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A revolution by fiat: the Fed's IBF decision

by David Goldman

The Federal Reserve approved, pending a 60-day comment period, the New York Clearing House bankers' proposal to establish "International Banking Facilities" (IBFs) in a unanimous Nov. 19 decision. Although the first IBFs will not come into operation, under the plan, until October 1981—despite the impatience of IBF advocates like New York Governor Carey—the Fed decision is a public signal of an *attempted coup against the American banking system.*

Once in motion, the IBFs will effectively draw the entire American deposit market into the Eurodollar pool, the $1.2 trillion mass of offshore funds that turns over every month. The technical features of the change can be summed up in one characterization: the plan will replace what Americans know as *banking* with British-style *arbitrage.* The ability of most of America's 14,600 banks to create *risk assets* anticipating economic growth will give way to a funding system that excludes investment in economic growth from consideration.

New York Federal Reserve Bank President Anthony Solomon, a leading proponent of the IBF plan, argued in a supporting brief made public by the Federal Reserve that the International Banking Facilities will contribute to Federal Reserve control over the Eurodollar markets. The IBFs permit American banks to accept deposits without reserve requirements—as in the Eurodollar market—through their head offices on American territory. Moreover, American banks will be able to establish IBFs in states now forbidden them for domestic banking functions. Supposedly, the banks will only be able to accept deposits of foreign origin, which would otherwise end up at their Cayman Island branches. Therefore, Solomon argues, the IBFs would bring offshore funds back to head office facilities, where they would be subject to closer monitoring.

The opposite is actually the case: the IBFs would turn control over the American banking system and the bulk of power to create money over to the Eurodollar market. The Fed has already hinted that it will enable U.S. corporations to make deposits in IBFs, against which the recipient bank will hold no reserves. Earlier, the Fed had given out assurances that only the foreign offices of U.S. corporations could use the IBFs. In return, the corporations expect to obtain loans at lower interest rates, because their bankers will not have to put reserves up against their deposits.

Rapidly, the bulk of large corporate banking will shift into the reserve-free Eurodollar channel. To a significant extent this is already in process. American corporations are borrowing directly from the Eurodollar market, or using their foreign subsidiaries to obtain dollar loans intended to fund domestic American operations, because the cost of funds is marginally cheaper in the Eurodollar market. The IBFs would open a new window for this sort of circumvention of reserve requirements, even if American corporations' head offices were excluded. By including U.S. corporations, the Fed is giving a green light to the end of reserve requirements on lending. *This makes a farce out of the Federal Reserve's much-discussed concern over controlling the monetary*

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aggregates.

Reserve requirements are a central bank's only weapon against unlimited money creation by the banking system. Banks create money as much as the national bank does, by re-lending deposits that result from previous loans. The "banking multiplier," now about 2.5 in the American banking system, describes the ratio between the "monetary base," including creation of new money by the central banking authority, and total deposits. The multiplier in the Eurodollar market, where there are no reserve requirements, is at least 6—more than double the U.S. multiplier—according to Federal Reserve Governor Henry Wallich.

In supporting briefs presented to the Fed's Board of Governors by the Reserve City Bankers Association (the money center bankers' club) and the American Bankers Association in May and June, the IBFs are represented as a harmless means of bringing business to the United States that would otherwise be conducted in some Caribbean offshore banking center. But the IBF plan is revolutionary in content. Only a handful of major banks among the 14,600 now in business can afford the foreign staff and facilities to conduct Eurodollar business. Bringing Eurodollar-type operations back to banks' head offices makes it possible for hundreds more banks to get into the game. The IBFs would force the next tier of regional banks to join in and play by the rules set by Citibank and Chase Manhattan. And because Citibank can operate IBFs in any state that permits it, they will be competing with Citibank on their own home ground.

The picture for smaller banks

In related measures, the Fed is creating the conditions for a wave of mergers in the banking system which would—in *Business Week* magazine's recent prediction—reduce the number of significant banks in the United States to fewer than one hundred. The provisions of the Monetary Control Act of 1980 phased into effect last week show unambiguously what the Federal Reserve has in mind. The Monetary Control Act ordered 8,000 small regional banks who previously worked outside the Fed system to put up reserves against deposits by Fed standards starting last week. Simultaneously, it reduced reserve requirements on banks with checking accounts in excess of $400 million from 16 percent to 12 percent. The result is a shift in the reserve costs of the banking system from large commercial banks to small commercial banks.

The Fed also took the opportunity to raise interest rates another notch. Before the 8,000 small banks came on board the Federal Reserve system, the federal funds rate was trading at about 15½ percent—the basis for a 16¼ percent prime rate. The entry of the new banks produced a temporary surge in demand for federal funds (excess reserves borrowed and lent overnight among banks), largely for technical reasons. On Monday, Nov. 17, the funds rate hit 19 percent and then, as expected, began to fall. But Fed Chairman Paul Volcker only permitted the rate to fall to 17 percent, a 1½ percent increase in the most important short-term interest rate. This augurs a prime lending rate in the range of 18 percent by early December.

From the standpoint of the arbitrageur, this represents no significant problem. The "profitability" of most American banking operations on the Eurodollar market is unrelated to interest rates: commercial banks borrow at whatever the London dollar rate happens to be and lend to borrowers at a "spread" above that rate. The fact that a majority of American banks' loans merely provide developing-sector debtors with the means of paying principal and interest on previous loans has nothing to do with the bookkeeping profit on such loans.

The phaseout of commercial banking

What is most dangerous about the Eurodollar takeover of the American banking system is the extension of this practice to American lenders. As *EIR* reported in a Nov. 11 forecast of 1981 economic performance based on results of the LaRouche-Riemann econometric model, more than 50 percent of the proceeds of new loans to industrial companies during the second quarter of 1980 represented refinancing of debt service. With the rise in interest rates from an 11 percent prime to a 16 to 18 percent prime, that proportion will increase to more than 100 percent by the beginning of 1981—forcing corporations to reduce inventory and lay off workers in order to meet debt-service requirements. Those large commercial banks with continued access to the "bottomless" reserve-free pool of Eurodollars will show profits—as they did during the second quarter collapse, when similar conditions prevailed. But the majority of banks depend, instead, on deposits generated by their customers' flow of income. If that income collapses in a second-stage economic downturn, the regional banks will be against a wall.

In summary, the Federal Reserve is destroying the conditions under which commercial banking—the creation of risk assets—can compete against mere arbitrage. It is enhancing the position of the arbitrageurs on the regulatory side, and destroying the position of commercial banks through actions that directly impact the national economy. *EIR* warned in a Sept. 29 survey entitled "The Undeclared War Against American Banking" that the IBF plan in context of continued monetary austerity would destroy the resistance powers of the majority of American commercial banks, no matter what Congress did. Now war has been declared.