

A brave new world of financial decontrol

by David Goldman

Half a year ago *EIR* surveyed the argument of banking decontrollers that the world money markets were moving out of the control of any central bank, and that this presaged a terrible period of financial and economic dislocation. The first quarter's monetary results show that this regime—the integration of the uncontrolled Eurodollar market with the domestic money markets—already prevails. Already the American financial system is feeling the effects of the transformation in a number of ways, the most immediate of which is the present rapid increase in both long- and short-term interest rates.

An accompanying graph shows narrowly defined money supply (“M1B”) during the past six months. Note the spectacular increase in the growth rate since December 1980, to a per annum rate of growth in the most recent four-week period of over 16 percent. Two aspects of this are important.

First, the American economy avoided a *sharp drop* during the first quarter *only* because money supply grew out of hand. Despite the reported 6.5 percent rise in “real GNP,” due to juggling of inflation indices and so on, and the 1.4 percent rise in the March “index of leading indicators,” based on oil price increases, the economy remained *dead flat* in the first quarter. To do so while the prime lending rate stayed close to 20 percent required an extraordinary volume of money-supply increase, to circulate a debt service bill that rose to above half of corporations' gross internal funds. *EIR* will analyze this in detail in an upcoming survey.

Second, the money-supply growth during the first quarter occurred while all domestic sources of money supply either fell substantially (bank loans) or remained virtually unchanged (total Federal Reserve credit, bank reserves, and monetary base). For the first time, a major spurt in monetary growth came from the *Eurodollar market*. Part of this showed up in the first-quarter banking numbers, in the form of a \$3 billion rise in U.S. corporations' borrowing from foreign banks (mostly foreign offices of U.S. banks) of \$3 billion, while loans from U.S. banks fell \$5 billion. Most of the Eurodollar inflow, however, took the form of U.S. corporate subsidiaries borrowing abroad, sending the loans home via leads and lags in payments, for deposit in the domestic banking system.

As it normally does, the Federal Reserve waited for a visible provocation—the rise in M1B—to lower the monetary boom. Attacks on the Fed's monetary course by Treasury Secretary Donald Regan and Undersecretary Beryl Sprinkel amount to “a lot of support for a tough monetary policy from the administration,” a former Treasury Secretary told *EIR*.

The markets have taken the message clearly, in any event. Michigan Bell's failure to market more than two-fifths of an April 28 \$250 million bond issue at a record 15¼ percent interest rate, and the April 29 move of major banks to an 18 percent prime rate, are the beginning of an interest-rate run up which will take the prime rate above 20 percent within the next two months, and

possibly much higher. Barring a change of heart over monetary policy at the White House, this new round of tightening will sink the economy before the end of the second quarter.

Otherwise, Treasury Secretary Donald Regan has revised the legend of the little Dutch boy, and placed dynamite against the leaky dike. In testimony before the Senate Banking Committee April 28, Regan said, "The administration and the Congress share the responsibility to resist protecting the parochial interests of some institutions. We must place greater reliance on market forces to determine the character and structure of our financial system." This means that "at some point all the institutions must have the same powers to perform the same types of business. . . ."

Senate Banking Committee Chairman Jake Garn will block some of Regan's ideas, such as fish-in-a-barrel takeovers of troubled savings and loan institutions by commercial banks, and especially takeovers across state lines. But he wants to remove present ceilings on the interest rates that the S&Ls may offer on their deposits. In March the S&Ls lost a record \$2.7 billion in deposits, mostly to the growing money market funds managed by brokerage houses, which invest (reserve free) in large-denomination, high-interest paper and offer substantially higher rates of return. The Garn proposal (see Banking) would help the battered S&Ls survive the new interest-rate escalation, but transform them into adjuncts

