Pull down the U.S. to build up London

A third-quarter collapse will shut down domestic loan demand so that funds can shift to London.

Wall Street banks in cooperation with Federal Reserve Board Chairman Paul Volcker plan to use a recession in the third quarter to collapse loan demand in the United States, in order to siphon off the money to branches in London where it will be used to roll over Third World debt.

"This seems to me a very good possibility," stated James O'Leary, chief economist of U.S. Trust. "This would provide the New York banks with the wherewithal to cover Third World debt obligations."

"Absolutely, that seems to me exactly what might happen," said Richard Kjeldsen, chief international economist for Security Pacific National Bank of California. "In the third quarter, the domestic side of lending will be off. The needs of international lending will be there. Some people have tried to suggest that the U.S. would pull back from its commitments to the Third World, but the loans by banks like Citibank to Brazil are substantial. The banks will use the slack in third-quarter domestic loans to send the money to the Eurodollar market to fund Third World debt."

This option would be a repeat of what was done after the March 1980 imposition of credit controls by Fed Chairman Volcker. While U.S. loan demand plummeted, $15 billion was transferred from principally New York banks to their London branches within a three-month span during the summer.

Thus far, both International Monetary Fund Managing Director Jacques de Larosière and Federal Reserve Board member Henry Wallich have estimated the current account deficit of the Third World non-oil-producing nations for 1981 to be between $95 and $100 billion, the largest deficit since 1974. At most, $25 billion of this can be financed by the Third World drawing down reserves or getting loans from multinational agencies like the IMF.

The pace of short-term U.S. corporate borrowing has been frenetic. Despite a slacking off during the past two weeks, commercial bank commerce and industry loans grew by over $10 billion since April 1. Commercial paper—short-term corporate IOUs of usually 90 to 270 days maturity—has grown by almost $12 billion, including nearly $4 billion in the latest two reporting weeks.

As we showed in previous columns, the money flowed into four principal areas: mergers and acquisitions; financing involuntary inventory buildup; paying off interest on previously contracted debt; and investment in U.S. energy and mining sectors.

Now the plan is to pull the plug on those loan areas, except, perhaps, for the merger and acquisition movement. Edward Yardeni, chief economist of E. F. Hutton & Co. investment bank, stated that "the policies from Washington will show a bottom line of pain" for the economy, according to the July 27 New York *Daily News*. Yardeni reports that this will entail only a 3 to 4 percentage point drop in the prime rate during the third quarter. As a result he predicts that:

- Unemployment will increase by 1 million people by October.
- Bankruptcies, which are occurring at a rate of 313 per week for the first half of this year versus 220 for the comparable period last year, will go up by 10 percent.
- The housing market will experience acute illiquidity.

The problems of the housing sector could be the trigger for an outright economic collapse in the third quarter. The auto and housing sectors of the economy are already deep into recession. Housing starts at 1.032 million units in June are down 38 percent from January's levels. With the average mortgage rate for new homes at a range of 14.5 to 16 percent nationwide, the housing market is past the straining point.

The danger sign is that permits authorizing new housing, which had averaged 1.2 million for most of the year since January, plunged to 976,000 in June. When permits fall, housing starts usually follow. And if housing collapses further, the beleaguered thrift industry—which suffered $5.6 billion in withdrawals in June—will follow suit.

As Fed Chairman Volcker steers this course haphazardly in tandem with the New York banks, loan demand in the United States will dry up, just as it did in the second quarter of last year. And that will open up the door for Wall Street to shift funds to London to step up rollovers of Third World debt.