EIR Economics

U.S. Interest rates: how far will they decline?

by David Goldman, Economics Editor

Federal Reserve officials themselves are sharply divided in their outlook for the immediate weeks ahead. A New York Federal Reserve official foresees a possible stabilization of the prime rate at around 15 percent (see appended interview); a Philadelphia Federal Reserve official warns of "intense volatility" during the next few weeks; while a Board of Governors economist in Washington does not rule out a further increase in the relative near-term.

The reduction in major banks' prime lending rate to 18 percent had not yet persuaded institutional investors to risk their money on long-term bonds as of deadline on Oct. 14, and, indeed, the day's rise in the federal funds rate back to 16 3/8 percent, the previous day's two-point fall for long-term bonds, and the same day's 15 point drop in the Dow-Jones index on the New York Stock Exchange clouded the prospects for additional lowering of interest rates.

The Fed's problem is not much different from anyone else's, namely, that it does not know to what extent the present sharp decline in economic activity will reduce credit demand, or even increase credit demand for the immediate coming period. It is not merely that the Federal government's borrowing requirement, both on and off-budget, is likely to exceed $120 billion (minus whatever dribbets David Stockman can find to save) in the fiscal year that started Oct. 1, but that the private sector is running its own, similar deficit. To this must be added the present $35 billion rate of credit expansion that is going to refinance old debt service of developing nations.

Our own view is that the economic downturn will continue, but that rates will nonetheless stick at around their present level, and that the New York Fed's suggestion that the prime could stabilize at 15 percent is far too generous. The monetary system, which traversed the land-mines surrounding the Oct. 1 shiftover to "same-day settlement" at the New York Clearing House, will remain fundamentally unstable and volatile for the foreseeable period.

The mechanism

What has happened thus far is simply explained. Although, as the Federal Reserve insists, it made no addition to total bank reserves during the past six weeks, nonetheless it permitted banks to pay off reserves borrowed at 18 percent at the Fed's discount window by adding fresh non-borrowed reserves to the system, to the extent of about $1.2 billion.

It made those reserves available at rates lower than the discount rate, taking pressure off the banking system in anticipation of the Oct. 1 clearing date—precisely as Fed officials told this publication would happen (see *EIR,* Sept. 29). As the federal funds rate fell, the Fed brought the discount rate down, and banks brought down the prime lending rate.

Because the mechanism of the interest-rate fall was the substitution of reserves provided at the Open Market desk for reserves borrowed at the discount window, the relevant rates to compare are the discount rate (plus surcharge) and fed funds; now that the discount rate and the three- and six-month Eurodollar rates are stable at the 16 percent range, there seems no good reason why the fed funds rate should not also stabilize at that level, and no good reason why the prime rate should not remain at 18 percent.

Throughout the process, the rate of bank lending continued at a quick pace, i.e., 13 percent per annum in September and 20 percent in the 13 weeks ended Sept. 30; the rate of commercial paper lending was considerably faster. However, as a Board of Governors economist explained, the dropoff in economic activity reduced corporations' transactions balances, or demand deposits, while the continued corporate scramble for liquidity promoted growth of time deposits, money-market funds balances, and so forth. Therefore, M-1 barely rose while M-2 and M-3 continued rising at double-digit rates. Since commercial banks must keep only 4 percent of time deposits on reserve, against 15 percent for demand deposits, the shift from M-1B to M-2 and M-3 enabled them to lend more on less reserves, permitting interest rates to fall.

The continued strength of loan demand in the face of what is clearly a rapid fall in economic activity suggests strongly that the basic illiquidity of the corporate sector is holding interest rates up. So much borrowing is due to capitalization of old debt service, or financing unsold inventories—we calculate about 70 percent of total borrowing—that a decline in economic activity has not yet produced a reduction of credit demand, only a technical reaction on the banking reserve side. Clearly, at some point, a reduction in total lending will occur. Although the energy sector, which took about 20 percent of the bank loans issued in 1981 so far, is expected to borrow even more during 1982, other sectors will ultimately have to diminish their short-term borrowing. But it may require major bankruptcies and other forms of reorganization of the economy's growing debt to finally stop the lending bubble.

The outlook

The foregoing suggests that the decline of the nation's economy between now and year end will be sudden and cruel, and dump a major decision on the desk of the President. If to the credit problem a major rise in oil prices is added, interest rates will shoot back up quickly. Indeed, the West German central bank is reported by *Der Spiegel* magazine Oct. 12 to fear a rapid lowering of interest rates, precisely on the grounds that an oil-price increase is likely due to the recent events in the Middle East.

As for the international markets, despite the warning by the International Monetary Fund's Interim Committee Sept. 27 that the present $100 billion payments deficit of the developing nations is "unsustainable," there are no signs whatever that commercial banks are cutting back on deficit-financing loans. On the contrary, major regular borrowers such as Brazil are continuing to get all the credit they ask, while nations such as India and Nigeria, who have stayed off the private markets, may start to tap them substantially in 1982. We argued (see *EIR*, Oct. 6) that the U.S. Treasury and Federal Reserve proposal to force a reduction in the Third World lending bubble could not work, and no current evidence is available that it will work. On the contrary, Fed officials responsible for enforcing the lending-reduction program worry privately that the economic downturn in the United States and other industrial nations will widen the developing nations' deficits, by reducing their export markets, and that this would force the commercial banks to put themselves further out on a limb.

Therefore, the basic outlook remains one of political-economic crisis. The Federal Reserve may well have won the last round with the White House, but the real confrontation is yet to come: Fed Chairman Volcker has, in the view of the White House, destroyed the prospects of the President's economic program, and will have to answer for it.

Going bump

The thinking behind the Fed's policy may have been exposed in the London *Economist*'s Oct. 3 cover story, "Things that Go Bump in the Morning," which warned of a 1930s-style crash unless governments took unprecedented action to slash expenditures, reduce wages, and bring down living standards. Since the June meeting of the Bank for International Settlements, the central banking elite has used the spectre of financial catastrophe to bludgeon advanced-sector governments into adopting this type of regime. With the American Congress balking, and the German and Japanese governments refusing the demands of the central banks point-blank, a likely point of political confrontation was the Oct. 1 conjuncture.

In a way, the Fed's decision to permit rates to soften slightly represented a political backdown. Had the chain of payments broken, the Germans and Japanese could have, and probably would have, responded by remonetizing gold.

Could it be that the masters of the BIS believe that a threat to the Euro-Japanese aorta, the Persian Gulf, could accomplish what the threat of financial crisis could not?