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INTERNATIONAL CREDIT MARKETS

Oil crisis tightens international bond markets

The upward spiral in the price of oil and other imported raw materials is pushing up interest rates and destabilizing bond markets in the leading economies of Western Europe and Japan. Hardest hit are the capital markets of such former "strong currency" countries as West Germany, Switzerland, and Japan, which have up till now benefited from relatively low interest rates.

In West Germany, which relies much more heavily on imported oil to fill its energy needs than does the U.S., wholesale prices rose by a stunning 3.1 percent during the month of February. A 9.1 percent increase in the cost of light heating fuels was responsible for much of the rise. The Bundesbank has already moved to restrain money supply and credit expansion during the last month and a half and there is now speculation that an increase in the central bank's discount rate—presently at a low 3.0 percent—could be the next step.

The oil price rise not only threatens to depress capital investment in Europe and Japan, but also threatens Franco-German efforts to create a "development dollar" under the aegis of the newly-formed European Monetary System. To summarize, the Franco-German plan was that the EMS and Japanese central banks would soak up much of the footloose Eurodollars currently glutting world markets and recycle them into long-term development project loans, at low interest rates comparable to those prevailing in the German and Japanese economies rather than at the prevailing Eurodollar market rates of 11 percent or more. Unless brought under control, the oil crisis could instead bring rates in the deutschemark sector up toward the high levels of the U.S..

Japan, which must import virtually all its oil as well as much of its food and industrial raw materials, reported a 0.9 percent rise in wholesale prices during February — the steepest rise in almost three years. Similarly, Switzerland experienced a 1.1 percent increase in retail prices in February. This is an extraordinary development given that Swiss retail price inflation was *only 0.7 percent for the whole of 1978.*

Swiss Franc-denominated bonds have taken an especially heavy beating in the last two weeks. The Swiss government had great difficulty finding subscribers for its 2-3/4 percent 12-year issue and dealers now say that coupons of 3 to 3-1/4 percent are required to market any issues with maturities of over ten years. Disaster has also struck the Swiss franc foreign bond sector; the Austrian Kontrollbank's 3-1/2 percent 12-year issue plummeted from an issue price of 99 to 93-3/4 in only one day. The Swiss capital market authorities have responded by lowering the amount of new paper which will be permitted on the domestic market during the second quarter to SF1.3 billion ($776 million), compared with SF1.6 billion for the second quarter of 1978.

Although the deutschemark sector has stabilized somewhat in the last week, the Bundesbank's tightening, a heavy government deficit financing schedule, and inflation fears have brought yields on long-term government bonds (over four-year maturities) up from about 6.2 percent at the beginning of the year to 7.2 percent at present. A similar deterioration of the deutschemark Eurobond sector has been alleviated by the German capital markets subcommittee's decision to reduce the volume of foreign deutschemark-denominated issues to only DM450 million in March, less than half the February volume.

In another context, the reduced volume of DM borrowing by foreigners might appear as a blessing — the last thing the West Germans (or Swiss or Japanese) want is the evolution of their currencies into secondary lending currencies at the expense of the U.S. dollar. However, what has occurred is not the revival of the Eurodollar bond market — which survives only due to the relative dearth of new issues — but the contraction of virtually all the other major sectors.

The crowning irony is that the British gilts (government debt) market has enjoyed a sudden, albeit temporary, renaissance. Higher North Sea oil earnings, as a result of the jacking up of world oil prices, has propped up the geriatric pound sterling for the last several weeks and has brought a flood of foreign money into Britain, seeking to "lock up" the high 13-14 percent yields available on British government securities.

— ***Alice Shepard***

BRITAIN: Columnist Marla Minnicino is on assignment preparing an economic survey of Ireland. Her column will return next week.

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