Ibero-American debt crisis turns into dollar debacle

by Richard Freeman

According to a well-informed Washington source, the International Monetary Fund (IMF) and the World Bank have been holding secret discussions about the deep trouble of the Mexican banking system. But that's not all they are talking about at the sessions, which "will not be made public." Also of great concern, according to Jerome Levinson of the Washington, D.C.-based Economic Policy Institute, are the effects of the recent instability of the financial markets and huge capital flight from Venezuela, where the value of that country's foreign debt has fallen by 27% since the beginning of this year.

"Different people, both inside Venezuela and bankers outside Venezuela, have told me there could be a coup in Venezuela towards the end of the year. If [Venezuelan President Rafael] Caldera can't make good his campaign promises to ship water and provide sewage and so on, there could be a social explosion," Levinson said.

The crisis is also bound to strike at the U.S. dollar itself, and at least some in the U.S. government are painfully aware of it. Levinson characterized the latest financial hemorrhage as "almost like an eerie replay of the 1970s [debt crisis]. . . . My feeling is that beneath the surface of 'everything is wonderful,' [the Clinton administration] has been scrambling to head off this week a financial crisis in Mexico."

Two events, separated by the span of only four days, illustrate just how shaky things have gotten. On April 25, the United States and Canada, after many frantic late-night emergency discussions, triumphantly announced a $6.7 billion permanent line of credit to Mexico's central bank, in order to shore up the plunging Mexican peso, and on a larger scale, to help stabilize the shaky Mexican financial system. Since January, Mexico had drawn down one-fifth of its $24.5 billion central bank foreign reserves, in a desperate attempt to defend the peso.

Second, since mid-February, Mexico's stock market has seen $10 billion flee the country, most of it U.S. dollars. The Mexican stock market is a pure bubble, of course: The dollar valuation of stocks traded on the Mexican exchange, at $175 billion, almost equals the size of Mexican Gross Domestic Product ($196 billion), whereas the actual stock value of companies in Mexico is barely one-fourth of that. Since most Ibero-American (and Asian) stock markets are similarly built on sand, no wonder U.S. banking circles are at pains to act fast to prop up Mexico's financial system for a little while longer.

But by April 29, the very dollar that was supposed to protect the peso, was itself under savage attack, and falling. On that day, the U.S. Treasury and the Federal Reserve's open market desk began a policy of direct intervention, rarely used in recent times, in order to protect the dollar. Treasury Secretary Lloyd Bensten said he had ordered the intervention in order to re-establish "orderly markets." Over the following week of May 2-6, the U.S. government spent massive amounts in further defense of the dollar.

Most market analysts said the U.S. had intervened in order to protect the dollar from falling against the yen, which threatened to break the historic barrier of 100 yen to the dollar. They cited the Japanese government crisis, plus the prospect of continued Japanese trade surpluses with the United States, as putting upward pressure on the yen.

But most of these analysts overlooked the obvious: During the same week of April 25-29, the dollar also plunged against the German deutschemark, settling in the range of 1.65 DM to the dollar. Why, one must ask, was the dollar falling here as well, especially since interest rates are rising in the United States, and according to standard market rules, should be attracting funds from abroad, thus strengthening the U.S. currency?

Part of the answer lies in the assault on the U.S. presidency being run through British intelligence and the Toronto-based Hollinger Corp. media empire. But another significant part is that the dollar, which speculators "globalized" during the 1980s and 1990s in order to spread financial derivatives and various other speculative ventures to the four corners of the globe, is now over-extended. Both the so-called Brady bonds—instruments named after former Treasury Secretary Nicholas Brady and issued by Ibero-American countries in exchange for their old, unpayable bank loans—and the Mexican and Venezuelan banking system are underpinned directly by the U.S. dollar. Thanks to the international drug traffic, and such deals as the North American Free Trade Agreement (NAFTA), there is not a market in Ibero-America, from banking to stocks, from derivatives to foreign exchange, from debt to infrastructure "privatization," that the dollar is not involved in. So when on April 25 the United States put together its $6.7 billion credit line—ostensibly for supporting the peso—it was not out of altruism; it was necessary to do so in order to save the dollar.

