

tween banks, much of it re-lending of the same original loans, but ultimately lent out to non-bank borrowers who cannot repay the principal value of those loans on demand. An informal boycott of suspect banks began with the Luxembourg-Ambrosiano affair; many foreign banks, as well as Canadian banks, are now surviving by borrowing funds from American banks at exorbitant spreads. Typically, big American banks will issue holding-company commercial paper, to re-lend the proceeds at half a percentage more interest. "We are far from the point where this banking arbitrage has reached its limits, but we are monitoring the situation daily," reports a worried Fed official. Despite the temporary solution of the Mexico program, the situation for the suspect banks is getting worse, not better. Mexico might tell the IMF, "We may not survive this crisis, but neither will you," at any moment, and there are Argentina and Brazil still to be dealt with. Even Chase Manhattan, Bank of America, and other large banks had trouble marketing their certificates of deposit upon the breaking of the Mexico crisis.

The default of a major bank, following the Ambrosiano-Luxembourg model, is perhaps even more dangerous for the market than a default of a major country, since its example would cause a general run against banks deemed similarly weak. At this point the demands against the fire brigade at the Federal Reserve would run out of all proportions, and the Euromarkets would disintegrate.

### 'Pushing on a string'

"It is impossible to tell how long we can go on creating high-powered money under conditions of debt-deflation," a senior Fed staffer commented. "Modern economic theory has no tools to deal with this; you have to move into 'catastrophe theory' to ask, 'When does the bubble burst?'" The problem is known in economic jargon as "pushing on a string," i.e. what the Fed was reduced to during the 1929-33 period: When lenders are convinced that their debtors are past saving, they will not lend no matter how much new high-powered money the Federal Reserve injects into the banking system, or how far interest rates fall.

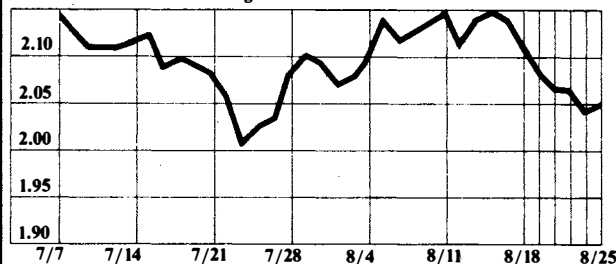
History-minded observers will not, therefore, take the central banks' commitment to "bail out the Euromarket" at face value. There is no way to stabilize the financial system without measures to revive world trade and investment, the opposite of the austerity program associated with the supposed bailout. The final step of the program would put the Fed, its balance sheet ballooned out of proportion, in the same position as Mexico, beholden to the International Monetary Fund for financial aid.

Since advisers to Secretary of State Shultz speak frankly about a change in the Mexican constitutional system, the inference is not hard to make that the authors of the bailout proposal have few illusions that it will succeed on its own terms: They expect, however, that it will give them time to flatten whatever opposition now exists to their hopes for picking up the pieces when it fails.

## Currency Rates

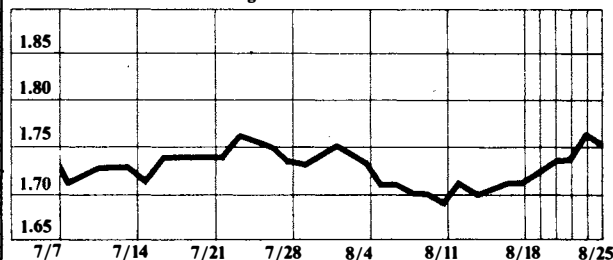
### The dollar in Swiss francs

New York late afternoon fixing



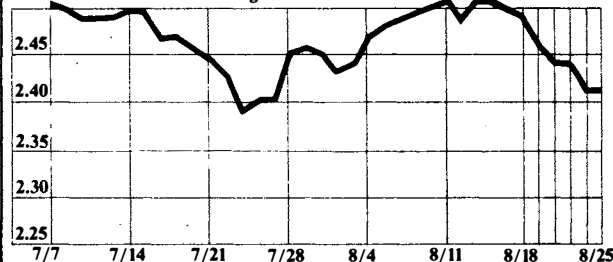
### The British pound in dollars

New York late afternoon fixing



### The dollar in deutschemarks

New York late afternoon fixing



### The dollar in yen

New York late afternoon fixing