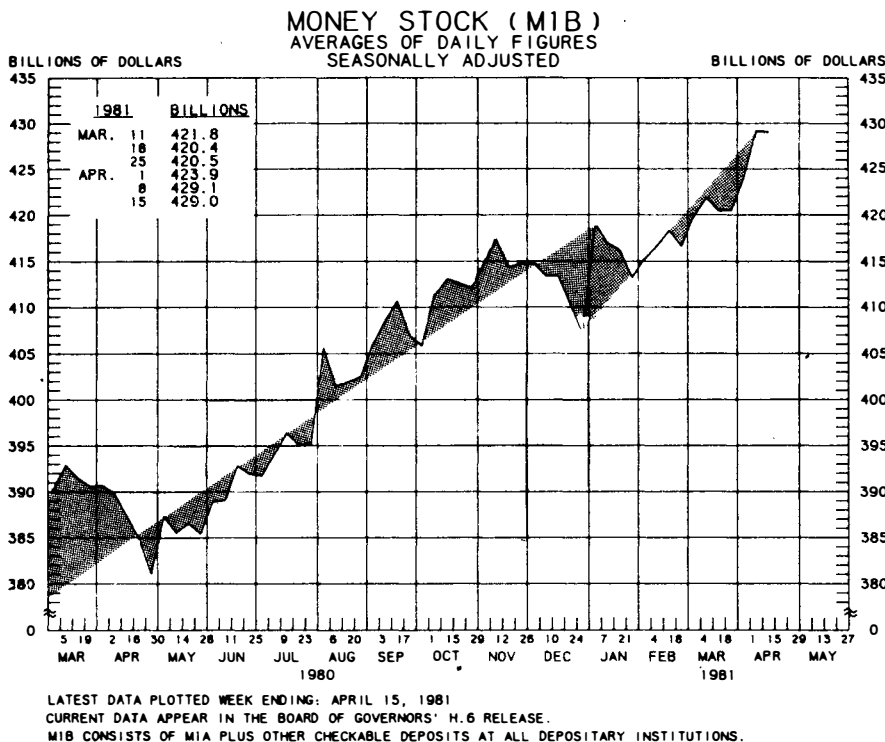
of the money market funds in the process.

The Eurodollar flow, unfortunately, works two ways. Here is how a former top American monetary official describes the predictable results of the banking deregulation now in progress:

"What we have now is a free-for-all. Interest rates have been totally deregulated. In the U.S. under the Monetary Control Act [of 1980, last year's Reuss-Proxmire banking deregulation bill], interest rates are now being shuffled around by everybody and his brother. As it stands now, the commercial banks can do whatever they want with interest rates, and they can do whatever they want with inflation, which is behind the interest-rate problem, because they are making loans around the world and moving money around at a very inflationary rate.

"Furthermore the banks are now moving to do whatever kind of banking they want around the country. And the entire financial system is being shifted internationally. We're undergoing a minor revolution in finance.

"For example, the recent mergers of Bache into Prudential Insurance and Shearson Loeb Rhoades into American Express will create new types of financial institutions whose impact on the money markets will be imponderable. Think of the amounts and sorts of funds they will be able to move around. These new parameters will create outlandish fluctuations in interest rates here



The accompanying graph, provided by the St. Louis Federal Reserve Board, shows a doubling of the rate of money-supply growth starting in December, 1980. On May 1, the Federal Reserve announced a further \$4.2 billion rise in the money supply (M1B) for the latest reporting week, extending the trend. The money-supply explosion is a "perverse effect" of high interest rates; it has created a self-feeding spiral characterized by rising credit costs and persistent increases in money supply. On May 1, Irving Trust of New York raised its broker loan rate to 20½ percent from 18 percent, signaling a probable advance in the prime to at least 21 percent.

and abroad.”

The speaker, who was in financial press headlines during a 20-year official career, declined to be identified, but the judgment is by now fairly commonplace. Apart from the implications for market instability, the importance of this *structural shift* has not been lost on banking officials who are concerned with the liquidity of the international markets. However illiquid the domestic money markets are, the Eurodollar market they are merging into is *less liquid still*, due to the enormous deficit position of the non-oil-producing developing countries. This is estimated at between \$60 billion (OECD) and \$100 billion (Bank of America) for 1981, and requires massive new financing for countries whose total external debt, public and private, now exceeds \$500 billion.

