# Foreign Exchange by David Goldman

## Baker at Canossa

*What did the United States Treasury offer in return for the West German bailout?*

Treasury Secretary James Baker III's visit to Bonn the morning of Oct. 19 turned into a barefoot pilgrimage to Canossa, as bankers blamed his German-bashing speech the previous day for the Black Monday panic on stock markets. Baker had threatened America's trading partners (and creditors) with a new round of competitive devaluation, hurting both Western European exports and the foreign-currency value of their U.S. debt holdings.

The stock market panic, however, persuaded the repentant Baker to prostrate himself before the toughest of his creditors, asking for leave to bring down U.S. interest rates, and stem the tide of financial panic.

The Germans assented, but grudgingly: Rather than lower interest rates sharply, as Baker had demanded on Sunday, and then begged on Black Monday, the Bundesbank lowered its key repurchase rate a mere 1/20 of a percentage point, to 3.80%. However, the Bundesbank made heavy purchases of dollars, bringing the U.S. currency up from its near-record low of DM 1.77 Monday morning to close to 1.80 during the course of the week.

However, German and Japanese reluctance to continue financing the U.S. deficit has not given way to unlimited charity. Rather, the Bundesbank and Bank of Japan have granted Washington a respite, on the condition that it adopt drastic austerity measures, including sharp reductions in federal spending, and a rise in taxes.

Well-informed European analysts discount as silly a report circulating in the markets, that Baker had precipitated the plunge deliberately, in order to scare the Germans into cooperating.

The more important question is, how are they cooperating, and in return for what?

Wall Street blew out after the Germans and Japanese central banks declined to continue buying U.S. Treasury debt at 1987's first-half rate of $160 billion per year. They neither wanted to, nor could afford to, maintain it, without putting their own monetary systems into the same sinking boat with Wall Street.

Sources close to Japan's Finance Minister Miyazawa emphasize that Japan intends to maintain investments in the United States, in order to give the next President a chance to straighten things out—but that Black Monday gave Wall Street precisely what it deserved. "Baker is stupid," snorted one well-placed Japanese analyst. "What he said on Sunday was ridiculous."

The turning-point for the stock market came Oct. 14, with the announcement of another monster U.S. monthly trade deficit. "This puts enormous pressure on Greenspan and the Fed to raise interest rates," a London analyst warned at the time. "He will have to, one way or another, tighten interest rates. He will likely hesitate, maybe for even one or two weeks. But the longer he waits, the further the dollar will fall."

Germany and Japan both took the occasion to raise interest rates, forcing the Federal Reserve's hand; and the subsequent rise in interest rates on U.S. markets toppled the stock market.

The drastic reduction in interest rates brought about by the Fed starting Oct. 16 did not avert the Oct. 19 crash, but it did support fixed-income bond markets in a big way, temporarily sustaining the liquidity of the banking system, which depends on its security portfolios.

Once the smoke clears, Europe will watch Washington closely. The 6% decline of the London stock exchange and the 9% decline of the Swiss exchange Oct. 22 was a bad omen; European institutions voted "no confidence" in Alan Greenspan's money-printing exercise.

If Washington produces more pre-election hot air, rather than brutal austerity measures, the creditors' committee won't give Washington a third chance.

Apparently, the Bank of Japan and Bundesbank have not considered the consequences of their own recommendations, not much different than the standard International Monetary Fund ultimatum to developing-sector debtors. A collapse of consumer and government spending would wipe out the last props of nominal economic activity in the U.S., along with their export markets.

"The problem in Tokyo is that we do not have any far-sighted leadership. Our own government is still relying on America for leadership," commented a senior Japanese analyst. Tokyo and Bonn continue to follow the same monetarist criteria that caused the depression in world trade after the 1980-82 Third World debt crisis.

The major German and Japanese institutions have stood behind the value of stock prices, preventing the sort of uncontrolled panic seen in New York. In the short run, they may insulate themselves. But their policies push the United States down the fastest path toward depression.



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