For example, various East Bloc countries tried to reduce their borrowing at the end of 1976 and during the first quarter of 1977. But seeing that this was impossible without impairing their economic growth, they have restarted borrowing again— and the amounts borrowed have doubled between the first and the second quarters of this year. Moreover, Poland and the USSR, which have the most dramatic need for credit, have now to rely heavily on short-term bank credit. The case of Turkey is worse: it has based its industrial development on short-term bank credit (convertible accounts in Turkish lira) and is now unable to service its debts— except by borrowing more.

Another token of credit-for-rollover needs is the situation of the U.S. bond market. Foreign bonds issued in the U.S. reached $1.3 billion during the first quarter of 1977 and $2.1 billion during the second quarter. Despite the increase, the total was 40 percent inferior to that of 1976. But in July only $1.2 billion foreign notes were issued on the market — much more than than in 1976.

To meet those new requirements, the money supply has been drastically increased in the U.S., and now interst rates have been raised to save the dollar.

The banks are therefore facing the following dilemma: on one side, their cost of borrowing is increasing despite overflowing liquidities, while on the other side a new round of bankrupt borrowers is coming back to the markets and pressing for low interest rates.

Burns Tries To Save New York Banks; Ruins The Dollar

While Treasury Secretary Blumenthal has been lashed for the last month in the international press, with some justice, for destroying the dollar, Federal Reserve Board chairman Arthur Burns has been quietly and deliberately acting as the real force bringing on the dollar's downfall.

Since the beginning of this year, Burns and his Wall Street cohorts have been rushing to plug the widening holes in the badly leaking New York banks' real asset picture, using any means at their disposal, no matter how illegal or damaging to the nation's economy and credit.

Under Burn's direction, two complementary strategies have been followed. First, with Burns' active approval, the largest New York commercial banks have violated sound banking principles — and perhaps several laws — to transfer huge volumes of deposits from domestic accounts at their New York head offices to their foreign branches. Between January and August, a net swing of $12 billion of liquidity of the ten largest New York clearing house banks has been effected. Second, beginning approximately June 1, Burns started a policy of pumping federal funds into the accounts of the Wall Street banks at artificially cheap prices.

The net effect of these policies: the deposits and federal funds have been pumped into the Eurodollar market. There, unencumbered by reserve requirements, they have been re-lent several times over to prop up the swollen book value of New York's bank loans to notably over-indebted Third World countries.

Why the Money Supply Has Shot Skyward

The most immediately visible of the Burns' solutions to save Wall Street has been manipulation of the federal funds rate by the Federal Reserve's Open Market Committee (FMOC).

Since June 1, the FMOC has been making increasingly heavy purchases of Treasury Securities in order to hold down the rate at which banks borrow money from each other — the federal funds rate. Until the first week of August, the FMOC kept the federal funds rate for the two previous months to between a narrow range of 5.3 percent and 5.4 percent. Consequently, for the month of July, bank reserves increased at a stunning 18 percent rate, and since June 1, the monetary base has grown at an annual rate of 12 percent.

But this easy-money policy immediately reverberated throughout the economy, pushing skyward the monetary aggregates, which strongly reflect the amount of new reserves pumped into the economy. According to the latest Federal Reserve weekly figures, M1, consisting of currency in circulation and demand deposits, has been growing at a staggering 18.5 percent rate for the last four weeks, and M2, consisting of M1 and savings deposits, has skyrocketed at a 12.9 percent rate for the last four weeks. The eight-week averages of these aggregates have been equally high.

Business Week senior editor Bill Wollman, in an Aug. 15 commentary in that magazine, titled "Has the Fed Made A Costly Blunder?" points out that "the Fed has been indulging in a binge of money creation that ...threatens the world economy with sharply higher prices, soaring interests rates and unstable currencies." "Why did the Fed indulge in a cheap money policy" which is clearly so destructive, Wollman asks.

The answer has nothing to do with the domestic economy. By holding the federal funds rate low, the Fed kept the New York banks flush with a supply of cheap and abundant funds. Because of the highly competitive conditions existing in Europe, which have lowered the bank spread between obtaining and lending funds to 1 percent interest, the Fed policy gave the New York banks an extraordinarily important marginal advantage in the price they paid for funds.

And borrow Fed funds the New York banks have done, in record amounts. By the week ending Aug. 3, the ten largest weekly reporting New York commercial banks had a cumulative purchased position of over $20 billion in federal funds, more than 15 percent of their total liabilities! No other regional group of banks even approaches this figure.

