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Push comes to shove after October first

by David Goldman, Economics Editor

October 1 just might stand out as the most significant day in monetary history since August 15, 1971, that is, as a turning point of general transformation of the monetary system. Some American and European bankers are suggesting that a major liquidity crisis could rip the markets on that date, although no such development is within the limits of predictability. However, a series of events converging upon that date will likely mark the beginning of an entirely new universe of monetary developments.

The events we refer to include:

1) The introduction of "same-day settlement" into the $160 billion per day clearing mechanism of the New York banks, the Clearing House International Payments System (CHIPS);

2) The introduction of "all-savers certificates" per the direction of the Reagan tax bill;

3) Probable congressional debate on the Thrift Institutions Restructuring Act of 1981;

4) The convening of a secret meeting of 100 commercial bank regulators from the major industrial countries at the offices of the Federal Reserve Board of Governors in Washington, as a spinoff of the simultaneous International Monetary Fund Annual Meeting in Washington and;

5) The extraordinary condition of the Sept. 30 payments period for international loans, made messy by the default or quasi-default of Romania, Poland, Costa Rica, Turkey, Ghana, Bolivia, Nicaragua, and possibly some surprise additions to the list.

Viewed from inside the mind of the Federal Reserve, October appears to be a *managed crisis*. That the Federal Reserve is aware that its actions produce a general crisis of the banking system, we have argued for more than a year, and now have the documentation to prove it. A Federal Reserve document prepared by Board of Governors economist Robert Flood and University of Rochester economist Peter Garber, dated April 1981 and revised August 1981, sets forth two related scenarios for a banking collapse. The authors state:

"Our aim is to determine conditions under which a collapse eventually will occur and the timing of such a collapse. . . . We set up a model for the behavior of bank owners and produce a sufficient condition for setting off a systematic bank collapse; the condition amounts to a *floor on the nominal interest rate*. . . . At least in some instances, a banking collapse can be viewed as a predictable phenomenon, rather than as a sudden outburst of mass hysteria."

The Federal Reserve's intent

Since October 1979, with a brief interruption in the May-August period of 1980, Federal Reserve policy has been to put a *floor on the nominal interest rate*. And Paul Volcker declared in Brazil on Sept. 4 that he intends to maintain a high floor for *two more years* (see

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What the Federal Reserve staff declares—as if it were not already obvious—to be the "sufficient condition for setting off a systematic bank collapse" is the Federal Reserve's own monetary policy. Stripped of the mathematical-symbolic mumbo-jumbo, the analysis amounts to a simple statement: high nominal interest rates which collapse the value of banks' fixed-income portfolios (a problem principally applicable to the savings banks and savings and loan associations) and which simultaneously force the banks to fund old low-interest assets with new high-interest liabilities produce a collapse.

In this context, the introduction of all-savers certificates starting Oct. 1 becomes problematic. The expected result of the introduction of a tax-free bank certificate of deposit offered by both commercial and thrift institutions will be a reflow of a couple of tens of billions of dollars out of money market funds, whose assets swelled to $152 billion so far this year at the expense of the banks.

According to the president of one large East Coast bank, the problem of "reverse disintermediation" could hit the sensitive commercial paper market badly. The money market funds will have to liquidate a sustantial volume of paper to repay depositors who shift into the all-savers certificates, including a large amount of commercial paper (unsecured corporate IOUs), a standby of money market fund portfolios. The problem is that the commercial banks and thrifts will not invest in commercial paper, preferring Treasury bills. Since a great deal of corporate financing this year has taken place through the commercial paper market, the potential ramifications of a drop of institutional investor interest in commercial paper are obvious.

We will have a great deal more to say on the witting culpability of the Federal Reserve in this matter. The "October Scenario" summarizes as follows:

First, the Bank of England, the Fed, and the Bank for International Settlements staff will make other major central banks an offer they are not expected to refuse at the bank-regulatory meeting held in secret during the IMF's annual festivities, namely, that they agree to unify regulatory standards for international lending or face the likelihood of messy and intractable banking crises on the international markets.

Second, the Senate Banking Committee chairman has already backed down from his opposition to legislation which would turn the savings and loans into big money market funds, among other things, and eliminate their mortgage-lending role to a great extent; passage of this legislation is expected during October preparing the ground for the administration's already-promised "total review" of the Glass-Steagal restrictions on investment banking by commercial banks, and the McFadden Act restrictions on interstate commercial banking. Third, the "same-day settlements" procedure at the CHIPS, which is on the surface an innocuous improvement in the way international business is conducted, may well administer a form of "shock therapy" to the international markets. Apart from the level of dollar interest rates, no other action by the American monetary authorities has excited such suspicion among foreign bankers.