The Group of 30, an economists' and bankers' panel chaired by former International Monetary Fund managing director Johannes Witteveen, is about to release a study of the Third World debt problem. Witteveen told a London press conference in mid-April that the rise in U.S. interest rates endangers the finances of the developing countries, whose debt service rises by about \$3 billion for every 1 percent rise in interest rates.

Warns Princeton University economist Peter Kenen, chairman of the Group of 30's Academic Panel, "I'm surprised that a crisis hasn't already broken out." "The key to the whole system," he adds, "is how a shock spreads through the interbank market," the half-trillion dollars of short-term loans between banks at home and abroad. Kenen explained, "The Bank for International Settlements is working on three scenarios. First, you can step in and deal with a moratorium on debt payments at the country level, which the Bank for International Settlements now does [as in the case of the recent four-year rescheduling of Poland's debts—D.G.]. Second, if some developing country is in real trouble, and, by implication, banks holding its paper are in real trouble, you can go to the aid of the banks. Third, if some banks have made a bad mistake, you can let them take the consequences, and set the line at the interbank market," bank from triggering a domino-style run of others.

The Group of 30 economist concluded, "The thing that makes any of these options work is to broaden the base of the interbank market, linking up the domestic interbank market with the Eurodollar market. We practically have a single interbank market now, and the linkup between Fedwire [the domestic electronic funds transfer system] and CHIPS [Clearing House International Payments System, the electronics funds transfer system for the foreign operations of New York banks] will make it a single market."

On Oct. 1, 1981, or slightly later, the Federal Reserve expects funds transfer system into the international CHIPS

system, which now clears \$180 billion *per day*. This link was the leading demand from regional banks, who demanded instant access to the international markets through the CHIPS computer in return for acquiescing to the New York banks' proposal for reserve-free "International Banking Facilities" onshore. This means that American regional banks, savings banks, and other newly deregulated institutions will be able to place funds overnight at higher prevailing rates in the international market as easily as they can now invest in American short-term markets.

The Treasury's deregulation plan effectively opens up over \$1 trillion of U.S. banking assets to "broaden the base of the interbank market," per the requirements of the Swiss-based Bank for International Settlements.

A shift back to controls?

British and American monetary planners are confident that the monetary whirlwind they have unleashed has knocked down official French and West German proposals for a global reduction of interest rates. "Chancellor Schmidt and President Giscard want a controlled market," said the monetary official cited earlier, "but for the moment the free market people will win, because we don't yet have the machinery to control these international markets. The international arbitrage and interest-rate fluctuations going on cannot be controlled. And as electronic funds transfer systems are expanded, the market will get more and more out of hand. They can't control them. Eventually, however, Schmidt and Giscard are right—we will have to have some sort of central bank machinery put into place. The central banks will have to get control over the international markets."

The deceptive feature of this discussion is that the decontrollers and the proponents of controls are the same people, i.e., the Bank for International Settlements colloquium of central bankers. Some monetary officials, including former Federal Reserve Board Chairman William McChesney Martin and ex-Bank of Italy official Rinaldo Ossola, now argue for a return to some form of gold standard, in the form of a link between gold and the International Monetary Fund's "basket currency," the Special Drawing Right.

Inside the Reagan administration, a "gold lobby" formed in March on the inspiration of proposals from the old "Siena Group" of economists, including supply-side theorist Robert Mundell of Columbia University, Italian banker Ossola, and Securities Group economist Eugene Birnbaum (see *EIR*, March 24, 1981). But the various controls plans offered by these economists, with the backing of the so-called supply-side group inside the Reagan administration (Jack Kemp, Treasury Undersecretary Norman Ture, Assistant Secretary Paul Craig Roberts), are disingenuous. They imply as a precondition the type of market reorganization now under way.