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New York Banks Deplete Their Domestic Deposit Base

The Burns-FMOC manipulation of the Fed funds rate intersected the other half of the strategy to bail out the New York banks, which began in early January. This complementary strategy centered around shifting domestic deposits of New York banks to the banks' foreign offices, leaving the U.S. economy, especially industry and agriculture, high and dry for funds.

In the first quarter of this year, while Third World commodity prices were still artificially jacked up to peak premium price levels to facilitate Third World debt repayment, Europe began to experience need for funds to finance Third World import purchases.

To accommodate this call on funds, the ten largest New York banks began their major transfer of deposits operation. Between Jan. 12 and Aug. 3, total net domestic deposits of the ten largest New York commercial banks declined $6.7 billion, while in approximately the same time span, these New York banks' deposits into their foreign branches increased $6.7 billion — a net swing in liquidity of $13.4 billion. Most of this transfer of funds occurred by April 12, according to New York Clearing House Association figures.

This transfer having achieved its purpose, by the end of the first quarter, the demand of industrialized OECD nations for funds slackened off, coinciding with the late-March break in the commodity-prices bubble, and by a drop in the volume of bond issues placed during the second quarter. However, by the end of the second quarter, Third World and weaker-OECD nations' demand for funds began to escalate again, exemplified by the leap in July figures of foreign bonds placed in the U.S. of $1.2 billion.

As the outlines of upsurge in renewed borrowing became evident, Arthur Burns swung into action, starting in June, by artificially depressing the federal funds rate, and swamping the banking system with reserves.

Burns Strategy on the Rocks

In the midst of Burns' Grand Financial Manipulation, a number of danger signals converged into an outright crisis. First, the U.S. ever-widening trade deficit reached $12.59 billion by mid-year, according to Commerce Department figures which were ominously released July 27.

Second, various European forces, intent on breaking with the dollar, used the opportunities presented by the underlying weakness of the dollar to begin a series of anti-dollar raids, signalled by Britain's break from the dollar July 27, and the strong Swiss-French-Arab axis move into gold. At the same time, a number of alarmed U.S. industrialists, who saw double-digit inflation on the horizon, let out squeals of concern.

With the Aug. 4 release of money-supply figures showing M1 growing at nearly 20 percent, Arthur Burns was forced to pull in his horns. By Aug. 5, the effective federal funds rate had been yanked to 5.80, a leap of 40 basis points in one week.

Burns still hoped to carry on his strategy in a limited fashion by forcing German and Japanese reflation, which would offset the effects of U.S. inflation, by generalizing inflation world wide, and allow the U.S. not to tighten the Federal funds rate any further.

However, on Aug. 10, the Bundesbank rejected Burns' "magical stimulative medicine". In immediate response, on Aug. 11, the Fed executed two large repurchase agreements, sending the federal funds rate one eighth of a percent higher. Several financial analysts, including Donald Maude of A.G. Becker, are predicting a 6 percent federal funds rate by this coming week, the highest rate in a long time.

Further, on Aug. 11, the Eurodollar rate, moving in tandem with the U.S. federal funds rate, rose one eighth of a percent to six and one-half percent, and is expected to go to six and three quarters by the end of August. The Dow Jones Industrial average of the New York Stock Exchange proceded to fall 9.6 points Aug. 11, closing at 877.43, its lowest level in 19 months.

Who's Going to Survive the Embroiled Bank War

The explosive unraveling of Burns' grand strategy to save the New York banks brought up the question among bankers in its sharpest form: who will survive?

The raising of the federal funds rate has the strongest implications. According to a spokesman for the Union Bank of Switzerland, many banks are now borrowing short-term three to six-month money and lending long-term — for as long as 8 to 10 years in some cases. The rapid increase of short-term rates will lead some banks to take a bath.

Precisely this view, according to a Robert Loverd of Kidder, Peabody, has divided even top-level banks into a three-tier system. The first-tier banks, says Loverd, will get slight benefits, as the second and third tier banks will have to pay marginal but decisive premiums for their funds. Some second and third-tier banks will not survive long.

Indeed, a terminal case has very quickly matured in the United States between the two bankrupt New York giants, Chase and Citibank. While in the first seven months of this year, Citibank increased its overall net domestic and foreign deposit base (which can be put to supporting its share of bad loans) by $3.5 billion, Chase Manhattan's overall net deposit base declined by $2 billion. Citibank effectively gained a $5.5 billion edge over Chase. According to one analyst, if Chase loses some of its critical Latin American depositors, it could suffer a rapid bankruptcy, with Citibank coming out of the depression alive if not intact. The remainder of the international banking community has become acutely attuned to these possibilities.

— by Richard Freeman