Central-bank bailout plan in tatters as crash nears

by Laurent Murawiec, European Economics Editor

The conditions that prevail on the world financial markets can only be described as the symptom of a pre-crash period. That period will be short, highly unstable, and highly destabilizing for markets as well as for the actors and witnesses of the drama. The old, post-1971 system built on the ruins of the Bretton-Woods institutions, is in its turn dissolving, and the shape of the future is as yet unclear.

The astonishing series of incidents, accidents, and limited earthquakes that have hit the financial markets in the last two weeks bears witness to their fragility, to the imminence of their demise. Penn Square and its spillover onto leading U.S. banks; Canada's Dome Petroleum's troubles and their implications for at least three top Canadian banks; the strained finances of Germany's AEG Group and its creditors' accounts; the many and troubled rescheduling processes affecting sovereign borrowers, from Eastern Europe to Latin America. . .

The idea for which this journal and its founder have been notorious for many years—that the world's debt could not and would not be paid, that the Europmarkets were bankrupt, and the day of reckoning was predictable within specific time brackets—has become universally known and accepted.

But while the perception that the collapse of the $1.5 trillion Euromarket is imminent is feeding a race into highly liquid and reliable assets, it also generates a battle for the minds—whose *political* solution to the great debt reorganization of 1982 will triumph?

Advocates of the 'controlled collapse'

Let us enter the conference room of one of the world's most clandestine institutions, the Bank for International Settlements in Basel, Switzerland. On July 12 and 13, the world's leading central bank governors were meeting, including, quite unusually, U.S. Federal Reserve Chairman Paul Volcker, and, very unusually, IMF managing director Jacques de Larosiere. Main item on the agenda: how to face the imminent banking and financial crash.

A group of Fritz Leutwiler (BIS chairman and Swiss National Bank head), Christopher McMahon (Deputy Governor of the Bank of England) and Henry Wallich (number two on the Federal Reserve Board), led the pack demanding the immediate establishment of detailed emergency plans, and of a "safety net" laid by central banks. The Bank of England was the most insistent, and its attitude verging on discourteous frenzy—because of the extreme fragility of the City of London, the world's biggest "offshore" center. "The Bank of England wanted other central banks to shoulder part of their responsibility—they are very scared that a collapse will fall mainly

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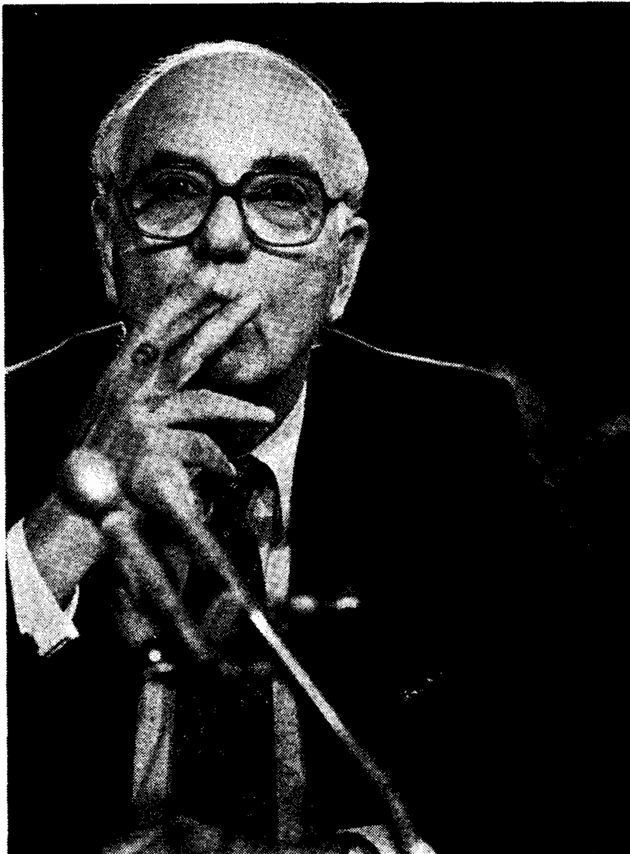
Stuart Lewis/NSIPS

Paul Volcker

on them," a Swiss official commented, not without some sarcastic pleasure. In truth, it was rather unusual for the Old Lady of Threadneedle Street to resort to armtwisting tactics such as leaks to the press to get its way.

