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Volcker pledges to print money... for the British

by David Goldman, Economics Editor

The Bank for International Settlements' Annual Meeting, held this year at the bank's Basel headquarters July 11-12, is usually the most secretive of all financial gatherings; the BIS, the "central bank for central banks," is beholden to no government but that of its host, Switzerland, and weaves its web behind closed doors. For the first time since the institution's 1931 founding, a part of its proceedings were opened to the press, by the Bank of England. Contrary to protocol, the British made known that the assembled central bankers were contemplating a global financial collapse.

Yet, as striking as the Bank of England's report was, an even more secret, more astonishing subject of deliberation was kept from the press: an agreement in principle to *make the United States treat $1 trillion in offshore bank deposits as if they were official obligations of the U.S. government* in the event of a banking crisis, an action which would collapse the U.S. dollar's international value, by as much as 40 percent, according to Bank of England estimates. *EIR* correspondents in 10 financial capitals worked together to ferret out a story which a Federal Reserve official boasted "we will never spill": if a financial panic occurs, the American central bank has made a commitment to provide liquidity in unlimited amounts to foreign central banks who need dollars to prop up their own banks, or local branches of foreign banks. That amounts to a Federal Reserve obligation to directly bail out every troubled bank operating in the dollar market in the world. We will explain this in more detail—and also why it may not happen—below. First, the Bank of England's extraordinary version of events.

'People don't know how bad it is'

"Pessimists among the world's central bank governors estimate that more than $200 billion of outstanding international debt is of doubtful or potentially dubious quality. This emerged from a meeting of central bankers at the BIS, at which delegates attempted to assess the degree to which international lending poses a threat to the international banking system. There are widespread disagreements about the extent of the problem, however, and not all those present shared the gloomy view of the pessimists," wrote the London *Financial Times* July 14, on the strength of Bank of England briefings. "The main trouble spot is Eastern Europe, where total foreign debt is $80 billion. But concern now growing about Latin America, with total foreign debt of $220 billion, has been heightened by a disclosure that Mexico has had to draw on its credit line with the Federal Reserve to supplement its meager cash resources."

To this, a Bank of England official added: "American banks are up to their eyeballs in Latin American debt, and no trigger is needed to detonate that. Very soon, the U.S. banks will be presented with a lot of non-serviced accounts. People around the world do not know how bad the situation is as well as we know it. At that point, just one instance of undermined confidence in the U.S. banking system combined with the domestic crisis in the United States, and off they go. Mexico, Argentina, Brazil—they'll go, in that order. Other countries may hurt, for example German banks, or Austrian banks, which are in any event state-owned and must be bailed out.

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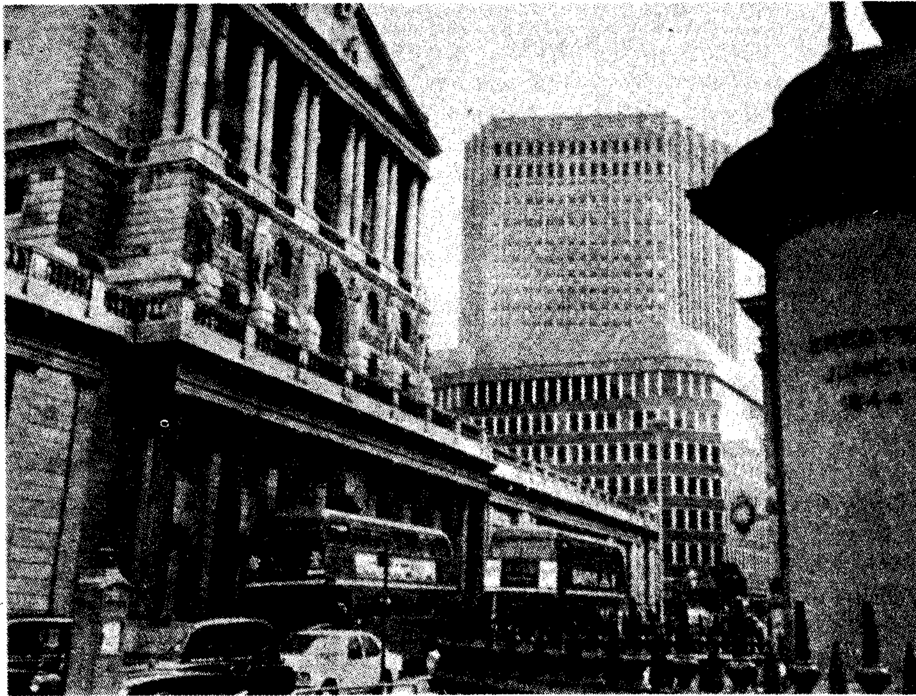

