City of London bankers brace for Ibero-American debt shock

by Laurent Murawiec

I recently had the opportunity of meeting a series of leading City of London figures, bankers and merchant bankers, journalists and bank officials, brokers. Contrary to earlier such meetings, I was struck by the virtual disappearance of the traditional 'chutzpah' so typical, otherwise, or in other times, of the City: No one there now seems to think that he has the world all sewn up, under control, and orientable at (his) will.

Concern and disquiet were evidence that the last two years of frenetic efforts to bring the successive explosions of the debt crisis under control had come to naught. Several times, the opening sentence shot out: "So, your debtors' cartel is now a functioning entity, huh!" The fear looming large in many of the City's most sober minds is that a global redistribution of financial power is under way, whereby banks that have lent much and provisioned little for loan-losses are going to lose their shirt in the great write-off they see ahead, while those banks that lagged somewhat in the lending, and have set money aside, will appear the stronger as a result when the debt dust settles. British as well as American banks are main components of the first category; Swiss, German and Dutch banks of the second.

"Frankly, the game is up. The debtors have established their cartel, whatever you or I choose to name it, and whatever fancy name they gave it—"a mechanism of coordination —and it is a fait accompli," said a director of the Bank of England. "The debtors can only radicalize, and they clearly are going to. My main concern is that it is governments that are going to have to take over the debt—how can we avoid 'nationalization'? The write-off is going to be gigantic, and banks would go belly-up in droves, unless a massive bail-out is engineered. We are going to have to do it."

Technocrats and 'clearers'

The Bank's deputy governor, Christopher McMahon, another City figure mentioned, has told the banks at what price they could sell off their poorly performing or nonperforming claims against debtors: The Bank of England would buy them up at discounts of 50%. In fact, an active discount (secondary) market in dubious bank and syndicated claims against debtors has already developed in London, where banks can unload their Brazilian paper at 25-30% discount, their Mexican paper at 20% loss, their Yugoslav paper at 70-75% of par, etc. But if the institutions intervene, "the cost will be savage, punitive for the banks."

McMahon is unanimously recognized as the most experienced hand at international financial and monetary affairs. There is—courtesy of Mrs. Thatcher's peculiar conception of team-work—precious little competition. The man in charge at the Treasury, Peter Middleton, was described as "a manager, a technocrat who spends the first half of the week figuring out how he's going to reach Sunday." His ascent to his powerful position of responsibility at the Treasury was due to the smooth expulsion of the eight civil servants above him in the line of succession, whom the Prime Minister dispatched to other government departments to make way for her favorite. As a result, expertise, experience, and personal connections are in short supply at the Treasury.

At the Bank of England, the governor, Robin Leigh-Pemberton, gained quasi-immortal fame only a few days after Mrs. Thatcher broke tradition by appointing, for the first time ever, a "clearer" (he then chaired the National Westminster Bank) as Bank governor; he stated for the record: "The debt crisis, if ever it was a crisis, is over." That was in January 1983, and his reputation has not yet recovered.

'The end is nigh'

The *Financial Times,* the "voice of the City," has printed an uninterrupted series of articles in the last few months on the theme "how to pick up the pieces," how to reorganize debt. "They don't want to create a panic needlessly by blaring out that 'the end is nigh,' " a City observer said, "but anyone who reads between the lines knows what they're talking about. The message is sinking in."

However, the likely course of action to be followed is "a big 1982-style bailout accompanied by a smattering of each mini-solution you can think of that will smooth up the losses on the edges," a City journalist said. "A bit of everything. There is really no grand strategy behind all that, it's crisis management, hand to mouth. When the bailout comes, so many dollars will be printed that interest rates will fall, and the dollar will tumble—all the more that the United States is now a net debtor. In fact, the dollar has *already* been devalued since higher and higher interest rates are required to sustain it. And U.S. banks are in very bad shape: look up the Ponzi games being played by a certain major S&L in California, which is offsetting its losses only through cashing in huge fees on dubious operations. It cannot go on much longer."

'Insulate the City'

The danger for the banks, and the whole financial structure, has not remained unnoticed, and a great deal of work has been done in the City, at Whitehall, and at the Bank of England on how to "insulate" the City from the expected shocks in international finance. This is why an unprecedented spate of mergers, acquisitions, buyouts and so forth has hit the City in the last year, and has been accelerating constantly.

Brokers, stockjobbers, and other financial service units are being taken over in part or *in toto* by merchant banks, clearing banks, and insurance companies. "The capitalization of brokers and jobbers is low, too low to absorb heavy trouble if and when it comes—and there's plenty of that already," a broker said. A considerable regroupment is underway, which aims at consolidating and capitalizing a lesser number of financial units in order to mimimize the amount of rubble that will have to be cleared. The 8% loss of capitalization suffered in one day by the Midland Bank at the end of June, on account of its large Latin American exposure, has left a deep mark.

Despite the sober analytical acknowledgment of the reality and urgency of the debt and banking crisis, there is little sign that action will be taken or initiatives thought up and acted upon that would go beyond the "muddle-through" policy. At least, no such intent appeared in these various conversations.

'The debtors' cartel is now a reality'

The following is an interview with a prominent City of London merchant banker, who requested that his name be withheld from publication. The interview was conducted by our European Economics Editor Laurent Murawiec in London on June 28.

Q: How are banks doing in the present phase of the debt crisis?

A: A tremendous loss of liquidity is developing as banks find increasing holes on the asset side of their balance sheets, and the holes are going to have to be plugged. [Swiss National Bank director] Markus Lusser's proposal of a secondary market for discounted bank claims can't work. The capital structures of the banks cannot take it: How do you replace the lost liquidity? Selling an asset at a discount means that it is lost forever, which cuts the net worth of the bank, and therefore, its overall ability to lend, since the "gearing" is necessarily at a lower level. At a 25-50% discount on assets, it becomes untenable. No, emergency liquidity will have to be provided to the banks.

The debtors' cartel is a reality, from Cartagena onwards. Debtors will radicalize, and concessions will have to be made. Which brings about two problems for the banks: cash-flow and accounting.

Q: Creditor bankers have publicly been insisting that they would stick to a hard-line with the debtors, although. . .

A: Creditors are in a bind. U.S. banks stick to their idea that concessions mean loosening the IMF grip, and reducing the incentive for debtors to behave as good boys. Concessions mean loss of authority, and radicalization. But no concessions means a confrontation, in which the debtors can now fight—and perhaps win.

Central banks have all kinds of contingencies planned out, all based more or less on relaxing monetary targets—the line Fritz Leutwiler [outgoing chairman of the Swiss National Bank and Bank for International Settlements] expounded first in his *Die Zeit* interview in June.

Q: What about the numerous recent proposals for easing the debt burden while keeping the assets, interest capitalization, interest rate capping, and so forth?

A: Capitalization is not an option: on the one hand, it means making the debt eternal, through compound interest. On the other hand, it's just like lending new money, or adding new debt. Capping is not going to work: Who is going to cap how much, related to what, and on whose authority? If you cap interest rates, there is no incentive. Of course, no interest is really being paid at present, but it shows that this "solution" just brings us back to square one, where we are anyway. So, why move?

Q: What do you think could be done, then?

A: Well, some coordinated action between debtors and creditors, I think, with the U.S. taking the lead. If emergency liquidity is provided, and dollars printed en masse, bank stocks will fall dramatically, so will the stock markets, and interest will go down significantly. But banks must be enabled to keep on lending to the productive sectors, to save the world from terminal recession. The problem is to control the