In spite of their differences, however, the Swiss, the British, and the foreign agents who run the Federal Reserve fell into basic agreement on the following plan: each central bank would "take care of its own flock," its own banks and their offshore extensions, and provide liquidity to stave off a collapse in case of a crisis on the interbank markets. At first, each central bank would draw on its own dollar reserves to do so, then extend emergency help in its own currency to the banks, which then would have to acquire dollars themselves. If that did not suffice—and in a Euromarket panic, it certainly would not—normal swap lines with the Federal Reserves would be activated: the Fed would print billions of cash dollars which it would swap against pounds sterling, Swiss francs, etc. Some sources even report that special swap lines were arranged at the BIS meeting.

In other words, Paul Volcker and Henry Wallich agreed that the Fed—to bail out the world's biggest casino and funny money establishment, the Euromarket created by British and Swiss financiers—would accept what it has brutally and consistently refused to do to save U.S. industry and farms, make more liquidity available! Volcker's congressional testimony on July 21 only confirmed this, when the Fed chief stated that "under special circumstances," money would be printed. A Geneva banker explained the meaning of Volcker's views: "The Volcker-Wallich clique is all prepared to break U.S. industry apart, they don't care; but they won't let the banks go."

Everything seemed to be in the best of all worlds for the central bankers, whose view it is that the world economy is inevitably headed for a "controlled collapse," with increasing control, that is, for the BIS and the "elite" of financiers and banks that are its collaborators.

A monkey wrench was thrown into their game. Of the world's three largest and most powerful economies, two refused to play. If the United States, through the treasonous Federal Reserve, has agreed to place its economic might as the guarantor of the Euro-fortunes of continental European and British oligarchic financiers, Germany and Japan flatly refused to do so. Japan, whose leadership believes that only a general and orderly debt moratorium for the developing sector can avoid a total collapse and relaunch world economic growth, and Germany, which obstinately refuses to bail out the mistakes of others, simply refused to enter the "safety net." Without Germany and Japan, the virtues of any "safety net" are dubious at best, nonexistant at worst.

As a result, the communiqué, which as an unusual measure had been prepared by the BIS, was not published. "Any preparation you make will be destroyed by a collapse, you will be overtaken by events," the argument went. A leading London merchant banker commented: "The central bankers don't have much going. They might think they have something of a preliminary safety net, for some of them, but they are hopelessly behind events."

The homage paid by vice to virtue

In times of crash and crisis, investors turn to what are the most liquid and trustworthy assets in the world. The bills of the Treasury of the United States are that—which demonstrates that it is nation-states, and particularly the strongest of them that generates the most secure and best-backed financial assets. All the oligarchs' financial managers who have been quietly converting their assets into U.S. T-bills recognize the fact.

In the last two months, portfolio managers throughout the world have started to switch their investment from bank deposits to U.S. Treasury bills. Geneva's leading private banks, which manage much of the world's largest fortunes (Lombard, Odier; Ferrier, Lullins; Pictet; Hentsch & Co.; etc.), had completed this process before that. The drug-linked Hongkong and Shanghai banking group is now starting to do the same.

Only the extreme discretion and the gradual nature of the conversion, explain why there has not been an explosion on the markets: this is a slow-motion collapse.

"The switch from bank deposits to Treasury securities creates massive problems for the banks," a London broker said. "Clearing banks pay 1/16 percent over LIBOR, but merchant banks, which have no deposit base, have to pay 3/16 percent already. The smaller the bank, the weaker, the higher the premium it has to pay. The differentials are already impressive, and they apply to all non-U.S. banks." There, too, the command of the dollar deposit market—the continental United States and its economy—is a principle of reality which even speculators are forced to acknowledge, even if only to be better able to loot it.

