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War among central banks

As European governments tighten capital flows, the United States threatens to collapse dollar.

Treasury Secretary James Baker III issued a veiled threat Oct. 15 to force the U.S. dollar down, in a competitive devaluation. Baker was responding to a general, preemptive tightening of European and Japanese monetary policy.

Baker threatened to undertake the policy most likely to produce an immediate general crisis on financial markets.

But none of the alternatives acceptable to Baker and the New York banking crowd he represents could work, after America's overseas creditors signaled their intention to cut back on the $200 billion per year capital inflow from abroad which has kept the United States solvent so far.

Since net foreign private inflows of money dried up in November 1986, and Japanese institutional investors are now trying to reduce their holdings of U.S. paper, the central banks' decision seals the fate of the U.S. market bubble.

Central banks bought $78 billion U.S. dollars through foreign exchange intervention during the first half of 1987, and invested those dollars in United States Treasury securities, meeting virtually the whole Treasury financing requirement for that period.

The result, European central bankers noted with alarm, was a threatened flight out of all currencies, marked by a 25-50% rise in precious and base metals prices during the year's first half.

Authoritative European financial sources warn that the United States monetary authorities plan another round of dollar inflation, in reaction to the near-certain aggravation of the Third World debt crisis in the weeks ahead.

The Oct. 26 meeting of U.S. bank regulators to determine the status of Brazil's debt, which has paid no interest since February, may force a $20 billion write-down of major U.S. banks' assets.

Under the circumstances, banking observers think the U.S. monetary authorities will have no choice but to pump money into the banking system. Brazil may not be the worst of the banking system's problems in any case (see *Banking*).

In that regard, the Swiss daily *Neue Zürcher Zeitung* reported Oct. 13 that the coordinated rise in European and Japanese interest rates preempted such action by the U.S. authorities; the Europeans do not want to be stuck with the bill for the bailout of the U.S. banking system.

"There is an immediate fear that the massive money-creation by the central banks as a result of their dollar support operations will lead to inflationary tendencies. The stronger the major industrial nations' governments commit themselves to exchange rate stability, the greater the inflationary potential. There are very concrete fears that the new rise of raw materials prices, especially higher metals prices, could strike through to the general price level in the industrial nations . . . and in the background, there is the growing foreign debt of the U.S.A., which they fear will lead in time to the irresistible temptation to lighten the weight of debt service by eroding the real value of the dollar. A strong inflation of the dollar would also contribute, in part, to a 'solution' of the debt crisis of the developing nations," the Swiss daily characterized central bankers' views.

It appears that the central banks made their decisive move on Oct. 9, when, in Japan, yields on 10-year government bonds rose sharply to 6.08% from 5.86% the previous day. West German government bond yields rose to 6.87% from 6.75%.

Baker's bitter complaint against his Western European colleagues, to the effect that their recent interest rate increases violated the "spirit of our recent consultations," as well as the February 1987 Louvre agreement to stabilize exchange rates, has some justification. That agreement presumed that the European central banks would print money indefinitely (or at least through the November 1988 elections) in order to sustain the American stock market bubble.

In a heated exchange with Baker days prior to the Oct. 1 annual meeting of the International Monetary Fund, former West German Economics Minister Count Otto von Lambsdorff warned that such action by the Europeans and Japanese was politically impossible. James Baker should have listened harder.

In fact, Baker had promised tighter money at the IMF meeting, by suggesting that an index of raw materials prices including gold might determine Western monetary policy. That represented a verbal concession in the direction of the Bank for International Settlements, the syndicate of European central banks.

But Baker has now discovered that he could not undertake such tightening without bringing down the U.S. securities markets, as well as huge chunks of the banking system. The Europeans are forcing him in that direction, willy-nilly.

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