

# On the world credit markets

## *The ghost of Keynes strikes out at European Monetary System*

The European Monetary System (EMS) strategy for a reform of the Euromarkets based on stable, *long-term* international dollar bonds, ultimately to be gold-backed, is entering rough waters. The week of Feb. 26-March 2 saw a generalized rush out of long-term instruments into short-term paper spread from the Euro-currencies across the international capital market. "Corporations, institutional investors, any money manager wants primarily liquidity right now," said a major New York Eurocurrency trader on March 1, "and there is a rush into short-term Eurocurrency deposits."

This morbid revival of Lord John Maynard Keynes's un-mourned "risk avoidance," as the Feb. 26 *Wall Street Journal* put it, is the latest result of the British government's not-so-secret war against the EMS. It is the politically motivated run-up in oil and commodity prices, together with shooting wars from Asia to the Middle East which feed the fears of inflation and credit crises behind this "liquidity preference." As our coverage this week documents, in energy, in commodities, in Asia and the Middle East, the British crown is behind each and every destabilization.

The new danger this week is the spectre of "liquidity inflation" haunting the strong-currency nations of West Germany, Japan, and Switzerland. Their governments are under pressure to follow the lead of the U. S. Fed and Bank of England toward harsh double-digit interest rates. If they do, the two-tier credit system "global EMS" on the agenda for the heads of state economic summit to be held in Tokyo during May will be rendered impracticable.

### **Why the EMS and Keynes don't mix**

The core of the EMS as conceived by West German Chancellor Schmidt and French President Giscard d'Estaing is to soak up dollars through intervention and then increasingly through *long-term* Eurodollar bonds backed by remonetized gold, as Giscard emphasized in Mexico City on Feb. 28. The dollars are then loaned out ExIm Bank-style to high-technology and highly productive LDC development programs, yielding a high rate of return.

As part of the plan for a "global EMS," which the Japanese government announced as its program for the Tokyo summit before Ohira assumed the Prime Ministership, West German Finance Minister Matthöfer and the Japanese Finance Ministry have out-

lined what they call a "Consolidation Plan" or "transparency" in the Eurodollar markets. With the Bank of Japan joining in, these central bank "ExIm dollars" would be pegged to domestic German-Japanese interest rates, now at a 4-6 percent level. Thus, a "two-tier" international dollar market would be created: a profitable lower tier and a speculative upper tier at the London Interbank Offered Rate (LIBOR), currently over 11 percent. The Bank of Japan has already deposited dollars somewhat under LIBOR with Japanese banks.

In other words, under this regime the billions in dollar intervention by the EMS and Japanese central banks have until now been *dis-inflationary*, because they authorities have actually begun to provide dollars at subsidized rates to their commercial banks which have used them to generate foreign export orders.

But throw in soaring oil and commodity prices, wars, and threatened defaults, such as in Iran, on top of the dollar intervention, and inflation starts for real inside these intervening countries. The drains force available dollar resources to be kept liquid to pay for raw materials and for emergencies.

### **Tightening**

Under the headline "Bank of Japan Studies 'Preventive Tightening Possibility,'" the *Japan Economic Journal (Nikkei)* on Feb. 20 signaled the alarming result: interest rates within Japan, the lowest in the lower tier, are under an upward pressure. The Bank of Japan is studying "combining ... raising the official discount rate and reserve requirement ratio, strengthening 'window guidance' of financial institutions (central bank monitored voluntary loan restraints — ed.), and inducing an elevation of short-term money rates.... With the welter of price factors in evidence, the situation is extremely severe."

In the German deutschmark sector, inflation fears have already forced three-month Euro-deutschmark rates up from 3 3/4 to 3 7/8 percent over the week. Rumors are flying that the Bundesbank will have to put up the Lombard rate (central bank repurchase rate — pegged to the discount rate) over its current 4 percent to stop the alarming recent 15 percent annual rate of growth of the money supply.

Any significant rise in these hard-currency sector interest rates would endanger the two-tier credit proposal.

## The dollar bubbles

In the dollar sector of the international markets, "risk avoidance" has meant a dangerous bidding up of short-term Eurodollar bank deposits, as corporations and institutional investors, especially in the United States, rush to London to place their funds for six months at 11 percent. This has meant, temporarily, that the dollar is very strong. There is also a lot of liquidity, but it is extremely inflationary, since investors are demanding higher rates. While three-month LIBOR has held "meta-stable" around 10.5 percent, the medium maturities have risen inexorably; six-month Eurodollars have steepened from 11 percent to 11 3/16 over the week.

The effect on the international bond market has been electrifying: long-term instruments such as the \$200 million Dow Chemical issue in London, priced at 99.5, are trading in the 96 range; Honda's \$50 million 10-year convertible, priced at par, fell as low as 94.5. Unlike previous weeks, foreign exchange rate considerations have nothing to do with it; the Euro-DM and Euro-Swiss sectors are equally depressed.

Worse, the effect is very direct on Japanese and German mobilization of their own dollar reserves. The Bank of Japan reports that while it will be able to continue the

same volume of cheaper dollar deposits to Japanese banks, the banks have already had to cut their overall world dollar lending by 30 percent in January from the \$4 billion October to December level. The intense competition and high interest rates in the Eurodollar market, where Japanese banks get the majority of their dollar deposits, is to blame. The Japanese authorities fear the return of a 1974-style London "Japan rate" surcharge on their Eurodollar borrowings.

Finally, this bid-up of dollar deposits cannot go on forever. If it continues, "at some point, long-term prices will fall so far that no one will be willing to sell their bonds," a New York investment bank source said March 1. "Liquidity will disappear from the short-term market and the dollar will be in for a real fall." Chaos will hit the currency markets.

Given this ominous scenario, it might seem that Keynes's ghoul might indeed strangle the EMS. As an official in the European division of the IMF stated, "We have been warning for over six months that the inevitable rise of oil and world commodity prices coupled with runaway government spending and inflationary psychology will make the functioning of the EMS quite difficult if not impossible."

—Kathy Burdman

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## CREDIT MARKETS

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### U.S. credit markets are moving to the short side

U.S. banking liquidity shrank further this week under the impetus of Federal Reserve Chairman G. W. Miller's campaign to dry out bank lending to U.S. industry and agriculture, using sharply increased interest rates.

For the week ending Feb. 14, nationwide U.S. commercial and industrial (C & I) loans rebounded upward \$960 million. However, since the high point of November 1978, C & I loans have dropped nearly \$2.0 billion. Pacing this drop is the fall in

large placement of negotiable Certificate of Deposits (CDs) into the banking system. On an unadjusted basis, large scale CDs fell to \$99.4 billion from a high of \$101.4 billion just three weeks ago.

At the heart of this liquidity shift is the fact that higher interest rates combined with a series of scare rumors is forcing various investors and buyers onto the shorter side of the U.S. credit market.

Exemplary of this process is the stupendous growth in commercial

paper, which represents 30-to-270-days promissory notes. While U.S. banks are losing the industrial portion of their C & I loans, corporations are going to the commercial paper market which offers cheaper short-term rates. For instance, in a recent week, the interest rate on 30- to 60-day commercial paper ranged from 9.63 percent to 9.98 percent, while the banks were charging their best prime customers 11.75 percent plus bank balances.

This shift in U.S. banking liquidity, if it becomes more pronounced, will strike at a particularly bad time. The threat of the oil shortage hoax with an accompanying increase of oil prices and a run-up in raw material prices, would force panicked investors even further onto the short side of the market, just at the time when more liquidity is needed to finance energy and raw material price increases.

—Richard Freeman