What's behind the fall in interest rates

by Richard Freeman

The speed of the fall in interest rates during the last two and one half weeks has left nearly everyone in the U.S. money markets aghast. The fall was as volatile downward as the movement upward had been inexorable over the seven months since the credit-tightening pulled by Federal Reserve Board chairman Paul Volcker.

Yet most people in the business and financial community have not understood why the fall has occured. The normal reasoning is that a recession brings less business activity, which brings a reduced demand for funds and therefore rates fall. This conventional wisdom was given an additional boost when on May 6, Fed chairman Volcker removed the 3 percentage point discount surcharge (on top of the 13 percent prevailing rate) that banks with $1 billion in assets or more pay when they borrow from the Fed discount window.

Summarizing this widespread conventional view, Bankers Trust of New York economist Donald Woolley said May 6 "the recession has broken out and the recession psychology is everywhere."

But far more important reasons were at work influencing the fall in interest rates. Almost overlooked is the fact that before the big money center banks began lowering their prime lending rate, and Treasury bill rates started falling, Paul Volcker himself was helping undo the high interest rate bubble. Is this the same Paul Volcker, who last year publicly endorsed the Council on Foreign Relations call for the "controlled disintegration of the economy?" Is he suddenly reversing that strategy and proposing to save the U.S. economy with low interest rates? Don't bet on it.

On April 21, the federal funds rate stood at 17.65 percent. On May 6, 10.0 percent. What happened in between? In the interim, Federal Reserve Board chairman Volcker had injected reserves into the banking system at an increasing rate. Volcker bought up billions of dollars of Treasury securities from the commercial banking system, thus making available liquidity. On days when the federal funds rate was trading at low levels, Volcker refused to intervene to push the rate back up.

Something far more important than the oncoming recession was motivating Volcker at this moment: first of all, it was preserving the very integrity of the banking system. As a result of the previous 7 months of the Volcker credit stringency, the U.S. banking system had come to the edge of a total blow-out, as non-performing assets outweighed a shrinking volume of earning loans.

"U.S. banks were finding it almost impossible to operate," said Peregrine Montcrief of First Boston Corporation May 7. "The banks had no mortgages on their books," he continued, "no inventory financing, no good assets. For the 30 day period after March 14, banks were constrained by the Volcker corset [limit on new loan growth—ed.] and that was hurting them." In addition, between March 14 and the end of the third week of April, the money supply became sharply negative.

The First Pennsylvania Bank failure in late April simply heightened the severity of the crisis. First Penn was put into effective receivership by a consortium of the Federal Deposit Insurance Corporation and 26 commercial banks. The scapegoat firing of Robert Abboud as

Paul Volcker: Easing up interest rates just in time to avoid a bank collapse

chairman of troubled First Chicago, and the potential loss on investments by the First Wisconsin and First Seattle banks as a result of the Argentine banking collapse, brought the issue to a head.

Volcker bailed out the banking system. By reducing the cost of funds on the interbank market, Volcker helped restore the profit margin spreads of the banks. Then Volcker eliminated the 3 percent surcharge.

Once Volcker began manipulating the federal funds rate downward, Morgan Guaranty Bank, the leading pro-British commercial bank in the U.S., began driving down the prime rate to create the impression of well-being.

Appeasing Europe

Volcker had another matter on his hands in the last week of April: appeasing Europe. The high interest rate of the U.S. has become an increasingly painful thorn in the continent's side. The attraction of flight capital funds into the U.S. forced Europe to jack up their interest rates, leading Germany to hike its Lombard rate to 9 1/2 percent last week, while France's prime rate is hovering at 13 percent.

Europe's export trade financing—the backbone of its economy—is threatened by the Volcker action.

Euro-loan syndications plummeted by 25 percent in the first quarter to $14.4 billion from $19.1 billion the previous quarter as a result of the high lending rates Volcker imposed on the world. Moreover, the internal economies of France and Germany do not work well under such high interest rate regimes. By means of astronomical U.S. interest rates the Europeans were simply having a red flag waved in their face by Volcker.

By antagonizing the Europeans, Volcker hightened the tendency for the European Monetary System architects, French President Giscard and German Chancellor Schmidt to find solutions outside the Anglo-American monetary order, a thought chilling enough for the City of London to send transatlantic cables to Volcker telling him to temporarily lower rates.

Reorganizing the U.S. economy

The recession in the U.S. was of course a consideration. During recessions, rates do tend to naturally come down, even of their own accord.

But Volcker has something else in mind in terms of the U.S. economy. The credit crunch of the last seven months has produced collapse in entire sectors, such as auto and construction. Volcker may have thought that key industrial sectors were sufficiently broken and their downturn steep enough to allow a reorganization from the top. This process is already underway in the devastated auto industry, where the number three auto maker, Chrysler corporation, is being scaled down to a minor producer and where discussions began this week between the government and Big Three on how to "reorder the industry" in exchange for government aid.

In this regard, Volcker's tight credit policy was a softening up move to reorganize the economy. With the softening up objective partly accomplished, Volcker can ease off on interest rates a bit.

Yet, whether Volcker can maintain interest rates at a lower level is an open question. "I don't see interest rates going below 12 to 13 percent by the end of 1980 in any event, and they could go higher again," reported Banker's Trust's Woolley.

Indeed, there are compelling reasons why interest rates may rise. First, the U.S. federal budget deficit for the first half of fiscal 1980 (which ends in September) is $51.7 billion. This could be a $100 billion deficit by the end of the budget year, expecially since each 1 percentage point increase in the unemployment rate, which is shooting up fast, adds approximately $20 billion to the deficit. Thus, the Treasury will make a large demand on funds.

Secondly, corporations have a huge pent-up demand for funds, which has only partially been off-set by the dramatic turn around in the corporate bond market of the last two weeks and by the swelling of the commercial paper (corporate IOU) market. Hence, despite the fact of the onset of the recession in an even bigger way, corporate needs will build up credit demand.

Thirdly, reported John Duffy, bank analyst for Keefe Bruyette investment house, "There are still trouble spots in the banking system. Detroit and St. Louis are centers were layoffs will hurt the banks. Sunbelt states dependent on construction are another crisis center. Alabama has banking problems because of construction and steel cutbacks." These regional banks need funds to lend.

In the event Volcker attempts to meet the combination of these needs, money supply may surge and the hyperinflationary spiral will be off and running again. The only answer would be to push interest rates back up.