstein told a congressional committee April 3 that the United States dollar must fall from its current status of overvaluation.

The wild swings in apparent Federal Reserve activity should be seen in this light. Last week the Fed was clearly aiming at a 10% federal funds rate, foregoing a widely expected rise in the discount rate for the reasons we cited: dampening the monetary shocks from the expected Argentine default. On April 2, the Fed said it is willing to let the Fed funds rate "float" (upwards), and permitted it to rise to 10$^{11}/_{16}$% before adding funds to the market. The Wall Street propa-

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ganda mill, starting with Henry Kaufman, began beating the drums April 3 for a tighter Fed monetary policy.

The intervention of Mexico, Brazil, Venezuela, and Colombia into the Argentine debt cliffhanger over the weekend appears to have changed the political character of the problem. Previously, as sources close to Mexican President de la Madrid emphasize, the banks were committed to a confrontation with Argentina, expecting an early collapse of the Alfonsín government, and the Federal Reserve was prepared to dampen the monetary consequences in the short term, as we reported last week.

Mexican President Miguel de la Madrid, visiting Brazil at the time, determined that Argentina must not be allowed to go into chaos; to the great shock and upset of the banks, the four Latin American nations put through a package including $100 million of short-term loans each. The British banks were brought on board only at the last minute Friday evening, and the package was denounced April 2 in the Swiss daily *Neue Zürcher Zeitung* (NZZ) for taking pressure off the debtors to "adjust." Alfonsin is still bucking the IMF's demands, and reports from Argentina indicate no more likelihood of a deal on the IMF's terms than previously. If the Argentina negotiations now fall through, as they are likely to, the Latin American debtors will all be in the negotiations for the first time.

"This is a precedent that creates more problems than it solves," wrote the April 4 *NZZ* of the prevailing opinion in the City of London. "Only the immediate problem has been bypassed, which was only a matter of bank regulations in the United States. The euphoria over the avoidance of an international banking crisis will soon die down, because nothing has changed with respect to the fundamental question, i.e., how the debt mountain owed by Argentina and other Third World nations can be reduced, without endangering creditors and debtors alike. . . . In the City of London the argument is heard that European banks' participation in such a bailout package is unthinkable the next time around."

Of course, the official euphoria in Washington has not abated. On April 6, newswires reported that President Reagan had telephoned Argentine President Alfonsin to congratulate him on the successful completion of the rescue action. The wires reported the same day that Alfonsin, who must now negotiate with the International Monetary Fund for the money required to repay Brazil, Mexico, Venezuela, and Colombia, warned that he would not accept any reduction in Argentine living standards in return for IMF money.

Answering Treasury Secretary Donald Regan's comments that the Argentine bailout had put the idea of a debtors' cartel "to rest," Reagan-Bush '84 economic adviser Norman Bailey said: "He's misreading it. What these countries are saying is, 'We're demonstrating Latin American solidarity to make you come up with something better.'"

Bailey's interpretation of these events is widely shared even by the financial press, and is well understood in British and Swiss banking circles, which are outraged at the re-emergence of the debtors as an independent political factor since the collapse of Brazil's resistance to IMF austerity demands in July 1984.

Who makes U.S. monetary policy?

These considerations indicate how little actual power the Federal Open Market Committee has over American monetary policy. Since mid-1983, the large European portfolio managers have become the principal creditors of the United States.

The U.S. statistics on the volume of foreign capital inflows are adjusted for what is euphemistically called the "statistical discrepancy in the U.S. balance of payments." This reflects inflows which cannot be accounted for by the U.S. authorities, and represents, overwhelmingly, flight capital moved into the United States from Ibero-America and other endangered sections of the world monetary system.

These data are notoriously incomplete, but they nonetheless suggest a pattern. The "statistical discrepancy in the balance of payments" peaks in late 1982, following the collapse of Mexico, and rapidly comes down to virtually zero by the middle of 1983. This reflects the exhaustion of flight capital available from Ibero-America and other developing-sector sources. The cumulative total of capital inflows by the end of 1983 was certainly above the $200 billion level. However, once the off-the-books side of the capital inflows began to dry up, the total volume of such flows declined as well.

Since the flight capital available from the developing sector began to decline, the United States became increasingly dependent on large European portfolios to provide 40% of the financial resources required to finance the federal budget deficit. This leaves the Europeans with veto power over whatever ideas the Federal Open Market Committee may have.

These plain, if unfortunate, facts of the matter should also demonstrate that the normal criteria by which the financial press and brokerage-house analysts consider Federal Reserve policy are irrelevant. The most frequently heard argument is that the Federal Reserve is tightening credit in response to overheating of the domestic economy. The economy is not overheating and the Federal Reserve could not respond to it, even if it wanted to.

Should the Federal Reserve fail to tighten credit—despite the obvious and disastrous implications for Ibero-America and the American banks in the present context—the major European investors need only withhold investments in the dollar for a certain period of time to force a rise in rates, since inadequate domestic resources exist to absorb the required volume of Treasury securities.

As Pöhl's statement implies, the European financial oligarchy is not merely forecasting a monetary crisis, but imposing one.