The City of London

"But it is the United States that you ought to watch. It is not a matter of 'European retaliation' against the pipeline sanctions or financial warfare against the East bloc on the part of the United States. That just isn't necessary. The domino effect is automatic. We are beyond the stage of financial warfare, you understand. For the last few years, the United States led financial warfare against Europe, and Europe lost out. The U.S. has got to realize that its interest rates are untenable, and their result is catastrophic. We are probably beyond the point at which things could have been controlled. We'll have to write off the whole debt of the East bloc, Latin America, and many large U.S. corporations."

The Bank of England spokesman added, "Our London banks are much more solid, in a sounder position than banks on the continent." But that is hardly a general view. A senior Swiss monetary official explained that the Bank of England "was trying to scare the central banks into taking more sweeping measures to deal with the crisis because it is afraid that the London market may collapse, and the Bank of England will have to take responsibility for the entire mess. Understandably, they are trying to shift responsibility to somebody else."

Both the British and Swiss statements are true in their own way, but they leave out the main item on the BIS agenda, an American financial commitment so huge that a leak of its contents might subject Federal Reserve officials to suspension from Washington lampposts. The "someone else" that the Old Lady of Threadneedle Street has in mind to pick up responsibility for the London Eurodollar market, still the biggest center of offshore banking, is the Federal Reserve.

Central banks have never agreed as to which one of them would be responsible to pick up the pieces of a failure of a branch of a foreign bank in their country. The Bank of Canada insists, for example, that the New York branches of Canadian banks, which do little but borrow dollars from the New York banks and re-lend them through their Montreal head offices, are not the Bank of Canada's responsibility; since the Canadian bank's New York outlets are chartered under U.S. law, the Bank of Canada says that the Fed must be responsible should any problems arise, which is a more than hypothetical problem. This agreement to disagree, following the collapse in July 1974 of the West German Herstatt Bank, goes under the official name of the "Basel Concordat."

Federal Reserve Chairman Paul Volcker, who led the American delegation to the Basel annual event, set the United States up for disaster in threefold fashion. First, the unabating high-interest-rate posture of the Federal Reserve has put the world monetary system past the point of bankruptcy, as the Bank of England's background discussions correctly argue. Secondly, the Federal Reserve represented the "I'm all right, Jack" attitude toward this imminent bankruptcy denounced by the Bank of England. Playing the insensitive heavy, the Federal Reserve told the gathering that the Fed believed "no crisis is imminent," as a Volcker aide put it. In particular, the Federal Reserve chairman denounced the recent action by European central banks to

assemble a $510 million loan package for Hungary, following the U.S. administration's economic warfare posture towards Eastern Europe. The Europeans believe not only that the United States has endangered their fundamental interests by conducting economic warfare against the Soviets, but that the administration and American banks are intent on instigating a German banking crisis to punish the Germans for lending to the East. This was the subject of the title story in this week's issue of Germany's leading newsweekly, *Der Spiegel,* and is widely believed by German bankers otherwise.

