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The crunch is on

With rates on the Euromarket soaring, the question of who goes bankrupt and who doesn't will be determined by who gets control of the Federal Funds market.

Short-term interest rates went through the ceiling on the Eurodollar market March 31: 20⅝ to 20½ percent for one month deposits; 20 to 19⅞ percent for three months; and 19¾ to 19⅝ percent for six months. March 31 tax payments and other end-of-the-quarter factors may have put added steam under the Eurodollar rates. However, the primary reason is a scramble for short-term funds by banks who are cash short in the face of the Federal Reserve's new reserve requirements.

In the current bank reporting week which ends April 11, the new marginal reserve requirements unveiled by the Federal Reserve March 14 go into effect for both Federal Reserve members *and nonmember banks*. This prong of the Fed's program is designed to jack up the banks' cost of funds, thereby "encouraging" them to cut back on loan expansion.

The Fed's authority to impose reserve requirements on nonmember banks stems from the Credit Control Act of 1969. The Depository Institutions Deregulation and Monetary Control Act of 1980, signed into law by President Carter March 31, subjects nonmember financial institutions to reserve requirements as a matter of course, and allows the Fed to raise those reserve requirements as high as it deems fit.It is an open secret that many of the nation's smaller financial institutions will not survive the squeeze.

According to Jeffry Nichols of Argus Research, the area where the Fed's credit crunch will strike the hardest is bank borrowings from the Eurodollar market (a category known as "managed liabilities"). The Eurodollar market has been a major source of additional liquidity for the U.S. economy over the last year. As of the current bank reporting week, all supplementary borrowings over a base period by the money center banks to fund outstanding long-term loans or make new loans will be subject to a heavy penalty of 10 percent reserve requirements.

A significant portion of the banking system's demand for short-term funds has already been deflected to the Federal funds market, the overnight interbank market, where major banks are reportedly borrowing between $4 and $5 billion per day. Since Fed funds purchased from other major banks are exempt from the new margin requirements, they are a cheaper source of funds than certificates of deposit (CDs) which are subject to the reserve requirements.

Who gets Fed funds at what price thus becomes the critical question. Charles Lott of Keefe, Bruyette, the bank stock firm, said in an interview that he is worried about the thrift institutions but not the large commercial banks. "The big banks can help each other out. They have Federal funds which they can pass around to help each other out. They will give these funds to the banks that they think worthwhile to keep out of trouble." Who ever controls the Federal funds market will determine who gets bailed out.

Despite some initial squeals from leading money center bankers, it has become quite clear that they welcomed and encouraged the March 14 measures. In a recent interview, Bankers trust economist Donald Wooley commented that with the cost of funds skyrocketing, all of the major banks wanted to retrench on their loan portfolios. The only thing stopping them was the concern that if they went it alone, they might jeopardize their market share and lose out on future business. "There was some measure of satisfaction with the Fed measures," he said, "because it imposed discipline on everyone to retrench together."

Many of the nation's smaller banks have no choice but to retrench fast. Smaller retail-oriented banks are particularly impacted by the new requirement to place 15 percent reserves in interest free deposits with the Fed on loans made above the base period. "Our strategy is to make sure there is no increase in our loan portfolio to avoid the penalty," stated the banker at one small New York state bank. As a result, all but the most "credit-worthy" customers face an imminent credit cutoff.

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