Click here for Full Issue of EIR Volume 7, Number 35, September 9, 1980

Banking by Leif Johnson

Liquidity pressures by year's end

U.S. bankers are preparing for the worst, and pumping up a fourth-quarter bubble.

This week's move to an 11½ percent prime rate took interest rate analysts in New York by surprise. The largely unexpected element in the picture was a sharp and rapid increase in banks' cost of funds, measured by the rate on six-month Certificates of Deposit (CDs), which rose from about 9.8 percent less than two weeks ago to 11¼ percent on Monday, Aug. 25.

Banks are scrambling to get hold of liquidity, both for hedging purposes and for fear of serious trouble ahead. Comprehensive figures are not available, but bank money market analysts report a rise in the outstanding issue volume of CDs during August far in excess of the increase in commercial and industrial loans outstanding. Banks expect the interest rate rise to continue, and are loading up on funds rather than pay more for funds later.

However, there is a deeper motivation for the rush to lock up funds now. Last winter, banks undertook similar funding operations mainly due to uncertainty about the domestic and international credit outlook.

Whatever the cost to balance-sheet bottom lines, banks have no choice but to lock up all the liquidity possible in periods when a general liquidity shortage is a real prospect. This anticipatory borrowing caused a sharp run-up in interest rates last winter. Although the rise will be considerably slower than during the frenetic first quarter of 1980, the same phenomena are at work.

Closely related domestic and international factors are working together to produce the sharp rise in rates—what *EIR* warned would be an "interest rate disaster" two weeks ago, before the run-up began in earnest.

First, bankers recognize that balance-sheet pressures on corporations are contributing to an explosive growth of credit demand on the bond markets. Manufacturers Hanover Trust wrote Aug. 25: "The volume of corporate bonds publicly offered during the four months ending Aug. 31 is expected to total $23 billion—almost equal to the new issue volume in the entire year 1979! Triple-A yields stood at 11.69 percent on Aug. 19, almost 58 basis points above month-earlier levels. Double-A corporates also posted substantial yield gains, rising 63 basis points during the four weeks ending Aug. 19 to 12.12 percent."

By the end of this year, commercial and investment banking liquidity analysts predict, the bond markets will be unable to handle the huge issue volume, and the banks will have to field the demand for credit. Toward the end of the fourth quarter, we expect that credit demand generated by the depression itself, including the $100 billion per annum rate of federal borrowing, will push up inflation, monetary aggregates, and interest rates simultaneously.

Some commercial bank analysts of a monetarist persuasion counter that both households and corporations usually respond to balance-sheet pressures by reducing short-term borrowing and cutting back on economic activity. However, Britain has reached the point where additional borrowing by the corporate sector is involuntary. A detailed examination of corporate balance sheets by Salomon Bros. reviewed in *EIR* last week suggests that the same will be true for the United States within a few months.

Banks themselves are avoiding the trap many of them fell into during the first quarter, i.e., mismatching short-term liabilities to long-term, fixed-interest assets. This is the bad combination that brought down First Pennsylvania and nearly floored First Chicago, along with many other banks that achieved less notoriety. Over the second quarter, banks restricted their fixed-interest investment to paper of less than five years' maturity, according to Federal Reserve statistics, remaining much more liquid than they had during the earlier period.

What worries the banks most is the international picture. The only reason that the developing sector escaped bankruptcy proceedings on about $250 billion in commercial bank debt during the first half of 1980 was the halving of interest rates between April and June. The current rise in interest rates has taken the financial system to within a couple of percentage points of a danger zone. Each percentage point rise of interest rates costs the developing countries an additional $2.5 billion in interest charges.

© 1980 EIR News Service Inc. All Rights Reserved. Reproduction in whole or in part without permission strictly prohibited.