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Squeezing into a British corset

For years U.S. businessmen have looked on with horror at the perpetual state of crisis on the British financial markets, where credit rationing and a high interest rate floor have permanently crowded industrial corporations out of the capital markets and sent interest rates on the Exchequer's "gilts" through the stratosphere. Now, following Federal Reserve chairman Volcker's recent adoption of the British "corset" approach to monetary

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policy, businessmen in the U.S. can look forward to the same conditions.

The Financial Times of London was among the first to applaud the Fed's new credit crunch package as "a considerable revolution in U.S. monetary policy," a needed change borrowed from the "British experience." In its lead editorial Oct. 8, the newspaper specifically hailed the imposition of marginal reserve requirements on new "managed liabilities" (above a September base period) as an adoption of the British "corset" controls. According to its press release of Oct. 7, the Federal Reserve will now impose eight percent reserve requirements on new Eurodollar borrowings by U.S. commercial banks, the banks' repurchase agreements with the corporate sector, and other liabilities with which U.S. commercial banks have been financing domestic credit expansion in recent months. The Fed's new emphasis on corseting the growth of the monetary aggregates and monetary base, no matter how high inflation goes, is also standard Bank of England practice.

The U.S. adoption of this policy means a precipitous constriction of short-term credit availability, escalation of short and long-term interest rates, and a self-feeding crisis of the lending institutions themselves.

Thomas Synnott of U.S. Trust said in an interview last week that the Fed is aiming for a decisive credit crunch three to six months hence. Short-term borrowing rates—which are already in the 15 to 18 percent range for non-prime corporate customers—will continue to escalate for several weeks until they choke off credit demand. Interest rates, under the scenario, will then subside.

According to Synnott, the Fed's new strategy is to constrict the growth of the monetary base—bank reserves and currency in circulation—which is the basic measure of credit supplied to the economy through the banking system by the Federal Reserve. Over the last three months the monetary base has been growing at a 12 percent annual rate. "The Fed will bring that growth down to the two to three percent range—preferably zero—between now and the end of the year," Synnott believes. This would balance out to a six percent growth rate of the monetary base for the entirety of 1979.

A contraction of the monetary base that severe means an even sharper contraction of short-term loan expansion—a collapse from the current 20 percent annual rate of expansion down to a five percent annual rate for the rest of the year. In the process, all but the banks' regular prime customers face a credit cutoff. The imposition of marginal reserve requirements on the banks' incremental Eurodollar borrowings and other deposits which have been the principal source of new liquidity for the U.S. economy recently will make the banks think twice about making "marginal" loans.

If interest rates do not begin to ease within the three to six week time frame, U.S. Trust's Synnott and other analysts believe the savings bank industry will be in deep trouble.

The savings banks and savings and loan institutions are already caught in a tightening squeeze between the interest earned on their assets—principally fixed-rate mortgage loans—and paid out on their high cost deposits. The president of a major New York City savings bank told EIR last week that his bank earns only an average of 8.08 percent on its assets. Fifty percent of its liabilities are high cost time deposits, a sizeable proportion of which are the new money market certificates, which now carry an interest rate in excess of 11 percent. "Sure our earnings are being squeezed. But if we were to stop paying those rates, we'd lose the money and be forced to retrench our lending activities even further. Some of our counterparts are running negative earnings. I foresee a period of heavy merger activity in the savings bank industry." He added that most of the money coming into money market certificates is coming out of 5 percent savings deposits.

Abraham Serfaty, economist for the Savings Bank Association of New York State, foresees an even bleaker period ahead for the savings banks and thrift institutions. Mr. Serfaty stated that he believes the intended effect of the Fed's new credit restraint package is to accelerate disintermediation—the flight of money out of savings deposits for high-yielding money market instruments like Treasury securities and the money market certificates now issued by the savings banks themselves. "Part of the point of the package is to slow down the housing market." He predicts that housing starts will fall to 1.5 million units for the year.

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Most analysts believe that the savings bank industry as a whole is liquid enough to meet anticipated outflows through the sale of short-term assets. The savings banks in particular—which have greater flexibility than the thrifts in where they can invest—built up an ample cushioning of Treasuries, Federal funds, commercial banks certificates of deposit, and other short-term assets as a hedge against eventualities like the present.

The pressure on savings banks to liquidate these assets combined with equal pressure on commercial banks to liquidate treasuries and bonds to satisfy loan demand—and forestall bankruptcies of their debtors—will feed the interest rate spiral and intensify the problems currently facing these lending institutions. The liquidation of Treasury securities and bonds intersects an exceptionally heavy fourth quarter borrowing by the U.S. Treasury and hefty pent up demand for long-term funds by corporate treasurers. The prospect of heightened competition for long-term funds between the Treasury and corporations contributed to the 400 basis points plunge in the corporate bond prices in the three banking days following Volcker's momentous announcement Oct. 6.

The Treasury, which bet on rates peaking by the fourth quarter, must finance some $15 billion in new cash needs by the end of the year, in addition to refunding more than $5 billion in maturing securities.

Corporate treasurers who have been taking on short-term debt at near record amounts since the beginning of the year—expecting that interest rates would ease later in the year—are now under great pressure to shift their borrowing to the long-term market. However, look at the experience of top-rated IBM Corp. last week.

As was well publicized, IBM's $1 billion financing ended with the biggest underwriting loss in history last week.
high as $30 million was suffered by underwriters who got stuck holding unsold securities when the bond market went into its slide.

One inside source revealed that the loss was even more of a disaster than the public realized. The much favored IBM issue, which had reportedly sold $800 million of the $1 billion offered by early last week, had only sold $500 million. The rest was unloaded by the underwriters through illegal swaps for Treasury securities. The cancellation of this dubious business by a senior partner of one of the leading underwriting firms broke up the syndicate on Oct. 10 and left the bonds selling at 94.5 percent of par.

—Lydia Schulman

Volcker's 'little depression'

Several New York City money center banks told the *Executive Intelligence Review* this week that they and their Fortune 500 industrial borrowers will escape the effects of a credit crunch initiated by the sharp tightening of domestic credit this week by Federal Reserve Board chairman Paul Volcker. "Consumer installment credit and the housing market will be hit by Volcker's move," a Citibank official stated Oct. 10, "but the

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larger-sized companies will not be much affected." He added that "this country can use a strong dose of Volcker's medicine."

A review of U.S. corporate liquidity and sales reported for the first nine months of 1979, however, demonstrates that the force of Volcker's actions will bring down the entire economy, and will not spare the large companies which imagine themselves safely sheltered. In short, the U.S. economy is too interconnected for one section of the economy to collapse without other areas being seriously damaged. Volcker and the New York City banking community's conceit, that they can run, in their own words, "a controlled disintegration of the U.S. economy," is rooted in wishful thinking.

Investment

Indeed, the very financial sections that Volcker proposes to triage first, housing and auto credit, are precisely those, as every analyst will admit, which have kept the economy from visibly plunging into collapse for the last 24 months.

A credit crunch will very likely force a repeat of the 1973-'74 U.S. depression, when unemployment rates hit 8.5 percent, industrial production collapsed by more than 10 percent, and inflation continued rising, not falling. The British Broadcasting Corporation, in heated anticipation of a U.S. collapse, nonetheless accurately tagged the huge Oct. 10 panic in the stock market following Volcker's tightening: "The only difference between now and 1929 is that now there are no bodies."

Corporate liquidity is not good

Volcker raised the discount rate to a record post-war high of 12 percent, allegedly "to halt inflation and bank