The Fed's battle plans against Western Europe and the Third World

EIR does not, as a matter of editorial practice, print unattributed interviews, but the following case is exceptional. The officer of the U.S. Federal Reserve who spoke with us off the record gave us a candid reading of the Fed's current views on interest rates, Third World debt, and the consequences of major country defaults. *EIR* did sufficient cross-checking with other Federal Reserve officials to determine that the content represents an official view rather than the individual's opinion.

Nonetheless, much of the content of the interview must be taken with a grain of salt. As *EIR* made clear last week, we do not believe that the "chicken game" that the Federal Reserve officer describes will work. On the contrary, we think the consequences will be entirely different than the Federal Reserve suspects. Contrary to the apparent elaborate contingency planning at the U.S. central bank, the possible default of Brazil on $60 billion of external obligations may not be containable. The notion that the West German mark may fall to DM 2.25 to DM 2.50 to the dollar, from 1.8845 at the Oct. 29 close, is exotic. The value of this document is the insight it affords into the internal deliberations at the Fed, and the motivations for the most recent sharp increase in interest rates.

Q: What did New York Fed president Anthony Solomon mean in his speech this week by warning of "sudden shifts of funds" which could "trigger a new round of exchange controls"?
A: Nobody here in my department had any idea; we were especially surprised that he raised the issue of SDR substitution to deal with this supposed problem.

Q: I thought the SDR doesn't have a snowball's chance at the Bundesbank.
A: It could get melted in a lot of hells, try Congress. There is no consensus on this, not among central banks, not even here at the Fed, which is why we were shocked Solomon raised this. If anything, I would expect the use of SDRs as a numeraire to come much faster from the private sector. Citibank in London and elsewhere offshore is already issuing SDR-denominated CDs, SDR-dominated bonds are also being done, as are SDR loans.

Q: Why not an ECU market?
A: Precisely. They see the ECU bonds and so on coming, and this is for competitive reasons. The ECU doesn't include the dollar, and so the U.S. banks, for competitive reasons of getting in first, want to go with the SDR, and with their own asset, the dollar.

Q: What about the problem with Brazil refusing to go to the IMF and the rest of the Third World demanding political control there?
A: Brazil is bargaining hard on spreads and conditionality, they're playing hardball with the banks and the Fund. They're telling the banks that the loans have to be done their way, or else the game is up. They're threatening the world with disaster—but because they haven't got anything else to do. They want smaller spreads, and the banks are bitching to us already. What are we supposed to do as central bankers? If Citibank comes to us, we have to tell them, "Look, you made the loan, now what are you going to do? Are you going to roll it over at 3/8 percent over LIBOR as Brazil demands and cave in?" Brazil is simply not bankable at 3/8 percent spreads. The spreads have to be much, much wider, because the fact is that the risk of lending to Brazil and some of these other countries is escalating dramatically. I think that as supervisors we should rattle our cage a little. We should ask the banks if they're sure the risks don't demand much bigger spreads. Say twice, three times as wide as currently. Brazil's credit rating stinks, it rates a 4½ percent spread as far as I'm concerned. The banks may not want to demand as much as 4½ percent but they will get the point.

Q: But Delfim Netto said quite bluntly, to our magazine, and on several other occasions, that they simply will not pay these rates. What will happen then?
A: They'll be forced to pay the spreads because they're not bankable otherwise.

Q: And if they threaten to push it to a crisis?
A: They are not in good position. They can't drive us all off the cliff because they will be the worst hurt. Did Bunkie Hunt make money in the end? No, because Volcker went out to bankrupt him. The natural instinct of the central banks is that if Brazil tries to drive us off the cliff, we will make them pay, pay the whole cost. That's how it is done—the guy that screws up, like Franklin National or Penn Central, pays the whole cost, takes it on the chin, and the objective of the entire rest of the exercise is to protect the rest of the system at his expense. If there ever was a case to do this, Brazil is the case, the way they are behaving. We can't let them hold us hostage. What will they do, declare they won't pay their debts? They're dead forever if they do that and they know it.