One schedule on which the best-informed London financiers operate was summed up as follows by one of them: "If nothing happens before the end of this month, then August should be quiet. You never know, but it should be quiet, because people will be drawing their battle plans. Then, the next deadline is the early autumn, when a lot of things could simply explode. And if the big crash is averted in September-October, then watch the year-end closing of accounts of the banks. Banks report only several months before, but shifts in their pattern of behavior will appear and be quickly spotted by the markets, like heavier than normal drawing on credit and interbank lines. . . ."

Sources close to the Bank of England are circulating rumors that Paul Volcker's more flexible attitude has been motivated by a run on "one major New York bank, the week of the Penn Square collapse, which was squelched quickly by the Fed which started pumping liquidity into the banking system." It is true that the Fed has been adding reserves to the system in the last few weeks, and even cutting the discount rate, in no proportion that could be of any help to industry, but simply to prevent an uncontrolled banking panic.

"The tension at present is worse than in 1974," commented the chief economist of a Geneva bank. Understandably. "The bankruptcy of the [Third World] debtors has now become the bankruptcy of its [Western] creditors," as *EIR* founder Lyndon LaRouche pointed out. The accumulaton of bad debts caused by the Malthusian policies of the world's dominant monetary and financial institutions, the central banks, the International Monetary Fund, the World Bank and the private and commercial banks that go with them, has not only made the desperate debtors insolvent—it threatens to blow away the whole system of their creditors.

The political fight in Brazil to oust austerity-minded Planning Minister Delfim Netto, and reschedule the country's $75 billion debt; the debate throughout Latin America on the use of the "debt-bomb," or the common approach of the continent to debt renegotiation, are among the most positive signs of that bankruptcy, or of the efforts to overcome it. The financial scene is more dominated, however, by desperate efforts to "pass the buck" and ensure one's neighbor's demise rather than one's own. British bankers, for instance, are especially keen on the destruction of the industry-oriented German banking system, for which reason they spread no end of rumors (which they later delicately attribute to U.S. sources.) The BIS central bankers' own operation, be it called "safety net" or "Basel Concordat" (a document agreed upon in 1975 to define the areas of responsibility and the tasks of the central banks in case of a global liquidity crisis), is commonly described as "full of holes," especially after the collapse of Italy's Banco Ambrosiano's Luxembourg holding. Italian banks have rightfully refused to take responsibility for the losses of a holding company located in an offshore center, and whose demise does not endanger the liquidity of any bank. The specter of "subsidiaries being dumped, offshore centers with no regulatory authorities to control them being cut off from their sources of funds" is haunting the masters of the Euromarkets. LaRouche's (and Charles de Gaulle's economic adviser Jacques Rueff's) oft-repeated assertion that unregulated (Euro) markets are ruining the good currencies and the hard-commodity-oriented banking systems, is being borne out with a vengence.

Now that the global financial crash that this journal has foreseen and analyzed in detail for many years is a palpable reality, the point must be made that the holier-than-thou central bankers are the ones who want to decide when and how the crash will occur. As a Brussels financier commented, "A liquidity crisis can only develop if one bank has been rebuffed by other banks and by its own central bank when it was in dire and urgent need of liquidity. A liquidity crisis will only occur if the central banks let it go." With all their protests of prudent virtue, the BIS central bankers intend to do exactly that—and they cling desperately to their illusion that they will indeed be able to "control" what will be the worst financial explosion since the 14th century!

There is very little time left for the world to escape the tragic "choice" it is presented with, of surrendering to the central bankers' "controlled collapse" or being precipitated with the sorcerer's apprentices into the tempest. The fact that the Reagan administration, after having "settled its foreign policy problem," is now "focusing on economic problems" with a personnel reshuffle being mooted, presents us with a desperately needed opportunity to be taken: even if President Reagan has no articulate program to propose, the mid-term political reshuffle must be turned into the entry point for the sweeping reforms of the monetary system proposed by LaRouche since 1975.