The 'same-day' consequences

What is at issue is so remote from the usual interests of most financial market participants as to appear esoteric, and indeed so complex that leading participants in the clearing house itself are honestly unsure of what the consequences may be. Presently the vast majority of international market transactions (Eurodollar payments and foreign-exchange transfers) are made through the CHIPS computer in New York City. A Eurodollar, after all, has legal status as a claim on an American bank account deposit. The $1.5 trillion Eurodollar market contains about $1.2 trillion Eurodollars, whose transfer in legal terms must ultimately take place in the United States. Over 100 international banks, therefore, clear their Eurodollar transactions with each other through CHIPS, which is really a giant computerized ledger for "netting" out the thousands of obligations the big banks incur to each other in the daily course of doing business.

Presently, transactions booked on Tuesday are settled at 10:00 a.m. (or a bit later if necessary) on Wednesday. As of Oct. 1, transactions booked Tuesday will be settled at 6:30 p.m. Tuesday.

Nothing in this technical shiftover by itself should represent a problem, as Federal Reserve officials correctly insist (see interviews). However, an undetermined number of domestic and international banks are funding a large portion, if not the majority, of their operations with overnight money or the equivalent. The entire banking system is highly *illiquid* in that sense, and the distribution of illiquidity falls most heavily on a narrow spectrum of the international banking community. In plain language, this means that daily life for a large number of banks is a matter of making the day's payments square with the day's collections, and of borrowing money from other banks if the collections fall short. Since major categories of lenders starting with about a dozen big developing-sector borrowers, are not paying, collections are falling short right and left.

The "technical" impact of the Oct. 1 change at the clearing house is that the bankers' elbow room for making their balance sheet add up is reduced from 16

hours to 2 hours. Rather than seeking free funds overnight in the Singapore market or the next day in the London market, who do their business before the next-day 10:00 a.m. CHIPS deadline, the banks will have to find the necessary funds to cover their accounts the same day. Just as important, instead of bidding in the Asiadollar market or the Eurodollar market, they will compete with domestic U.S. banks in the afternoon federal funds market (which the Federal Reserve extended by an hour last spring).

At least, the federal funds rate will hit the ceiling when the same-day system is introduced. Probably, some members of the system will be driven to the New York Federal Reserve's discount window to obtain funds, which the Fed says it stands ready to pay out if needed (see interviews). The New York Fed denies suggestions made in a *Journal of Commerce* editorial on Sept. 11 that it is using the circumstance to extend its credit-management powers into Eurodollar operations. But such will be the final result of the process, under the best of circumstances—which dovetails into the objectives that the Fed Board of Governors will demand of European bank regulators at the Washington meeting the same week.

The race-track principle

However, as the cited spokesman for Dresdner Bank argues, it is by no means certain that such a tightening of control could take place without breaking the entire chain of international payments, and throwing the system into full-scale crisis. We do not predict any such development, but merely indicate that the potential for such a crisis is an ominous weight on the hand of the Federal Reserve. Crises, as we have emphasized on a number of occasions, do not break out when two lines intersect on an economist's demand curve, as Fed economists Flood and Garber seem to imply. In real practice, crises occur when the comptroller of a major bank is caught with the bank's (inadequate) previous quarter's earnings at the racetrack, putting the bank's survival chances on a long shot. In one form or another, bankrupt institutions tend to try to gamble their way out of problems, and end up magnifying the problems out of all decent proportion.

If a handful of banks out there are in such a position, and it is hardly to be excluded that there are, the Oct. 1 business could produce a shock similar to the Herstatt events of July 1974 or the Franklin National bankruptcy of May 1974. A shock of that magnitude in the far more illiquid market of 1981 would have incalculably more serious consequences.

What dampens out shocks of this sort under normal conditions is the same sort of civil morality that normally prevents an ugly street incident from turning into a riot. Each citizen recognizes that uncivil behavior may ultimately redound to his own detriment. Bankers understand perfectly well that a hasty decision to cover their positions in a weak credit-risk situation might lead to a general pulling-in of horns, and produce a panic.

However, the open confrontation between the United States and Europeans over monetary policy, among other major issues, produces conditions peculiarly appropriate to "riot" conditions in the international market. American banks, in particular, have taken every possible opportunity to dump weak credit problems on their European counterparts. This emerged clearly in the case of Poland, and occurred with less publicity two weeks ago in the case of Romania, when New York banks forced Romania to pay down overdrafts of $50 to $100 million at each of a half-dozen banks by borrowing more from reluctant European lenders. Plainly, the Europeans do not accept the Federal Reserve's recommendation that they accept a restriction of commercial lending, i.e. a restriction of their foreign trade, to compensate for the consequences of a Fed monetary policy which Europe considers insane in the first place. To the extent that the European banks, e.g. Dresdner, are thinking of the crisis potential in the Fed's actions, they indicate that they have no intention of walking quietly into the gas ovens. These political circumstances, more than anything else, make the Federal Reserve's program for a "managed crisis" incalculably dangerous.