The multinational banking system can absorb Brazil. If Brazil goes belly up, we can handle it. We've looked at the banks involved, all their assets and all their liabilities, in Brazil and otherwise, with great care. All the central banks and the BIS have done this, and they know that while the central banks may have to do a little financing to bridge a gap—the plans are all worked out. *Brazil can be isolated.* They'll have to take it on the chin. And they know it.

Q: In the real world, now, what's really going to happen?
A: Look, there is some disagreement between the central banks, not on whether we can let them hold us hostage, but on just how to deal with crises. Many central bankers, Volcker among them, subscribe to the Hy Minksi theory, that we need these periodic crises to show the continued existence of risk in the banking system. Others say we must create a system which is insured against such risk. That was Tony Solomon's point. He wants to build a system which is riskless. Work out controls on the Euromarkets in advance, macroeconomic controls on the bank lending system so that it would be impossible for a Brazil to get enough credit in the first place to be able to drive the ship off the cliff.

In the real world, Brazil is course a lot bigger than Bunkie Hunt. What Volcker will actually do when the chips are down I don't know. I know he will try to do what I said. Fortunately the chips aren't down quite yet. We aren't really taking this guy Delfim seriously. In fact the BIS is so sure of the fact that he would never push things to the brink that they think that the actual market risk of default is low enough that raising the spreads for Brazil another $\frac{1}{4}$ percent or $\frac{1}{2}$ percent may suffice. We'd like to see more, but the result will be that spread do go up, period.

Q: How can you be so sure that Brazil's French and German trading partners, who would like to continue selling Brazil the billions of dollars worth of nuclear plants we refuse to sell them, would go along with Brazil taking the brunt? What if they decide to go in and finance Brazil, and let the Brazilians default only on dollar debt—throw the brunt instead of the U.S. dollar, issue ECU instruments as you said they plan to do?
A: Look, if Brazil goes belly up, Dresdner Bank goes belly up, I don't care what currency their reserves are in, they have plenty of Brazilian paper, dollar and otherwise. And why should you think people would want to hold onto deutschemark assets? The DM is in trouble. The Germans have come to the end of the economic miracle. The mark is in trouble, and the market knows it. It's a brave new world for them.

They are up against the same rate of technological productivity being widely available in countries with much lower wage rates.

We have been told just this in a series of eloquent lectures by Franz Schoel, the Foreign Department chief of the Bundesbank. He says that Germany is in trouble, it was a wonderful 30 years but now it's all over. Inflation is out of control. He's worried about a run on the mark. In fact he predicted last winter what is happening now. And the market knows all this. If Germany had a $2\frac{1}{4}$ or a $2\frac{1}{2}$ DM rate, it would be OK—then they'd have a fighting chance on exports.

Q: So the Fed and the Bank of England will continue to keep interest rates high, no matter what the result on the European currencies?
A: We must have real rates of return on investment, whatever that means for interest rates, of at least 2 to 3 percent above inflation. If inflation is 12 percent now, then the prime should be where it is, 14 percent, and move depending on inflation, maybe 15 percent.

Some Brits are worried. They've run into some trouble on the amount of flows they've generated into Eurosterling. I mean three- to six-month bank deposits, not bonds, there has been more than a few billion over the last couple of months. They didn't expect it, and now that sterling has no controls, they are vulnerable if interest rates fall. So some are worried, but the Bank of England is not ready for controls. They will just maintain a steady grip on interest rates.

Q: And Schoel at the Bundesbank, he has no solution?
A: His solution is to place a lot of DM paper with the Saudis, who have picked up some $5 billion worth so far this year, and cross himself, while introducing structural reforms in the economy.

Q: What if the Saudis went in on the ECU bailout of Brazil?
A: *That* would be a real problem. But they won't, why should they trade Brazilian paper for all their U.S. dollar paper? Or for marks?