

## The debate over rates generates no interest

The current debate over whether or not U.S. interest rates have peaked has a laughable air of unreality to it.

Perhaps the most striking example of the problem is found in the "business as usual" discussion of the federal budget deficit and the effects of financing it on the U.S. credit markets.

The widely read Manufacturers Hanover Trust *Financial Digest* argued last week that the impact of the looming fiscal 1980 budget deficit would not be "unduly disruptive" on the U.S. financial markets because of a large Treasury surplus, state and local government surpluses, and weak business loan demand. But at the same time, the actions of senior U.S. Treasury officials were making it impossible to finance a U.S. government deficit ever again.

Treasury Secretary William Miller's statement in Riyadh on Nov. 25, that he looks forward to a time when the International Monetary Fund's Special Drawing Rights will replace the dollar as the premier international reserve currency, can hardly have increased the Saudis' confidence in the dollar or their eagerness to continue placing surplus oil receipts in Treasury securities. The Treasury's freeze of Iran's dollar-denominated assets is another recent development which raises questions about future foreign purchases of U.S. Treasury debt, to say the least.

The implications for financing the fiscal 1980 federal deficit—which analysts now say could reach \$50 billion or twice the fiscal 1979 deficit—are extremely ominous. In 1977 and 1978, the OPEC nations, Europe, and Japan were the mainstay of the U.S. government securities market. Foreign investors increased their holdings of Treasury debt by \$31.6 billion in 1977 and \$20.8 billion in 1978. The net increases in holdings of Treasury securities by all investors in those years were \$35.2 billion of \$22.2 billion, respectively.

Figures compiled by Bankers Trust show that the liquidation has already begun. During the first three quarters of this year foreign investors ran down their holdings of Treasury securities by \$11.5 billion. The shift principally reflected the temporary stabilization of the dollar and the fact that European central banks were acquiring fewer dollars in currency support operations. Foreign exchange sources now report that the

liquidation is accelerating and taking place for other reasons. Over the last six weeks, \$9.5 billion in U.S. Treasury debt has been dumped by foreign holders, a full \$6 billion of which is accounted for by sales by the Bank of Japan, which desperately needs cash to defend the yen.

Having taken stock of these events, most money market economists now believe that the burden of underwriting the government's growing budget deficit will fall inescapably on domestic investors—commercial banks, savings banks, insurance companies and other institutional investors, and state and local governments. As Manufacturers Hanover noted in its Nov. 26 commentary, whether those sources can come up with sufficient funds to finance the Treasury deficit depends on the size of corporate credit demand—that is, the Treasury's needs can be met only if economic activity collapses and short and long-term credit demand evaporate.

### Is this the peak?

As the nation's stock and bond markets burst into euphoria last week over the slight drop in the prime rate, cooler heads on Wall Street were predicting a renewed ascent of rates before long and telling their clients "to go long." In fact, when Chase Manhattan lowered its prime rate to 15-1/4 percent on Nov. 27—a quarter point lower than everyone else—it issued a statement emphasizing that the reduction "shouldn't be interpreted as a prediction of future interest rates one way or the other" but was just "an accurate reflection of current money-market conditions."

The next day Henry Kaufman of Salomon Brothers, the guru of the credit markets, was quoted in the *Financial Times* of London as predicting that the prime rate would peak at 17 percent and not before.

Those sources putting their money on a higher and later peaking of rates cite first the possibility that corporate borrowers may take advantage of the slight easing of rates and rush to lock up more loans before rates go higher again. Loan demand is by no means quenched despite the recent slowdown over the last several weeks, because inflation has locked the corporate sector into a dependency on borrowed funds.

Second, they regard as imminent another major hike in world oil prices when OPEC meets in mid-December.

Expectations of this have already sent the dollar plummeting on the foreign exchanges again, and could provide the Federal Reserve with the pretext for effecting another round of credit tightening measures "to defend the dollar." Furthermore, Fed Governor Henry Wallich, who is usually privy to Chairman Volcker's deepest intentions, leaked to the press last week that he believes that the central bank should accommodate a higher oil price "as little as possible." That is to say, the Fed should let the credit markets and the economy feel the brunt of the threatened OPEC price hike and not relax its stringent monetary policy.

It is also expected that U.S. Treasury securities will be dumped by foreign holders, which would throw the whole Treasury financing ball to domestic investors and put more upward pressure on interest rates.

These well-taken considerations lead various sources to date the peaking of interest rates three to six months hence. What no one fully realizes, however—or at least is willing to admit publicly—is that when interest rates do "peak," it will be after months of economic devastation, and then there will be a drying up of loan demand and collapse of interest rates similar to what happened after the Kredietenstalt folded in 1931. Hardly an event to look forward to.

The easing of interest rates two weeks ago was rigged by the Federal Reserve to, if anything, cover for the budgetary and credit market crisis in the making, and allow the U.S. stock and bond markets a brief rally before the next deluge. The cut in the prime rate initiated Nov. 26 was the outcome of the Fed's generosity to the large commercial banks—the continuing supply of borrowed reserves to the banking system. As the recent statements of Secretary Miller and other senior U.S. monetary officials show, their chief aim is not merely to "cut money supply growth," but to phase out the dollar's role as a world reserve currency, bring on the SDR, and subject the U.S. economy to IMF dictates. In the process of engineering this, they can allow the credit markets to entertain the illusion that "interest rates have peaked."

—Lydia Schulman

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