The January industrial production figures showed an ominous 3 percent decline, but the government appointed commission on investment backed up Barre's public-private investment proposals for key sectors by advising that funds be guided from speculative real-estate into productive equities. The franc, of course, is not formally in the snake, but as *Le Figaro* pointed out, its health is a key to the prosperity of Franco-West German trade and thus to European growth.

The Germans Will Give In

The following is an interview with an official in the State Department division of monetary affairs, Feb. 19, provided by a free-lance financial journalist:

Q: I understand there is a good deal of State Department concern about the effects on our allies of Mr. Solomon's statements in Paris. In fact, sources have told me that they're convinced Blumenthal and Solomon are deliberately trying to create a breach between the U.S. and West Germany, and that's why there was a special State-Treasury meeting yesterday.

A: I wasn't at the meeting — there may have been some words from Dick Cooper to Blumenthal about Tony's putting his foot in it, but there is total agreement between State and Treasury on the specific issue of intervention. The policy is that under floating rates, there's no way to keep the dollar from continuing to go. What Solomon is saying is that we will continue to intervene to prevent large jumps in thin markets.

Q: There are reports that after Blumenthal's visit, West Germans are saying, forget it, if you won't actively support the dollar we'll have to gear up for trade war.

A: Eventually the U.S. may not have much choice about protectionism. But I think at a certain point the Germans will give in on reflation, when the unemployment is bad enough. There's been so much international pressure, they want to save face at the moment.

Publicly the Carter Administration has always been against protectionism, it is not our first option, but...

Battle Over World Credit Markets As U.S. Banks Decline

A recent report of the Bank for International Settlements (BIS) concerning Eurocurrency market development in the third quarter of 1977 has revealed a major shift in the pattern of world credit flows. For the first time since controls on U.S. capital exports were lifted in 1974, banks in the U.S. have emerged as net borrowers rather than suppliers of funds to the international markets.

BANKING

This startling development reflects both the severity of the dollar crisis — as foreign investors ran down their deposits at banks in the U.S., forcing U.S.-based banks to import funds from their offshore branches to shore up their positions — and the reduced share of U.S.-based banks in international lending activity. Moving into the breach were banks in the London and Luxembourg Eurocurrency markets, which accounted for the lion's share of international credit expansion during the third quarter and attracted the bulk of the new deposits.

In a nutshell: several tens of billions of dollars of deposit and lending activity have shifted from New York to London, from the domain of the Federal Reserve to the domain of the Bank of England. There are several, interconnected reasons for the shift, which is the most dramatic development on the international markets of the past year:

1) The profit-squeeze on international lenders due to the collapse of spreads on syndicated Eurocredits, much publicized over the past months, has compelled American banks to conduct a greater portion of their activity without reserve requirements that apply in the domestic market in order to compensate.

2) Fear of capital controls has kept a marginal, but important stratum of depositors leery of keeping balances in New York — although for the most part, the shift involves the same suppliers and takers of funds.

3) Higher interest rates on Eurocertificates of Deposit have accelerated the process — ironically, due to additional risk factors. The spread between comparable Euro-CDs and domestic CDs has risen to three-eighths of one percent, several times the usual difference. Partly this is the result of competition for funds in London. But, according to British banking sources, the premium is largely due to sovereign risk factors affecting the London Eurodollar market. There is a fear that the Bank of England, which has virtually totalitarian powers over London-domiciled banks, might impose controls on dollar outflows in the event of a run against sterling. In that event over one quarter of the Eurodollar market would be frozen in London. The effect this would have on the Eurodollar market stands in relation to the Herstatt collapse the way a modern thermonuclear device compares to the Hiroshima bomb. Extremely tight political coordination between leading central banks would be required to prevent a catastrophe.

According to the BIS, foreign claims on banks in the U.S. rose by a whopping $6.5 billion during the third quarter, $3.9 billion of which represented funds transferred from U.S. bank branches in the offshore centers of the Caribbean and the Far East back to the parent banks. Since U.S. banks' net external liabilities rose only $2.4 billion (see Table) compared to the $6.5 billion rise in total foreign claims, withdrawals of funds in the U.S. by

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other investors must have approximated $4.1 billion. It was this rather substantial deposit run-off which U.S. based banks attempted to cover by importing funds.

