Foreign Exchange by David Goldman

Liquidity squeeze buoys dollar

But the big question is, how long can the U.S. economy be kept from collapsing due to a run on the entire banking system?

In Frankfurt, the dollar rose on Friday to an official price of over 2.98 Deutsche marks at the fixing, up from 2.8803 marks before the weekend, its highest fixing since February 1973.

Unquestionably the strategic background, i.e., the cancellation of East German premier Honecker's much-heralded visit to West Germany, prompted some of the mark's weakness. However, the dollar was universally strong. The dollar's exchange rate has, perversely, become a reverse index of liquidity availability in the Eurodollar market.

Although the dollar may come off some from such giddy heights, tight rates, a firm dollar, and weak metals could persist for a space, as long as we have the current "walk" on certain U.S. banks, rather than a "run" on the system.

As we pointed out soon after European depositors began to walk out of Chicago's Continental Illinois, depositors were leaving the bank faster than the Federal Reserve was providing it liquidity. Losing deposits at a rate of $5 billion a week, Conti was forced out of the Eurodollar market during May, and all American banks had to pay exorbitant rates to try to attract replacement dollar deposits—which drove up Eurodollar rates. That situation, plus foreign exchange speculators who joined in buying the dollar, caused the big breakdown in metals prices in June.

That is, there was a "walk" on one bank, and funding difficulties for foreign branches of American banks, but not a general run on the entire U.S. banking system. Had there been, the Federal Reserve would have been forced to flood the system with cash. As long as Volcker did not actually open the floodgates, the banks' search for funds kept rates and the dollar tight.

No sooner was Continental nationalized than a similar "walk" began on Los Angeles' Financial Corporation of America (FCA), which has $15 billion in uninsured large deposits maturing at the end of September and is willing to pay exorbitant rates to attract dollars.

Then, as *EIR* reported in a previous issue, New York's Manufacturers Hanover itself was said to be losing deposits and borrowing at the Fed, perhaps as much as $4 billion. By the Aug. 29 reporting date, New York area banks' borrowings at the Fed were down again to zero, but that doesn't mean that Manufacturers Hanover isn't having problems.

In fact, a New York banking source said Friday major banks are planning to declare Argentina "in default." Manufacturers lost $21 million in June in Argentina.

The only way to get Argentina to the IMF is "shut off the money," he said. "To say 'You've not been good boys, so we won't buy you a sucker.' Nobody's going to give them any more money unless they take steps to cure their own acne. . . . The law is the law. Once the loans are 90 days past due, you have to write them down."

A top Wharton School consultant to the banks yesterday confirmed the report, noting that "several major banks" including Manufacturers are planning to write off more of their loans to Argentina during the September quarter. That is, the banks plan a calculated risk, as they did in June, that they can avoid large losses later by taking limited losses now.

In September, most large banks already wrote down 20% to 40% of their Argentine loans in the June quarter as "non-accruing," he said, "and they will continue writeoffs. They will write off 10% more, 20% more, and 30% more in December. They are going to write off Argentina entirely.

"Why? Because the more the banks declare Argentina's loans to be non-performing, the weaker the position of the Argentines is. Argentina's negotiating position was based on the consequences of Argentine default on U.S. banks.

"Now the banks can literally answer: 'Fine, don't pay! I don't care.' The moment you have made the write offs, it doesn't matter if they pay or not."

Citibank has meanwhile bought $900 million in insurance from a group headed by the Pennsylvania insurance giant Cigna, according to information released in papers filed with the SEC (see Business Briefs).

The question is, how long can Volcker "contain" the problem to a deposit outflow on one or two banks at a time? The challenge to Argentina supposes the banks can contain their Argentine losses again in the September quarter, and thus contain the deposit drain on the system. That is a real gamble. At a certain point, too many bank assets can go rotten simultaneously—and too many banks could suffer an actual run on the entire system.

As reported in this space last time, most sophisticated European money is betting that such a general run on the banking system, with attending consequences for the dollar, will occur sometime soon after the American elections in November.