Pumping out dollars

Third, the Federal Reserve has committed itself to swallowing the entire Eurodollar mess. The potential consequences for the dollar may be expressed in simple balance-sheet terms: the present foreign liabilities of the United States government are less than $200 billion, including foreign holdings of U.S. government debt and Federal Reserve notes. Under the responsibility assumed by the Fed at the Basel meeting, these could rise overnight by $1 trillion. As *EIR* has emphasized, at least five-sixths of the Eurodollar market consists of deposits generated through the potentially infinite banking multiplier of the reserve-free Eurodollar market; that is to say, they represent "bank money," rather than "Federal Reserve money." If the Fed steps in to rescue institutions which have lent this bank-created money to bankrupt borrowers, it turns $1 trillion or more in Eurodollars into Federal Reserve money, or U.S. government obligations—at which point the dollar will lose 40 percent of its value or more, according to Bank of England estimates, i.e, fall from DM 2.50 to DM 1.50.

The mechanism under the secret Basel agreement is the exchange of "central bank swaps." That is, if banks in one area suffer a run on their deposits in the "interbank market," i.e., if other banks pull their money out of banks in trouble or suspected of being in trouble, the entire credit system would implode; at least $800 billion of the total $1.7 trillion offshore market consists of such interbank loans. Under such circumstances central banks other than the Fed, which alone has the power to create dollars, would not have the dollars available to replace the bank money that would disappear through the reverse-multiplier of a banking contraction. These central banks, short of dollars, would issue their own IOU's, namely, foreign-currency Treasury bills to the Fed in return for cash dollars. The effect would be identical to the Fed creating dollars by purchasing U.S. Treasury bills on the open market, which is the way in which the Fed (under existing, regrettable arrangements) creates liquidity: dollar hyperinflation, and dollar collapse.

The limit to such an operation is the ability of the fundamentally weak American dollar to bear such obligations; after an initial period of money creation and dollar collapse a banking crisis would ensue in any event, because the dollar would have reached a point of weakness past which the Federal Reserve could issue no further such swaps.

The Ambrosiano case

However, it is doubtful whether the plan will click into motion in any event; it depends on the willingness of the European central banks to play the Bank of England's game. The present near-bankruptcy of the Italian Banco Ambrosiano, whose operations fit in somewhere between the purposes of the Propaganda-2 Freemasonic Lodge (*EIR*, June 7, 1981) and those of the Vatican, is a case in point: central bankers describe its far-reaching global operations as a "classic case" of central bank division of responsibility. It happens that its Luxembourg subsidiary owes $1 billion on the interbank market to City of London banks, in particular National Westminster and Midland Bank. The Bank of Italy has unsuccessfully demanded that the Vatican's financial organization, the Istituto per Opere Religiose (IOR) take responsibility for Ambrosiano, on the dubious grounds that the Vatican IOR had, at one time, issued some guarantees for Ambrosiano funding operations, long since lifted. The Bank of Italy also unsuccessfully attempted to persuade the Italian government to bail out the bank's foreign liabilities, according to Italian press accounts.

As of July 15, a six-bank consortium has agreed to stand by Ambrosiano's domestic Italian operations, and the Vatican—with an eye toward developments in Latin America—has agreed to support the operations of the bank in Argentina and Venezuela. No one is backing up the Luxembourg operation, through which Banco Ambrosiano assumed all of its interbank debt! The British are beside themselves. "This is a holy raving mess," said a source at a London bank which handles Ambrosiano's clearing operations. "If the Italian government doesn't change its hard line on bailing out Ambrosiano, there could be a general crisis of confidence." Italian press accounts say that both National Westminster and Midland could fail as a result, probably a vast exaggeration of the *direct* impact of an Ambrosiano failure, if not of its ultimate consequences. European banking sources describe Ambrosiano's payments status to its banking creditors as "a moratorium."

The result could well be that the Bank of England spoke truthfully about the banking system in general, and the Swiss official quoted above about the British in particular.