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Capital Markets

The anatomy of a Euromarket crash

by David Goldman, Economics Editor

Basel-based central banking sources, who declined to be identified by name or institution, report an extraordinary shift in the marginal movement of funds in the $1.7 trillion Eurodollar market, the market for claims on American dollars or other currencies held outside their national markets. During the two years following the late-1979 doubling of oil prices, what Europeans call the "second oil shock," the investible surplus of the Arab nations poured into the Eurodollar market. Deposited in Eurodollar banks and later re-lent as Eurodollar loans, these OPEC surpluses (or spare cash after payments for imports) to a certain extent compensated for the immense burden the higher oil prices had placed on the world's poorer nations, including both the developing sector and the less-well-off nations of the industrial world.

In 1980 the surplus peaked at $110 billion, and is estimated to have been in excess of $75 billion last year; the average surplus for 1980-81 was, to give an idea of the importance in world financial balance, about equal to the average deficit of the developing nations (in the International Monetary Fund's definition for the same two years). That is not to say that the OPEC surplus as such was lent to the developing nations, but that it increased the deposit base of the Eurodollar market to roughly the same extent that the lending requirements of the market grew with respect to the deficits of the underdeveloped nations.

As *EIR* has reported, and has been widely discussed, the OPEC surplus will dissolve this year due to the halving of demand for OPEC oil from peak 1979 levels and the drop in the oil price; starting in the last half of 1981 no further OPEC contributions were available to the Eurodollar market, and bankers in European money centers report substantial net withdrawals from OPEC depositors. Various monetary authorities have been asking why, in fact, the Eurodollar banks have kept lending, and why the entire underdeveloped sector has not gone bankrupt. Apart from politically originated problems, such as the current Argentine situation, the Third World has been borrowing essentially all the debt payments it makes back to its creditor banks.

The recycling process has broken down on two grounds, central bankers with access to detailed information on the state of Eurodollar activities report. First, the surplus is no longer there; and secondly, the banks which had been absorbing the surplus and re-lending it are no longer willing to do so. After the November 1979 American seizure of Iranian assets, Arab depositors began to avoid putting new funds into American banks, preferring Arab banking institutions, which rapidly became a major force on the international markets as a result, and Japanese institutions, who underwent their biggest growth period since they first entered the Eurodollar arena. That is far from saying that the Japanese or Arab institutions took all the risk of "recycling" Arab deposits back to Third World borrowers. Much of the primary OPEC deposits they received were off-lent, through the interbank market, to American institutions. Nonetheless they became the decisive force in lending to the underdeveloped sector during 1980.

Now these institutions have pulled back sharply. "It is not so much a matter of whether the Arab dollars are there or not," one central banker said. "Rather, the point is that no bank will now lend good Arab dollars to already bad debtors." Specifically, the Japanese and Arab institutions stopped lending heavily, while the Germans pulled back substantially. A director of one large German bank said, "It doesn't matter to us whether our central bank tells us to stop lending to the Third World or not. We're stopping on our own." A Swiss regulatory official says that Swiss banks have been virtually out of the market for new loans to developing countries for the past two years.

U.S. funds replace OPEC's

The entire difference has been made up, unbelievably, by the large American banks, the same institutions who have cried most loudly during the past two years that they cannot afford to keep increasing their exposure. Despite warnings from senior Federal Reserve officials, including repeated admonitions from Federal Reserve Governor Henry Wallich, the American banks put an aditional $30 billion net into the Eurodollar market during the second half of 1980, replacing the flow of OPEC funds lost, according to a top central bank economist working out of Basel. "This represents an enormous amount of credit creation from the United States, and an enormous risk," the official added. The flow has continued at roughly the same rate during 1982 so far, preliminary data are reported to indicate.

That the United States should become a massive exporter of capital at a point when its own internal demand for funds has grown enormously, due to both corporate as well as government deficits, is all the more extraordinary. "The United States, however, has a two-tier credit system," the central banker explained. "Even

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though many traditional credit users are starved for funds, the major money-center banks are continuing to export loans, as a result of the severe and continuing recession. As for the federal government, it will have to be financed through the recession, which eliminates credit demand in the economic base."

