Volcker credit crunch responds to debt proposals

by David Goldman

The central bankers' cartel centered at the Bank for International Settlements (BIS) in Basel has finally responded to Peruvian President Alan García's plans for debt reorganization, albeit in its own quiet and unpleasant fashion.

The response came in two forms:

First, Federal Reserve Chairman Paul Volcker set in motion a brutal reduction in American banks' rate of credit extension, in the form of remarks before the Senate Banking Committee on Sept. 11 favoring an increase in banks' capital requirements, as well as insurance for their foreign deposits.

Secondly, Fritz "I have a heart" Leutwiler, the former President of the Bank for International Settlements, emerged as the leading candidate to "mediate" between South Africa and its banking creditors, after Chase Manhattan et al. forced Pretoria to declare a debt moratorium during the first week of September.

The message to the major debtor countries, including not only Peru, whose new President has offered a plan capable of restoring world economic growth, but also Mexico and Brazil, who are quietly seeking reorganization of their own debt, as well as the Philippines, Egypt, and other countries now at loggerheads with the International Monetary Fund, is straightforward: total financial war. Volcker's supposedly "technical" response to the banking crisis is, in reality, an effort on the part of the unelected "fourth branch of government," the Federal Reserve Board, to preempt the American response to President García's proposal.

Since Britain's Lord Carrington instigated the Malvinas War in the spring of 1982, the Bank for International Settlements gang, for most of that period under Leutwiler's direction, employed the debt crisis to throw the debtor nations into economic ruin and social chaos. The danger to the banking cartel is that President Reagan may respond to the proposal of Alan García, among other Ibero-American leaders, to address the debt problem at the level of heads of state, above the heads of the bankers and "technicians" who caused the mess in the first place.

Volcker's low-key threats before the Senate Banking Committee, therefore, were as political as the New York banks' decision—a month before the latest upheaval began in South Africa—to force Pretoria to the financial wall. As the banking lobby complained, insurance on foreign deposits would cost the major banks roughly 25% on top of their existing insurance premiums. Raising their capital requirements from 6% to 9% of deposits would force the banks to come up with close to $50 billion in equity capital—not likely in the midst of a banking crisis—or to reduce their lending, with immediate, disastrous repercussions for the world credit situation.

Forcing the banks to reduce lending, as Volcker proposes, would force an immediate confrontation with debtor-nations such as Peru, who insist upon reducing their debt-service burden to a level which is economically bearable. It is no longer a matter of the banks' exposure to Peru, South Africa, or any other particular sector. As *EIR* reported last week, the end of the third quarter is bringing with it a series of financial disasters in both expected an unexpected places, ranging from the Farm Credit System's imminent bankruptcy to the Canadian government's liquidation of two energy banks in that country's Western provinces. The issue is not whether a financial crisis shall erupt, but who shall control its political course.

So many chunks of masonry are falling out of the financial system's ceiling that it is impossible to guess what may trigger Volcker's "financial debacle." Among these are—apart from the Peruvian and South African crises:

1) The Farm Credit System's $74 billion insolvency, whose 18-month projected time frame will be telescoped as crop prices fall sharply over the winter;

2) Projected writeoffs of $1 billion of loans to the Greek shipping industry, of which Bank of America and Continental Illinois hold about $300 million each.

3) The highest rate of bank and S & L failures since the great depression, projected by Federal officials to continue through 1986;

4) A wave of bankruptcies among Singapore finance companies, and major problems for commercial bank loans to the property sector;

5) The consequences of the continuing IMF squeeze on the Philippines;

6) The closure of two billion-dollar Canadian banks by the Federal government during the first week of September; and

7) The rumored closure of the majority of foreign banks operating in the Bahrein offshore banking zone.

The reemergence of Leutwiler

In that respect, the reemergence of the gnomish figure of Fritz Leutwiler in the South Africa events, telegraphs the next move of the banking cartel. Switzerland was the only stop on South African central banker Gerhard de Kock's tour of banking capitals in which bankers expressed sympathy with South Africa's position (even though Swiss banks had participated in the run against South Africa's short-term obligations).

Switzerland announced that the bank had approached Leutwiler, who retired from the Swiss central bank last December, to act as mediator between South Africa and the banks. Since De Kock had announced South Africa's intent to find an "internationally respected figure" to assume this function, the first time any debtor-nation proposed to negotiate through other than its own officials, while in Switzerland, the conclusion suggests itself that the Swiss offered him some sort of deal.

As one wire service noted in its report of the Union Bank statement, Leutwiler, "as president of the Bank for International Settlements, the clearing bank for central banks, from 1982 to 1984, he saw the BIS through the most difficult phase of the international debt crisis." Leutwiler was especially prominent in breaking Brazil's resistance to the IMF during July of 1983, when the BIS withheld short-term financing pending Brazil's accession to the IMF conditionalities which, subsequently, shut down the Brazilian economy.

In summary, Volcker has proposed a change in Federal Reserve policy which propels the banking system further into chaos, while Leutwiler steps in to take charge of the chaos.

'Re-regulation'

Volcker's program may be characterized as "re-regulation" of the banking system. After five years in which the legal barriers between traditional commercial banking, intermediation of savings, and stock market activity have gradually disappeared, the American financial system has reached a point of no return. *EIR* warned during a period of years that the economic content of de-regulation was the introduction of Eurodollar market conditions to American banking, i.e., the usually-infinite "Keynesian multiplier" through which a shrinking capital base and ever-declining reserve ratios could generate an enormous rate of credit expansion. This occurred at the expense of traditional lending functions, and the institutions which performed them.

On Sept. 11, Volcker warned that the game was over. "I believe a . . . major source of our current problems can be traced to certain changes in banking and public attitudes that emerged gradually as memories of earlier difficulties faded from consciousness. . . . In the absence of signs of real difficulty for several decades, a new generation of managers, directors and regulators . . . shifted the focus of bank policies away from concerns with safety and toward greater risk-taking," he said.

In particular, the deregulated savings and loan institutions had overstepped the bounds: "These risks have been aggravated more recently by reactions of some managers, particularly in the thrift industry, to a prolonged period of extreme earnings pressures in their traditional lines of business," which Volcker's deregulation had ruined following 1979. By permitting the commercial banks to encroach upon savings institutions' "traditional lines of business," Volcker forced them "to decide, in effect, to 'roll the dice' by undertaking particularly risky activities generating immediate profits or the hope for large gains over time. From the standpoint of managers or owners, the chance of failure of the institution was already large," as Volcker told the Senate Banking Committee on Sept. 11.

The problem, Volcker concluded, is that "depositors and creditors of banking organizations themselves, because of the [federal] safety net, may anticipate that the 'government,' in the last analysis, will take actions to protect them against loss, so they can be relatively indifferent to the risk exposure of depository institutions. That is obviously the case for insured depositors who, by design, rely on the federal insurance banking their deposits rather than on the financial health of their banking institution for the return of their money."

Should the federal government pull out the safety net? Not immediately, Volcker cautioned: "Instilling discipline at the expense of a financial debacle would be a pyrrhic victory." Nonetheless, the proposals he favored, including the increased capital requirements and insurance upon foreign deposits, indeed, the mention of these proposals alone, may have precisely this effect. It is too late to make the banking system a little bit pregnant.