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Domestic Credit by Richard Freeman

False appearances

The Fed's liquidity injections have brought down interest rates; a large, long drop is unlikely.

Recent discussion about a new surge of cash the Federal Reserve is providing for the banking system, is in effect, one of the most poorly constructed press campaigns about Federal Reserve "easing" of monetary and interest-rate targets of the recent period. Short-term rates—for federal funds and commercial paper—have fallen significantly over the last two months, but that fall is temporary, and will probably be reversed within a matter of months. Recent statements by Fed Chairman Paul Volcker about his need to hold the line against new "surges of inflation" and his pronouncements of little economic growth next year, give a better indication of what Volcker's monetary policy will be for the next 12 months.

It is undeniable that the rate on federal funds—excess reserves that banks trade overnight with each other and the Federal Reserve—has been steadily dropping. Fed funds were 18 percent on Aug. 21, and six months later, on Oct. 7, they dropped temporarily to 12.25 percent, a fall of nearly 600 basis points in six weeks.

The Fed is indeed injecting funds into the banking system through the federal funds market, which operates on a supply-demand basis; the more funds there are, the lower the federal funds rate falls. There are two special reasons that the Fed of late has been trying to make the banking system liquid.

First, on Oct. 1, the large money center banks with international accounts went on same-day settlement for those accounts. Since the banks had previously been able to get an added 12 to 24 hours of extra liquidity through the float, in the form of uncollected checks, the Fed moved in during a two-week period to supply the extra liquidity that would otherwise be drained. This brought the fed funds down to 12.25 percent Oct. 7, but I think the market will soon bounce back up to the 15 percent range.

However, the second reason that federal funds fell has to do with the Federal Reserve's worries about "overkill"—a repeat of March 1980, when Volcker imposed credit controls on top of a weakening economy. U.S. corporations and the household sector are so illiquid that the Fed is pumping money into the banking system to prevent a crisis. The Fed does this by buying Treasury securities, or putting "non-borrowed reserves" into the system; banks can use the reserves to create new checking accounts. The Fed is well aware that M1-B, checking accounts and currency in circulation, has grown by only 1.7 percent annualized rate since the start of the year.

Yet the reserves that the Fed lends through the discount window, sometimes called "borrowed reserves," have been falling as steadily as "non-borrowed reserves" have been growing. Since Aug. 2, when total reserves—both borrowed and non-borrowed reserves combined—stood at $47.2 billion, that total has actually fallen slightly to less than $47 billion today.

Therefore, the Fed's attempt to liquefy the system short term, however tepid, is not working, and M1-B is still stagnating.

Moreover, there is evidence that Volcker is planning to harden his stance, not soften it. David Jones, chief economist at Aubrey Lanston investment bank, told *EIR* Oct. 7, "Volcker has to show he's determined about fighting inflation. The credibility of the Fed went way down two years ago, and now Volcker is slowly painfully building it back up. If he loses, or gives in to pressure from Reagan to lower interest rates, he loses his credibility."

Jones continued, "Volcker knows that it will take pain and suffering in the economy and that there will be little if any economic growth. He said this last week in congressional testimony. But this is the price of crushing inflation." Jones himself is predicting that Volcker's policy will mean four or five consecutive quarters of negative GNP growth. He also predicts that long-term rates will be almost as high in mid-1982 as they are now.

Note as well the trend for Eurodollar rates vis-à-vis federal funds rates—both representing interbank borrowings, and both usually within a few basis points of one another. On Oct. 7, the day fed funds temporarily hit 12.25 percent, three-month Eurodollars were selling at 16.5 percent, meaning that three months hence, the market participants expect Eurodollars, and fed funds, to move back up to the 16 percent range.

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