A hot August coming for the money markets?

by Chris White

The word now going out among some of the more sanguine members of the U.S financial community is, to paraphrase the old saw, "Beware the Ides of August." Among those not so taken with the claimed invincibility of the powers of the public relations perceptions manipulators, which the present dominant crowd instinctively substitute for the policies they are incapable of comprehending, the fear is that the coming weeks may well turn out to be the most dangerous for the financial system since the near market meltdown of Oct. 19-20, 1987.

In the view of those quietly circulating such warnings, August is the most likely time-frame for a new phase of collapse. If the system can be kept together by whatever means over the coming weeks, then the same crowd think, it may actually be kept together through the first quarter of 1989.

Right or not, such ruminations from behind the scenes, point again to the reality that overall world monetary and financial developments can only be correctly seen as a disaster in progress. Those who have spent the months that have passed since October 1987 attempting to figure out which from their delimited repertoire of gimmicks they might best employ to keep things going a little bit longer, might do well to consider that each day they think they have successfully put behind them, brings the world surely one day closer to the collapse they delude themselves they are averting.

For example, the system was kept together from the time of the June Toronto summit of the Group of 7 heads of state, with their financial and economic teams, with a patchwork of what are called "coordinated measures" on the interest rate and foreign exchange fronts. Those who now warn of the dangers that loom for the month of August do so because the tactical adjustments adopted in June have just about run out of steam.

The better sort of analysts in Europe ascribe the June summit package, which produced the July rally in the U.S. stock market and a paper resurgence of the dollar to an 11-month high against the Japanese yen and German mark, to a decision made by the financial crowd which stands behind George Bush, and which acts through Treasury Secretary James Baker, to attempt to hold the line on the U.S. bond market. The cornerstone of the package, as we identified back in June, was a commitment by the United States to increase its internal rates of interest. Since then, the banks' prime rate has gone up to 9.5%, and the Federal Reserve's federal funds rate has gone up by more than a full percentage point to a level, at now just under 8%, from which most commercial banks will soon be forced to increase their own lending rates the next ratchet, back to the double-digit level of 10%.

To start with, the higher interest rates in the United States established a differential between U.S. markets and, especially, their German and Japanese equivalents, which brought foreign money in, reflected then as the turnaround in the dollar's exchange value. The increase in the dollar then began to force especially the European central banks into increasing their internal rates of interest, such that the Bank of England's base lending rate has been upped about five times in the period since the summit, and the German Bundesbank's "repo" rate twice. By the time some in the United States were warning of the dangers to be confronted in August, their counterparts in Europe had begun to put out the word that "the interest rate war is on."

For the Europeans, the key question, it appeared, had become, "What will the Japanese do now?" Their assumption was that as long as the Japanese held aloof from the international scramble to increase domestic interest rates to offset the effects of increasing U.S. interest rates, then the gimmickry of the coordination package agreed on at the Toronto summit could continue. There are political corollaries to such thinking, via the somewhat simple-minded algebra that asserts, because the Europeans have been more willing to increase their rates of interest to keep in step with the United States, they must be relatively more for Dukakis in the U.S. electoral sweepstakes, than are the Japanese, whose apparent reluctance on the question is thought to put them more in the camp of George Bush.

This follows, not so surprisingly, from the accompanying proposition that, whatever the short-term benefit to be derived from an upward pattern of international interest rates, the ultimate consequence will be to accelerate the momentum of the collapse in progress. Since a collapse will benefit Dukakis, the algebra goes, then, those raising interest rates want a collapse, and therefore they also want Dukakis. Those holding back on the interest rate front, for their part, must be for Bush because they don't want a collapse.

The process runs the policymakers

Perhaps, on some level, there is some truth to the logic. But on a more fundamental level there is not. In no country, including emphatically the United States, are those who claim to be on top of the financial and monetary policymaking process actually in such an elevated position. Rather, it is the process which is on top of them. In no case are such self-proclaimed policy or perception managers managing anything at all. They are instead being managed by the process of collapse, as the creatures of the collapse process.

At this dinner table, those who do not keep their seats end up as part of the menu. Too high a differential between U.S. interest rates and those which prevail in Europe, and the European side of the system comes down, led by perhaps the most explosive corner of the system, the City of London. Too low, and the foreign funds on which the U.S. depends do not come in. Either way, the collapse continues unchecked.

The only alternative to that tightrope walk to nowhere would be to change the rules of the so-called game or system. But as Felix Rohatyn, a mooted Treasury Secretary in a Dukakis administration, has told the Senate, and the readers of the *Wall Street Journal,* so-called policymakers' decisions, since last October's market crash, have been designed to ensure that nothing will change until after the collapse has taken its course.

In the week ending Friday, July 22, it began to appear that Japan could no longer be counted on to keep its interest rates down. Tuesday, rumors swept international markets that the Japanese monetary authorities were about to increase their lending rates. As the rumors spread, the Tokyo stock market index plunged, losing more than 2% for its biggest drop all year. Fearful of the consequences, central bankers began to act in concert to bring the dollar back down from the elevated levels it had reached in the almost six-week period since the Toronto summit. And what that will do, for those whose actions are governed by the process, is increase the pressure for still further increases in U.S. interest rates.

Meanwhile, the six-week "coordination package" cobbled together to defend the bond market, has had effects on the internal U.S. credit system which have only begun to come to light. Top on the victims list are the foundering savings and loans, whose borrowing costs have increased by as much as a percent and a half over the past two months. Already, in June, the rising cost of money, along with fears over the integrity of the system which spread in the wake of Federal Home Loan Mortgage Board's publication of its annual accounts, was producing a deposit outflow from the shattered system. To buy stability for the bond market, the number of S&Ls that are insolvent will have been nearly doubled, and the ultimate cost to the taxpayer increased proportionately.

Similarly, the some 25% of the nation's 14,000 or so banks which are classed as "farm banks" have seen their anticipated revenue stream wiped out by the combined effect of this year's drought, and the continuing insanity in every aspect of economic policy. The increase in their borrowing costs will push them over the edge, too. And it's not so different for the mega-banks. They can report all the increased earnings they think the regulators will let them get away with, as they have been doing in July. Such accountants' tricks do not change the reality that dependent as they are on the same securities markets, their shape, contrary to their accountants and the regulators, is no better than the market as a whole, which is bankrupt and illiquid.

In short, the warnings that August could well turn out to be another inflection point in the development of the worst financial crash in human history are well-founded, and well-taken. The more so in that the bag of tricks that was opened in the run-up to the Toronto summit has been exhausted, leaving the financial system not where it was before the tricks began to be employed, but in worse shape, less stable than it was before.

Some determined public relations expert, you may correctly project, is even now stretching what passes as his mind, to figure out the next set of gimmicks that will be employed to keep things afloat through August, and into the annual IMF meeting scheduled for West Berlin at the end of September. This package of gimmicks, like the previous ones, will be based on trading vicious austerity against you and yours, in the next year, against the short-term income expectations of especially the foreign creditors of the world's largest debtor. The more time that is ostensibly bought under such arrangements, the higher the reckoning will be, when that day comes. And the more certain it is that it will come sooner, rather than later.