At the same time, U.S. banks were forced to "pull in their horns" from the international lending markets as a result of their already overexposed position as holders of "soft" developing-country debt, declining bank profit margins on syndicated medium-term credits, and the threat of increased regulation by the U.S. Comptroller of the Currency. Indeed, the external assets of banks in the U.S. actually fell by $200 million (see Table) during the third quarter.

By contrast, banks in the Belgium-Luxembourg and United Kingdom Eurocurrency markets dramatically increased their positions from both the asset (loan and investment) and liability (deposit) side — accounting for well over half the growth in the total world market. The BIS figures include, of course, U.S.-based banks' branches in Belgium, Luxembourg and London, but there is substantial evidence that West German and other foreign banks — not U.S. banks — were responsible for most of the increased lending from these centers.

Furthermore, the $3.2 billion rise in external assets of U.S. bank branches in the Caribbean and Far East, which might be interpreted to indicate increased U.S. bank lending, was more than offset by the $3.9 billion transferral of funds back to the U.S.

There are important political-strategic differences as well between a U.S. bank loan or deposit booked in London or Luxembourg, and one booked in New York. The Bank of England could, if it desired, freeze Eurocurrency deposits in London or slap down reserve requirements on lending. The West German Bundesbank — albeit from a very different standpoint than the Bank of England — could dictate the policy of Luxembourg monetary authorities. Even the Cayman Islands in the Caribbean — generally known as a U.S. offshore "bailiwick" — has recently called in Scotland Yard to help investigate international banking activity in the area.

In sum, the BIS figures point to a substantial rout of U.S. banking, and an emerging rivalry for world leadership between the West German-dominated Luxembourg market and the London market — the former oriented towards gold and long-term export- and development-related credits, the latter dedicated to short-term speculative gambits and the restoration of British imperial power.

A seemingly anomaly in the BIS data is the fact that OPEC nations borrowed $2.2 billion during the third quarter, while their deposits only rose by $.4 billion. Thus the "oil-rich" nations also appear as net borrowers from the world market. Although this is partly due to hefty borrowing by Venezuela for development projects, London's *Financial Times* helpfully points out that the

External Positions of Banks In Group of Ten Countries, Switzerland, and Branches of U.S. Banks In the Caribbean Area and Far East

Amounts outstanding in billions of U.S. dollars

	Belgium-Luxembourg (a)	United Kingdom (a)	United States	Caribbean Area and Far East (b)	GRAND TOTAL (All reporting countries)
ASSETS					
end - September 1977	57.4	149.5	81.7	87.5	590.4
end - June 1977	52.9	144.8	81.9	84.3	572.4
end - September 1976	45.2	127.6	71.5	68.0	500.9
June 1977 - Sept. 1977	+ 4.5	+ 4.7	— 0.2	+ 3.2	+18.0
Sept. 1976 - Sept. 1977	+12.2	+21.9	+10.2	+19.5	+89.5
LIABILITIES					
end - September 1977	55.8	161.2	74.1	86.0	591.3
end - June 1977	51.0	155.8	71.7	84.2	571.8
end - September 1976	43.6	137.9	63.8	68.8	495.8
June 1977 - Sept. 1977	+ 4.8	+ 5.4	+ 2.4	+ 1.8	+19.5
Sept. 1976 - Sept. 1977	+12.2	+23.3	+10.3	+17.2	+95.5

(a) Includes only foreign currency (Euro-currency) assets and liabilities.
(b) Branches of U.S. banks only, as reported by U.S.

Bank for International Settlements

OPEC investors must have been shifting into other types of assets besides bank deposits — perhaps British Treasury securities or British merchant bank-managed "private placements"? The BIS also indicates that OPEC countries drew down their dollar deposits with branches of U.S. banks in the Caribbean and Far East by $.9 billion and with banks in the European Group of Ten countries by $.2 billion, while simultaneously building up their non-dollar deposits in Europe by $1.4 billion. Thus, OPEC "portfolio diversification," although not yet massive enough to crush U.S. banks, nevertheless represents a significant threat as long as the dollar is unstable and could swing the balance between the Luxembourg and London "systems."