The view from London

'The question is, can confidence be maintained?'

From a discussion with a top London investment banker on July 19:

EIR: What are the prospects for a banking collapse?
A: If nothing happens before the end of this month, then nothing will happen before September. August is a quiet month which people will spend planning things out (of course they could choose to make the big announcements then on grounds that the markets would react less, but I doubt it).

U.S. banks, Canadian banks, and German banks are the most likely to be hit. So the banks there will hold extensive talks with the banking and supervisory authorities on writeoffs, reschedulings, and so on. The year-end closing of annual accounts is the next danger point after September. By then, national authorities will have to have consistent policies on writeoffs, what can be classified as recoverable assets and so on.

U.S. banks report quickly, by January or February. Other banks are slower, but by February-April 1983, once the trend is apparent, the cat is out of the bag—which banks are suffering strains on their cash-flow comes out quickly. Markets are very quick to spot out if you're make extensive, unusual use of short-term borrowing, if you overuse your credit lines on the interbank market. . . .

My feeling is that the central banks have discussed that each would look after their own problems and their own banks. For example, in Germany—where Dresdner Bank is the prime candidate for crisis—the Bundesbank would sort it out. Of course there will be a chain reaction of some sort, but each central bank would handle their own areas, with the primary responsibility of being a lender of last resort for that area.

The second stage is this: in the event of a liquidity shortage, the central banks would presumably draw on the existing swap lines with the Fed, the Bundesbank, the Banque de France. . . . It is possible that special swap lines have been established in anticipation of events. In the short term, at any rate, the [central] banks would print money to cover their domestic problems, which would be highly inflationary. The result would also be a serious fall in stock markets. Recession would be sharp, So, a combination of high inflation and recession all depends on whether confidence can be maintained. You told me some time ago that [Hitler and Schacht's] Rentenmark was a spurious means to conceal a collapse, but it worked.

If it won't work, then there will be defaults by all major sovereign borrowers. Their debts of course could be rescheduled, but new money—except very short-term trade credits—would be nil.

EIR: How serious do you think the consequences of the Banco Ambrosiano bankruptcy will be?
A: It is generally thought that the case is peculiar to that bank. It would have gone under anyway, even without the present climate. The British banks called the default because Ambrosiano Holdings Luxembourg is not a bank, it is not covered by the lifeboat, lenders had no reason to believe that there was any money in Italy earmarked for paying its liabilities. So they decided to go ahead with a freeze, a default would be safer. With the freeze, assets are being checked into, there is time, creditors can agree whether to dismantle or reconstruct the non-Italian assets of Ambrosiano—they don't want Ambrosiano Luxembourg to be able to go on wheeling and dealing, and some more assets to disappear. . . . If IOR [the bank of the Vatican] had guaranteed some of the overseas loans, there might be something, but it really lies outside the lifeboat's scope. The Italians, and IOR, have no obligation to pay, a moral obligation perhaps, or something to do in order to avert a crisis of confidence. . . .

EIR: How do you see the Third World debt situation now?
A: It is quite likely that Brazil will go to the IMF, even though the Brazilians did raise in the first half the proportion of their borrowing requirement for the year that they needed. It is now getting stickier. They need more. If they go to the IMF (and there is only one thing really that the IMF could tell them, to cut public spending, otherwise, their policies are such that there is little that could be asked that they have not done already), Brazil could then draw on the IMF, and tide themselves over for this year. But there will be a rescheduling of some sort, just like Mexico. Even though the Mexicans have improved their situation since spring, when, as has been revealed, they had to draw on credit lines with the Fed, they have pulled some money in since then, they'll have to reschedule. Whether, in both cases, it is a formal rescheduling or rollovers is another matter. The Mexicans have a worse problem, given the imbalances in their

internal structure. Either they drastically reduce government spending, not easy, or get a major increase in oil prices, which is beyond their control. . . .