Volcker: two more years of high interest rates

From the Brazilian daily Jornal do Brasil *on Sept. 5, headlined: "Volcker Gives No Hope of a Drop in Interest Rates."*

The president of the Federal Reserve Bank of the United States, Paul Volcker, warned yesterday in a meeting with businessmen at the São Paulo Club, that they should not expect over the next two years, a perceptible fall in the interest rates in the United States. "I know that this is not good for a number of countries, including Brazil," he commented.

That policy is part of the United States' fight against inflation. He [Volcker] said that attempts of labor unions to raise their members' salaries by 10 percent is not opportune, because it will prejudice the country's fight against inflation. Mr. Volcker traveled from Brasilia to São Paulo in the company of the president of the central bank, Carlos Geraldo Langoni.

Mr. Volcker gave a 15-minute speech, explaining that in his country there is an effort to reduce inflation, and this implies the existence of high interest rates in the

internal market. "I do not see the possibility of a perceptible drop in interest rates in the North American market in the next two years," he affirmed.

For him, "high U.S. interest rates are uncomfortable for other countries, among them Brazil." Immediately he declared that Brazil is one of the few countries in the world that will shortly emerge from the difficulties caused by the economic crisis, which is worldwide. . . .

From the Brazilian daily O Estado de São Paulo *on Sept. 10, headlined "U.S. Policy Will Be Maintained."*

The president of the Federal Reserve Board, the U.S. central bank, Paul Volcker, recognized yesterday that it is "painful" for Brazil to pay high interest rates, as a result of North American economic policy; however, he emphasized more than once that United States authorities will continue to restrict, "to the maximum possible," the growth of the money supply, as a means of obtaining desired results: reducing inflation and balancing public accounts. He did not want to predict when interest rates would begin to come down, adding that inflation in 1981 "for the first time in several years," will be below 10 percent.

Speaking at the seminar "The Perspectives For The World Economy" sponsored by the central bank, and later in an interview with the press, Volcker reaffirmed the necessity of maintaining a monetarist-contractionist policy until the fight against inflation is won. Only at that point, he says, can what he calls the "basis for future growth" be built. For Volcker, in the long term "monetary restriction is the best thing to do," because it will lead to a reduction and stabilization of interest rates which, to his way of thinking, would not rise to their previous high levels.

EIR *interviewed a senior official of the Federal Reserve on Sept. 15.*

EIR: The New York Clearing House banks are moving their international payments deadline from 10 a.m. the next day up to 6 p.m. on the same day, as of Oct. 1. Does this drain overnight credits from the banking system and promote panic?
A: No. There is no overnight credit or "float" in the New York banks' CHIPS [Clearing House International Payments System] computer to eliminate. If you have a payment outstanding on CHIPS, you also have a debit outstanding on CHIPS, and they both clear together. Occasionally, the New York banks do make loans to European or U.S. regional banks to tide them over to the next day payments, and now they will no longer have to do so, because the Europeans can collect their CHIPS money the same day. The move eliminates an overnight risk to the New York banks without harming anyone else.

EIR: But European bankers say this could cause a crisis.
A: It will not cause anything, but it will put additional strain on whatever problems are already there. For the first time, everyone will be settling international payments not at 10 a.m., when the fed funds market is quiet, but at 5 or 6 p.m., when the entire U.S. regional banks are also trying to settle domestic payments. And 6 p.m. will be an absolute limit, whereas in practice banks often exceed the 10 a.m. limit. But the markets close at 6, so this adds pressure.

EIR: Aren't banks scrambling to get backup loans for this?
A: Yes, because everyone wants to make sure he has enough to pay his fed funds debts on Oct. 1 and for the weeks thereafter.

EIR: But if some don't get it, could this cause Herstatts?
A: Only if there are already potential Herstatts. There is no guarantee that all
necessarily get them. This will certainly heighten awareness of any cases which already exist. It will bring on an awareness and ensure that the lending banks make prudent credit judgments about banks coming to borrow. It will tighten credit standards throughout the payments system.

EIR: Is the Fed ready to bail out any bank rejected in the scramble, or isn't it true that the Fed, too, will have to "make its judgments," and might have to reject some?
A: The Federal Reserve is a bank, and is run like a bank. The Fed has to make the decisions. We intend to open the discount window if the need develops, if the fed funds system can't handle it, but we don't just open the discount window to all comers. It does depend on how creditworthy banks are in the first place.