—Alice Shepard

British Plot Bear Raid On Eurodollar Market

A Feb. 6 Financial Times *survey on the Euromarket subtly aired several British scenarios for "bearing" the Eurocurrency market in such a way as to wipe out the remaining U.S. bank competition and emerge on top of world credit flows. In 1974, West Germany's Herstatt Bank collapsed and momentarily paralyzed the entire Eurocurrency interbank deposit network. A Herstatt-type crunch could evolve again in many ways, the* Financial Times *editors suggest — from Third World defaults to a New York City bankruptcy to increased regulation of U.S. banks by British-oriented U.S. Comptroller of the Currency Heimann.*

If this situation (another Herstatt-ed.) is to be repeated one may expect an increasing strain on the U.S. banks' lending capacity during this year...The one development which could change this general picture (i.e., trigger a shift from the present excess liquidity to a credit shortage-ed.) is a sharp shock such as happened with the oil price rises and money market losses in 1973-74. For, while the numbers of institutions involved in the Euromarkets — and the commitment of the old hands in the business — has grown immeasurably since in the last four years, the market mechanisms are more firmly based only to the extent that solutions to the particular problems posed in 1974 have been found. The potential remains for tiered rates and a sharp and speedy contraction in the volume of inter-bank deposits, in the absence of any meaningful lender of last resort.

Czechs Say:
What's Good For The Dollar Is Good For Us

One clear statement on why the dollar must be supported issued this month from Prague, where the Communist Party daily *Rude Pravo* carried a two-part series of articles by Ladislav Alster on the currency crisis. Far from gloating over the U.S. currency's fall, as misguided Eastern European officials have often done—on the principle of "what's bad for the capitalists is good for us"—Alster focused on the devastating damage to world trade, not sparing Eastern Europe.

"The weakness and the decline of the dollar are no domestic affair of the United States, but a question of worldwide dimension," wrote Alster Feb. 2. Among the experts he cited to demonstrate the point were former U.S. Treasury Secretary William Simon, warning that without a strong dollar to ensure the economic stability of the United States an international crisis will occur; and Horst Siebert of the conservative West German daily *Die Welt*, who has written that the currency insecurity, consciously advocated by the Carter Administration, has done great harm to international investment activity and international trade.

Neither the West German mark, the Swiss franc, the Japanese yen—much less "so-called Special Drawing Rights"—could successfully be used to denominate oil transactions or other world trade, stressed Alster. In Saudi Arabia and in Paris, Carter was put under strong pressure for "the U.S. government to take energetic measures to support the dollar."

"Can the U.S. do anything for the international position of the dollar? Most likely it could....the U.S. remains by far the greatest capitalist economic power."

The dollar recovered somewhat after Carter's Jan. 5, 1978 statement that it would be supported, but the recovery lasted only until the president's State of the Union speech. "It may appear that the financial policy of the Carter Administration is helping the American economy by 'burning' its partners" (West Germany, Japan, etc.). "But this is not the case. Actually, nobody in the U.S. is really satisfied with Carter's financial policy....The so far very phlegmatic financial policy of the Carter government surely mirrors the crisis contradictions in the United States....Some of the phenomena cited are indeed alarming, and signal that the partially structural crisis of the capitalist world could easily turn into a high gear crisis, with unpredictable consequences, which to a certain extent would also have an unfavorable influence on the economy of the socialist countries."

In a follow-up article, Alster wrote that the U.S. deficit was only one problem underlying the fall of the dollar. More important, is the speculation against it, which has assumed "incredible dimensions and forms." Alster's cited European sources who believe the dollar is to be undervalued at this time, suggesting that central banks might attempt a wave of counterspeculation to boost the dollar.

The danger remains, he concluded, that "secret groups of insatiable adventurers can turn the economy into a huge roulette wheel."