A new debt bomb

The total size of all Ibero-American secondary market debt, according to *Latin Finance* magazine (a division of the British-based *Euro-Money*), is currently around $1 trillion. That includes all government debt, including Brady and non-Brady, as well as all traded corporate debt. Aside from double counting, the size of Ibero-American secondary market debt is in the range of $600-750 billion. Of this amount, approximately $125 billion is Brady debt. The market in Brady bonds is illiquid, and has been so since mid-March. The Salomon Brothers Brady bond index (1990=100) fell from 258 in January to 209 in March and April—a 20% drop. The May issue of *Latin Finance,* characterizing the Brady market, reported that "everybody got killed in every bond market."

According to a source at *Latin Finance,* the three biggest traders in Brady debt are Morgan Bank, the Morgan Stanley investment bank, and Chase Manhattan Bank. These and other banks took hundreds of millions, and potentially billions of dollars of losses.

With all the wreckage of this year, the New York and London bankers are petrified, and they will attack anyone who attempts to renegotiate debt—as some people in the Caldera government in Venezuela have indicated they would like to do—or who tamper with the situation.

Their fear is well-founded. The Venezuelan government, which was sworn in on Feb. 2, has taken two steps to challenge the bankers' rule. First, it announced that it would undertake to bring down the sky-high interest rates, by instituting systematic rate cuts, once every two weeks. In response, on April 26, Ruth de Krivoy, the monetarist head of Venezuela's central bank, handed in her resignation, accusing Caldera of undermining the "autonomy" of the central bank. Huge amounts of capital flight ensued. Next, Caldera's government had the courage to challenge the IMF's conditionalities policy, and even indicated that it may want to renegotiate Venezuela's Brady debt, which represents between $15.5 and $17 billion of the country's $34 billion total foreign debt.

The Banco Latino blow-out

On Jan. 13, Venezuela's second largest bank, Banco Latino, which has been accused of drug money laundering and is linked to the notorious Cisneros family, collapsed. Eight other Venezuelan banks collapsed around the same time. The bailout of these banks has cost the Venezuelan government $7 billion—nearly half its budget. On top of this, government oil production revenues, which comprise 80-90% of its total revenues—have been low because the price of oil is down to around $11-14 a barrel.

Finally, Venezuela must continue to pay interest on its foreign debt. Caldera campaigned on a platform of social reform, but there is next to no money in the budget for such programs. That will cause the social explosion which Jerome Levinson forecasts for the third or fourth quarter, and which could trigger a (pro-IMF) "coup."

When Venezuela contracted in 1989 and 1990 to turn its bad bank loans into 30-year Brady bonds, one of the stipulations was that Venezuela guarantee the principal amount by buying 30-year U.S. Treasury zero coupon bonds. (A zero coupon bond pays no interest; instead, the purchaser buys the bond at a steep discount, usually paying only $12 or $14 per $100 of face value. The interest is capitalized, and at the end of 30 years, Venezuela receives the full $100 face value. This functions like the old Series E U.S. savings bonds.)

Venezuela's zero coupon bonds are being held at an escrow account at the U.S. Federal Reserve, and Levinson—who, as former general counsel of the Inter-American Development Bank, ought to know—warns that in the event Venezuela is unable or unwilling to meet its regular interest payments, the commercial banks could seize the bonds. "The banks could walk in," Levinson said, "and say to the Fed, 'You're holding this pursuant to the escrow agreement; the conditions have now been met [i.e., Venezuela's non-payment of interest], we demand our collateral.' " That would be an extreme measure, but the banks, Levinson said, cannot afford to let Venezuela set a precedent by not paying on Brady bonds.

Levinson added that the IMF and World Bank are "very, very worried" (though "not in public") about the fact that 25-50% or more of the money in the Mexican banking system—and to a lesser extent in Venezuela—is from abroad, mostly dollars from the United States. These dollars take two forms: 1) dollar deposits, including large certificates of deposit; and 2) dollar borrowings by the individual banks in each banking system. These dollars can leave at any moment, triggering a huge financial collapse.