Domestic Credit by Richard Freeman

A short fuse under interest rates

With interest rates heading up again, the depleted U.S. economy may not recover.

Citibank's increases in its prime lending rate to 14 percent on Oct. 2, a full day before the bank's normal Friday announcement of increases or cuts, marked a further explosion in the U.S. interest-rate increases of the past month. Since the last week in August, the prime rate has jumped 325 basis points, a far greater increase than the combined hikes of last October and November, when Federal Reserve Chairman Paul Volcker first began to tighten credit.

The surge in interest rates will take immediate effect on the U.S. economy, which is far more depleted than it was in October 1979. And the interest-rate now is far steeper than the ones last year. The economy cannot withstand such a deep shock after 12 months of recession without permanent damage.

The immediate cause of the depleted state of the U.S. economy is the fact that it has been through two credit shocks already. As a result of Volcker's placing of a 9 percent ceiling on new bank lending and raising the discount rate in October of 1979 and the March, 1980 imposition of credit controls, the production level of key sectors of the economy fell by 10 to 40 percent. This meant two developments: first, that no new capital formation of any significance occurred during this period; second, industries were not generating the cash flow to store up for future capital formation. In the case of U.S. industries suffering from massive obsolescence, such as steel, and housing stocks, this means that they were pushed further from a position of recovery. A third interest rate shock will cut right to the bone.

The prime-rate increases will probably not stop short of 14¾ or 15 percent. There is no guarantee that rates will stabilize even at that plateau; it would take another blip in U.S. inflation and inflationary expectations for rates to go much higher, but that can't be ruled out.

The most immediate cause for the rise is Paul Volcker's incompetent handling of monetary policy. His "anti-inflation" program has led to a recession that widened the federal budget deficit and increased businss costs, in turn boosting borrowing needs.

Corporations have taken bank loans in greater volume recently, largely for inventory financing and for "bridge" financing, that is, for project costs committed by corporations months or years ago.

However, according to Wall Street analysts, there is now a panicky rush for short-term borrowing because corporations fear being shut out of the long-term bond market.

"With the long-term side of corporate bonds moving higher, corporations are scrapping their corporate bond issues, which they held off the market for a while hoping rates would fall, and are now going toward borrowing from the banks," stated Robert Synch of Bear, Stearns investment bank. It should be added that the pileup in loan demand is selective; not everyone can afford to borrow.

Federal funds traded at 13¼ to 13½ by Oct. 2, and the payout of more than $100,000 on certificates of deposit, which are sensitive to the fed funds trading range, is currently at 13 percent. Because of reserve requirements on CD deposits, the actual cost of funds for commercial banks on CD deposits is 13¾ percent. Since banks generally try to maintain a 1 percent spread, if Fed funds and CD rates stay at their current levels, the prime rate will have to rise to 14½ to 15 percent within the next week and a half.

With mortgage rates at 14 percent at leading savings and loan associations in California, new homes are once again being priced out of the range of the consumer. In New York City, for purchase of a cooperative apartment, the buyer is being asked to put up 25 percent of the purchase price in a down payment, plus 14 percent interest, plus 2 percent good will.

Another key sign is the 6.6 percent drop in capital goods orders reported by the Commerce Department for the month of August, which led the overall 2.3 percent drop in new durable goods orders for that month. Machine-tool orders plunged 47 percent in August. Machine tools had been one of the most buoyant sections of the economy.

The decline signals that capital formation is being axed, a signal that corresponds with the short-term panic borrowing of bank funds by corporations rather than their long-term borrowing on the bond market.

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