EIR *interviewed a Dresdner Bank director on Sept. 17.*

EIR: It certainly looks as though Chancellor Schmidt used his trip to Italy to catalyze a more serious campaign against U.S. interest rates than ever before.
A: Absolutely. It is now a matter of life and death, and if you like Schmidt's behavior in Italy, just wait another week or 10 days. He is moving way out front, and you are going to see a lot more coming from him now.

EIR: The dollar is dropping, and the markets are rumoring that major investors are moving out of dollars now, especially the Arabs.
A: This is true. The Arabs have gotten word that the U.S. budget is an unredeemable mess, it cannot and will not be financed. Our own budget situation is improving. That is pulling the dollar down, but it will probably take some time before it reaches the 2.20 level. The present

threshold of 2.40 marks is psychologically conditioned, not only by the Americans' high interest rates but also by the flareup of talk about remonetization of gold. No one here in Frankfurt believes that any of the gold plans under discussion in the administration right now are viable, so that the minute that anything just a little more dramatic happens, the dollar will start to slide to 2.20 at least.

EIR: How will the "same-day settlement" system affect you?
A: It could well be that the entire system will come crashing down the day "same-day settlement" goes into effect. Even if it takes only one day to get all the bugs worked out of the system while everyone is trying to adjust, there are definitely going to be a few failures. Some people are going to get caught short, and then the only question will be whether the Fed wants to, or can, move fast enough to keep enough shortfall cases afloat. The problem will not be this or that case, but rather the chain reaction. For example, we clear $15 billion daily. If money we expect from certain sources does not come in, the treasurer has the job of trying to dig it up somewhere else. So far we have managed it, and the Bundesbank functions as lender of last resort. If the Fed does not do the same thing—and fast—bust.

EIR: Won't this also curtail your own lending operations? Poehl says central banks want more control on volume and velocity of growth of lending. This looks right down that line.
A: Not really. The squeeze they want is on inner-American banking. We have set up private standby-lines with American banks. And not only in New York. If we have to rely on pulling funds in from other subsidiaries, it will mean we are de facto giving up clearing in New York. It may come to that, but it will not present us with any survival problems.

EIR: How does German banking evaluate the Washington revolt against Volcker's interest rates? Has it come down to a time question, or are people still cynical about the chances for any political motion against Volcker to really be effective?
A: Not cynical. What is now happening in Washington has everyone convinced that the people talking to those senators and congressmen in the recess period were really serious and made their point. It is a time question in a certain way, but actually everyone here sees President Reagan, and thinks he is going to be willing to defend his economic policies and high interest rates at the gunpoint of the National Guard if necessary.

EIR: Fine, that's your evalation as of now. But how do you evaluate your own position now?
A: All I can say is that the war-cry in Frankfurt now is "Bang that damned dollar bloody!" I do not know, no one knows what the Bundesbank will do at the IMF meeting in Washington [on Sept. 29], but I can tell you that German bankers are going to be telling everyone and the Americans that the United States needs lower interest rates. At this point we think it is appropriate to tell the Americans the obvious, which is that those interest rates mean suicide for the American economy itself. Since monetarists never listen to reason anyway, it will also be necessary to point out to people who listen to them that the experiment never worked in Britain, and there is no reason why it should work in the U.S., unless of course the Americans really want a British-style economy.

EIR: Chancellor Schmidt is showing a good deal of strength. Thatcher and Mitterrand are propagandizing that they too agree on almost everything. Who has more weight in Europe?
A: Mitterrand and Thatcher have no more than their common stupidity with respect to the Soviet Union in common. The British economy is a disaster, and the French are working overtime to destroy what has been built in the last 20 years. As far as their attitude toward the Soviets, they are in agreement with the Americans. All I can say is that I could care less about being dependent on the Soviets for raw materials and energy supplies to the tune of 20 percent and more. Who cares? At least they keep to the contracts, which is much more than you can say for jerks like Qaddafi.

LaRouche: how a gold standard should work

Lyndon H. LaRouche, Jr., the noted economist who is chairman of the advisory board of the National Democratic Policy Committee, has issued a call for serious open discussions of plans for returning gold to a central place in the world monetary system.

To prevent the imminent onset of a new depression, already upon us due to the incompetent usurious policies of Federal Reserve Chairman Paul A. Volcker, we have no alternative but to put the U.S. gold reserves to work as a base for massive credit expansion in capital-starved industry and agriculture.

The upcoming meeting of the Presidential Gold Commission presents an ideal forum for debate on how to return to a gold-based system.

Unfortunately, the most prominent spokesmen on the President's commission come from the British Fabian school of economics epitomized by Milton Friedman