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The dollar bubbles

In the dollar sector of the international markets, "risk avoidance" has meant a dangerous bidding up of short-term Eurodollar bank deposits, as corporations and institutional investors, especially in the United States, rush to London to place their funds for six months at 11 percent. This has meant, temporarily, that the dollar is very strong. There is also a lot of liquidity, but it is extremely inflationary, since investors are demanding higher rates. While three-month LIBOR has held "meta-stable" around 10.5 percent, the medium maturities have risen inexorably; six-month Eurodollars have steepened from 11 percent to 11 3/16 over the week.

The effect on the international bond market has been electrifying: long-term instruments such as the $200 million Dow Chemical issue in London, priced at 99.5, are trading in the 96 range; Honda's $50 million 10-year convertible, priced at par, fell as low as 94.5. Unlike previous weeks, foreign exchange rate considerations have nothing to do with it; the Euro-DM and Euro-Swiss sectors are equally depressed.

Worse, the effect is very direct on Japanese and German mobilization of their own dollar reserves. The Bank of Japan reports that while it will be able to continue the same volume of cheaper dollar deposits to Japanese banks, the banks have already had to cut their overall world dollar lending by 30 percent in January from the $4 billion October to December level. The intense competition and high interest rates in the Eurodollar market, where Japanese banks get the majority of their dollar deposits, is to blame. The Japanese authorities fear the return of a 1974-style London "Japan rate" surcharge on their Eurodollar borrowings.

Finally, this bid-up of dollar deposits cannot go on forever. If it continues, "at some point, long-term prices will fall so far that no one will be willing to sell their bonds," a New York investment bank source said March 1. "Liquidity will disappear from the short-term market and the dollar will be in for a real fall." Chaos will hit the currency markets.

Given this ominous scenario, it might seem that Keynes's ghoul might indeed strangle the EMS. As an official in the European division of the IMF stated, "We have been warning for over six months that the inevitable rise of oil and world commodity prices coupled with runaway government spending and inflationary psychology will make the functioning of the EMS quite difficult if not impossible."

—Kathy Burdman

CREDIT MARKETS

U.S. credit markets are moving to the short side

U.S. banking liquidity shrank further this week under the impetus of Federal Reserve Chairman G. W. Miller's campaign to dry out bank lending to U.S. industry and agriculture, using sharply increased interest rates.

For the week ending Feb. 14, nationwide U.S. commercial and industrial (C & I) loans rebounded upward $960 million. However, since the high point of November 1978, C & I loans have dropped nearly $2.0 billion. Pacing this drop is the fall in large placement of negotiable Certificate of Deposits (CDs) into the banking system. On an unadjusted basis, large scale CDs fell to $99.4 billion from a high of $101.4 billion just three weeks ago.

At the heart of this liquidity shift is the fact that higher interest rates combined with a series of scare rumors is forcing various investors and buyers onto the shorter side of the U.S. credit market.

Exemplary of this process is the stupendous growth in commercial paper, which represents 30-to-270-days promissory notes. While U.S. banks are losing the industrial portion of their C & I loans, corporations are going to the commercial paper market which offers cheaper short-term rates. For instance, in a recent week, the interest rate on 30- to 60-day commercial paper ranged from 9.63 percent to 9.98 percent, while the banks were charging their best prime customers 11.75 percent plus bank balances.

This shift in U.S. banking liquidity, if it becomes more pronounced, will strike at a particularly bad time. The threat of the oil shortage hoax with an accompanying increase of oil prices and a run-up in raw material prices, would force panicked investors even further onto the short side of the market, just at the time when more liquidity is needed to finance energy and raw material price increases.

— Richard Freeman

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