From the balance sheet standpoint, such continuing commitment to financing the Third-World-Lending side of the Eurodollar market might appear to be an act of pure insanity. The Eurodollar banks will have to write off between 3 and 4 percent of their total balance sheet during the next few years, according to a highly sophisticated estimate made available by central banking sources to *EIR*. However, the capital cover of the Eurodollar banks, including that assigned to foreign branches and subsidiaries by American banks, represents less than 1 percent of their balance sheets. Whenever the ice-dam breaks, the banks will be shown to be bankrupt. That the American banks, the most exposed of all the national banking sectors, should increase their exposure is a matter of great surprise. That it has passed without comment, thus far, is not difficult to explain; rather than syndicating public loans, the banks are simply lending short-term funds to debtor countries to enable them to roll over old debt service payments.

However, short of letting their debtors default, the banks have no choice but to continue financing them. The only really remarkable thing is the extent to which the American banks have been left holding the bag, as befits senior creditors. Since the Federal Reserve is not adding sufficient reserves to the banking system to finance the operation through traditional banking means, the Eurodollar banks are applying the equivalent of what is called "creative financing" in the Eurodollar market to this problem. That is, they are manufacturing money out of thin air.

Take the following hypothetical example: Brazil owes Citibank $100 million, and can't pay. Citibank goes onto the interbank market, the market for funds between commercial banks, and bids for $100 million in deposits (which Citibank could obtain in about 20 minutes). It then lends these funds to Brazil for six months at 1.5 percent over its own cost-of-funds, or London Interbank Rate (LIBOR). Brazil immediately pays the $100 million back to Citibank, which then repays its depositors. On paper Citibank may even show a profit, although the whole operation represents what Adam Smith, in his day, fondly called "kiting of cheques."

'Kiting cheques'

Of course, no such soap-bubble can go on forever; when the banks' political pressures on Third World nations to reduce their imports to free up funds for debt service, an exercise which central bankers admit freely cannot produce substantial amounts of money, go overboard, political crises erupt, and debts stop being paid, as the Argentine crisis appears to threaten. At this point the banks cannot keep "kiting cheques," and can do one of three things:

1) close their doors;

2) persuade the central banks to buy their utterly worthless paper from them at something close to par value; or

3) declare their own debt moratorium.

The third option has attracted considerable attention in the past several weeks. American bank management is considered stupid, but not stupid enough to ignore the sort of elementary tricks that every garment-center operator who has gone bankrupt in favor of his brother-in-law knows. In this case the following scenario is under review at a number of leading regulatory institutions: The American banks book loans to the Third World not though their head office but, say hypothetically in the case of Chase Manhattan, through a British bank, Chase Manhattan, Limited of London, which happens to be 100 percent owned by Chase Manhattan. Whether Chase Manhattan, Limited is in fact a branch of Chase Manhattan, or merely a British Bank in which Chase has an investment, is a question that is easily answered in fact, but not easily answered in a court of law.

The American loans, done through various such "investments" in banks in London, or the Cayman Islands, or heaven knows where, would be funded through the interbank market, as noted above. The banks would not be so stupid as to put their best deposits from their best customers, say Exxon in the case of Chase Manhattan, onto the books of the same subsidiaries who hold the worst loans, say to the Third World. Exxon's deposits would be held in New York, presumably at the "International Banking Facility" Chase set up late last year. Should the Third World bubble go, Chase would regretfuly write off the capital it invested in its foreign subsidiary which fell victim to the bust, a negligible sum, and regretfully announce that it could not take responsibility for its deposits! The possibility for such a chain reaction collapse of the interbank market was a major theme of the Bank of England's September 1981 *Quarterly Review*.

A senior official of Chase Manhattan, Limited in London, who asked not to be identified, said, "Technically we could indeed do that, but it would be immoral and unethical."

The result would be, however the technicalities worked themselves through, the elimination of an international market for lending as such, and retrenchment into national markets linked through heavily controlled exchanges, something like central Europe in the 1930s, with devastating consequences for world trade.