A united front [on debt] cannot be held [in Latin America]. The Argentine debt rescheduling will come imminently anyway, they have no other choice. And lenders are not prepared to deal with a joint approach by debtors. The method of rescheduling still uses very primitive methods—they deal with one year of maturities only; the mechanisms available are not sufficient or appropriate.

[A debt moratorium threat] could be a formidable weapon, but it will not be. The Latin Americans dislike each other too much. The Argentines have not coordinated anything with anyone. The Brazilians are a pragmatic race—if it suits their purpose they would approach the Mexicans for talks and review of debt renegotiations. . . .

I was discussing with a friend that private banks—which have no exposure to the interbank markets—will be immune from the banking crisis, or big Swiss banks with their huge deposit base and tiny interbank exposure.

Everybody is very jumpy. It is not clear to me that the central bankers have collectively taken a decision to support those that will go under. I fear that the central banks would let go some "small banks," with the argument that they reserve their ammunition for defending the big ones—and thus start the chain reaction they want to avert. Maybe in some months we'll have a central declaration about their plans of intervention. By that time, they will have been overtaken by events.

The view from Geneva

'The system can't absorb a refusal to make loans'

From a July 19 discussion with a top Swiss banker:

For a chain reaction to develop, there is a need for one central bank to have let it develop first. A bank turns to its peers, and to the central bank, and it is rebuffed—then it goes bust, because it was not helped. That's exactly what happened in 1974 with Herstatt, when the banks told Herstatt to go to hell and the Bundesbank refused to lift a finger. The Bundesbank compelled Herstatt to declare itself in default. Then trouble started.

Now if there's an international agreement to allow the banks to keep assets on their books, even if these are nonperforming, for the duration of a crisis, then a chain reaction can be averted.

My first question about the BIS meeting is this: are there cat-and-dog fights among the central bankers? Their grand plans are bunk in any case, but the key is whether some of them feel like opting out of participation. The BIS is concerned whether the Germans, the Bundesbank, would participate. The Bundesbank is not equipped and does not have the tradition for this kind of intervention, and they are the most susceptible to be uncooperative at the international level.

So the Bundesbank—and the Japanese, who want a general debt moratorium, so that the Western banks chalk up the old debts, and they [the Japanese] can then sell their stuff throughout the world. It's their clients that are indebted to us after all. And Bundesbank-Japanese cooperation is totally open; they are now openly cooperating to manage the yen-deutschemark rate. . . .

In the case of a run on a big bank, if there is will to do so, it is very easy to stave it off: other banks immediately recycle the deposits lost by the bank under attack. And the Fed can help at the [accounting] level.

It is very serious that the Banco d'Italia and so on are not covering Ambrosiano losses—it will increase the spreads between deposits in subsidiaries and deposits with main offices. If banks start dumping the subsidiaries. . . .

This period is more tense than 1974. The Basel Concordat is in bad shape—the Italians must cover Ambrosiano. The Banco d'Italia, if need be, will be assisted by the Bundesbank and the Fed, but they must support Ambrosiano Luxembourg. I have heard figures ranging from $600 mn to $2.4 billion and even more for the liabilities. The markets are boiling hot. There is no managing committee in any banks that is not reviewing their loans and deciding to cut credits here or there. The system could absorb 10 or 15 "Franklin National Bank" shocks—but not the refusal to lend, which turns into a default of payments on $400 billion of debt, especially since there is no concerted protocol for a moratorium, not even the beginning of one.

Even the clique of Volcker and [Fed Governor Henry] Wallich, who're all willing to dump U.S. industry without a blink, don't mean to let the banks go—they'll save the banks. The same with Bank of England. . . . I don't think that the Bundesbank has a mastery of the juridical mechanisms that is required for the time of crisis. In the U.S., when Penn Central went bust, the Constitution was violated by [Fed Chairman] McChesney Martin. The Germans could not overrule regulations. . . . Central bankers were fighting at Basel. The Bank of England was trying to force the hand of someone, to impose a detailed elaboration of emergency "planning."

Here [in Geneva], all precautions have been taken. In the portfolios, there are no bank deposits anymore. Only Treasury bills.