

## Autumn crisis in the Euromarkets?

by David Goldman

Both the American and international sectors of the world dollar credit market remain at the edge of a potentially devastating liquidity crisis, despite apparent efforts of the American authorities to contain it. In fact, American policy is running on two simultaneous tracks.

On one level, the State Department has taken over the day-to-day management of the dozens of banking consortia who handle the refinancing of the \$80 billion or so in developing countries' debt service this year, the great source of instability in the world credit system. The Federal Reserve has taken action to prevent the late August interest rate spiral from running out of control, and creating a possible crisis situation both at home and in the Eurodollar market.

But the emergency arm of the American government, the Federal Emergency Management Agency, is in full mobilization preparing for total financial crisis, including preparations for exchange controls, credit controls, and other extreme measures—in the event that stabilization fails (see Banking).

Without taking into account the global financial and political context, none of the recent—or coming—developments on the financial markets makes any sense. Let us review, sequentially, what happened in the week up to Sept. 4:

Eurodollar interest rates rose spectacularly during the week ending Aug. 29, with the benchmark six-month Eurodollar rate at  $12\frac{7}{8}$  percent, and the three-month rate at  $12\frac{1}{2}$  percent. Federal funds rose to a

high of  $11\frac{1}{2}$  percent on Aug. 28, up more than 1 percent over the week. Compared to the equivalent domestic rates, the Eurocurrency rates were a full 2 percent higher; the usual spread is less than 1 percent.

According to a wide spectrum of money-market sources at the leading commercial banks, Eurodollar bankers were scrambling to get hold of whatever liquidity they could in the shortest possible time period. As we reported in last week's banking column, bankers feared a major political crisis through either the Polish or Mideast theaters, and possible interruption of oil supplies or flow of funds. The pressure for funds was sufficient to drive interest rates up by two percentage points over the week.

Apart from the short-term political threat, bankers also considered the prospect for a medium-term squeeze on international liquidity, due to the bunching up of Third World debt-service obligations at the end of this year (see International Credit), amounting to the better part of \$80 billion.

One leading investment bank analyst considers the most telling development in the American banking system this year to be a net flow of funds from American banks to their foreign branches between March and the end of August of \$15 billion. In March, American banks were net borrowed of \$6 billion from their foreign branches; by August, they were lent net of \$9 billion to their foreign branches.

What this indicates is liquidity draining from the

domestic credit system, starting with Fed Chairman Volcker's March imposition of lending controls in the United States.

### **Credit control and downward rates**

The commercial banks have had extensive rollover requirements for Brazil and other major debtors during the last two quarters. While negotiations stalled over terms of medium-term syndicated credits—Brazil must borrow another \$10 billion or more this year—banks had to roll over trade paper or conduct similar short-term bridge financing to keep large borrowers afloat.

At present, the State Department is shepherding the medium-term credits through, telling banks where to lend (and also where not to).

The State Department itself believes that this process cannot continue much past the beginning of 1981's first quarter. Indeed, any significant market disruption, e.g. rapidly rising interest rates, would bring about a crisis much more rapidly.

Therefore, the Federal Reserve took steps to bring down domestic rates—in such a fashion as to ensure, in the consensus view of most Wall Street analysts, that the economy will remain flat or worse for the foreseeable future. First, the Fed injected reserves into the banking system on Friday, Aug. 31, bringing the Fed Funds (interbank short-term lending rate) down to between 8 and 9 percent.

More importantly, the Fed persuaded bond syndicators to postpone between \$3 and \$5 billion in bond issues that had been tentatively scheduled for September, according to an *EIR* survey of bond market houses. In effect, the Fed did once again what it had done in March: shut off lending in order to lower interest rates.

The break in rates is intended to make possible the refinancing operations internationally, i.e. to continue the drainage of funds out of the domestic credit system into the international credit system. The State Department and Federal Reserve hope that some deal can be struck with OPEC to make large-scale additional resources available through the International Monetary Fund for further refinancing. However, their staffs are pessimistic about the success chances of such schemes.

### **Volcker is mugging the same victim twice**

What makes this policy so much more unstable than it was last March is that the record volume of bond market financing during July and August, a major source of increased money supply and higher interest rates, was urgently required to rebuild the financial resources of the corporate sector, strapped as it was for liquid funds.

As Salomon Brothers showed in a July 21 study, the liquidity position of American corporations is at a postwar low, and Salomon Brothers analysts argue that the situation is worsening, not improving, through the present depression.

Cutting off the volume of refinancing, as the Fed did last week, threatens the stability of the economy in a fashion even more profound than last March's credit controls. In effect, the Fed has tried to mug the same victim, the American economy, twice. The pickings this time are much slimmer.

The underlying illiquidity of both the domestic and international sides of the market make the system continuously prone to crisis. This is evident from last week's sudden interest rate runup; the moment that market participants believe that the game may be over, the scramble for funds will push rates up violently.

On the American side, the threat of a Penn Central-style bankruptcy, which threatens to produce uncontrollable consequences, is significantly enhanced by the shutdown of the corporate bond market. The Federal government's \$100 billion per annum (including so-called "off-budget") borrowing requirement ensures continued pressure on long-term American interest rates.

Most of all, the continued, underlying inflation threat will tend to push dollar rates up sharply. A few analysts, such as William Griggs of Schroeders Bank, believe that inflation will subside to the 9 to 10 percent level in an utterly quiescent economy, making the current long-term interest rate for AA-rated securities of 13 percent relatively attractive.

### **Washington looks to continued inflation**

However, *EIR* does not believe that the inflation rate will fall in any such fashion. The damage already done to the farm sector and the transportation sector (through phased implementation of deregulation) have unleashed profound inflationary consequences. The current rate structure will not hold.

That the federal government itself does not believe matters are under control is indicated not only by discussions with the would-be crisis managers themselves, but by the cited activities of the Federal Emergency Management Agency (FEMA). FEMA's unpublicized but comprehensive preparations for a general financial crisis are the fallback position in place for the failure of the above scenario.

Gold's rise during the last week, to \$652 in London on Sept. 4, indicates how unstable the international situation is. The ultimate hedge against a breakdown of the international markets is the biggest gainer of anything traded.