Why rates will rise

The end of the fake U.S. "boomlet," and the advent of domestic and international debt crises will panic the Fed.

The only remarkable feature of the mid-August decline in interest rates is how slight it has been, compared to similar bouncing-ball declines earlier this year. It is irrelevant whether the Fed's apparent firming move Aug. 25, which interrupted the bond dealers' paper-exchange advertised as a "bond market rally," marks the end of the drop. Rates are going back up, by no later than mid-September. Whatever the Fed chooses to do, the outbreak of the Brazilian crisis at the end of September or early October will "make the Eurodollar yield curve stand up like a flagpole," according to the international economist of one big bank's Treasury department. Some analysts suspect the Fed may be panicking both over the imminent evaporation of the spurious recovery, as well as the Third World debt crisis, and will try to print money. This will not help any rates but short-term Treasury bills, the usual refuge for scared money in the event of real trouble.

The irony is that the rate-rise will proceed despite the death of the recovery hoax. Already the following negatives are being reported: a 3.6 percent fall in July durable goods orders, a 10 percent drop in building contracts, a homebuilding bust in progress, and a projected major auto production downturn, once the new auto model year comes on line.

Discussions with unionists at plants producing components for all GM cars show that zero overtime has been scheduled for September, following the changeover to the new models. Recently, auto companies have not rehired in proportion to their purported sales, preferring overtime at time-and-a-half. Overtime is scheduled weeks in advance, and the lack of plans for September indicate a sharp downturn in auto output. This suggests that the first big industrial production downturn in months could be reported for the month of September, and it would be reported at the height of the Brazilian debt negotiations.

Since the Fed hoked up the industrial production index through extraneous "productivity factors" based on previous recoveries, the rise has been overstated by an amount we are now calculating; *EIR* founder Lyndon LaRouche points out that the "screw-shaped error curve" in the estimation of the Fed index will show a faster rate of decline on the way down.

Indications are that the Federal Reserve is panicking at the political consequences of the economic unravelling. A source close to New York Fed President Tony Solomon said, "The Latin American debt situation is a big factor, but not in the obvious way; as long as it can be made to appear that the economy is in recovery, all the other problems can somehow be handled."

The Federal Reserve might react by trying to push interest rates down. The short-term rate for loans between commercial banks, or federal funds, fell to 9⅛ percent Aug. 26 from 9¾ percent the week before. But most New York banks' money market specialists say rates will head right back up in September. The Fed's actions do not appear to have convinced the stock market that the rate rise is over. The anemic bond market improvement reflects almost entirely institutional trading rather than retail buying.

Some room for this temporary traders' rally was bought by the completion of the third-quarter Treasury borrowing schedule and the disappearance of most corporate and many mortgage borrowers from the market during August, a harbinger of the new economic downturn. However, the Treasury's borrowing requirements for the fourth quarter are likely to be well in excess of the $65 billion government estimate (despite some baseless arguments that the "recovery" will raise revenues and reduce borrowing requirements).

The agricultural disaster now in progress in the Midwest through to Texas is the wild card in the federal deficit; short of commitments for some commodities under the purchase-in-kind (PIK) program, the federal government may be forced onto the commodities markets at a point at which prices are already rising sharply. Combined with other underestimates of agricultural spending, this could add an additional $5 to $10 billion to the deficit. With a collapse of tax revenues below still-depressed present levels, fourth-quarter borrowing could be really spectacular.

It is impossible to estimate how high rates might rise; gnomes like Olivetti's Carlo De Benedetti have been beating the drum for a dollar collapse since April, arguing that the Third World debt crisis will torpedo the dollar. A major exodus of European portfolio investment in the United States is likely, and would also push up domestic rates.