Domestic Credit by Richard Freeman

Volcker's old tricks

If interest-rate increases continue, they will wreck the so-called recovery and balloon the federal deficit.

When Paul Volcker told the U.S. Congress July 28 that "interest rates will rise," it was only five days after he had assured the Senate that he would not raise interest rates. That assurance had been the condition for the July 26 approval, by an 84 to 16 vote, of his reappointment to a second four-year term as Fed chairman.

The rate increase—spurred by the liquidity crisis in the Euromarkets (see article, page 4)—confirms the stupidity and spinelessness of the legislators who voted to keep Volcker, and will now watch him blow away the illusion of a U.S. recovery.

At Volcker's confirmation hearings in both houses, congressmen outdid themselves in groveling before the Fed chairman, alternately praising him—House Banking Committee chairman Fernand St. Germain (D-R.I.) declared, "Thank God you are not retiring from public life"—and supplicating him not to raise interest rates. Volcker merely grunted and told the congressmen in effect, "I'm a bottom line guy, do what I say."

No sooner had Volcker been confirmed than on July 29 and Aug. 1 he started raising rates in order to "slow and top out the pace of the U.S. economic recovery" (sic), according to Philip Braverman, chief domestic economist for Chase Manhattan Bank. Volcker's method was to raising the federal funds rate. On May 13, that rate—at which the Fed lends 24- to 48-hour money to the commercial banking system—was 8.48 percent. By July 27, it had risen to an average of 9.50 percent. Then on July 29 and Aug. 1, Braverman reports, the Fed tightened by selling Treasury securities through the federal funds window to the commercial banks, in order to drain liquidity out of the system, raising the federal funds rate further to the 9.75 percent range.

The Fed can sell Treasury securities, i.e., drain liquidity, on either a system-wide basis, putting the Treasuries up for general purchase, or on a *customer basis,* in which it approaches banks and asks them to buy. "For the past two days, the Fed has been conducting these operations on a customer basis," Braverman said Aug. 2. "The Fed was saying that the rise in the federal funds rate was fine. It was giving a direct signal to the banks that it wanted rates to raise by doing it on a customer-by-customer basis."

The federal funds rate, Braverman stated, will probably reach 10 percent by late August. The rate is crucial in setting general interest levels: the commercial banks normally peg the prime rate at 1.5 percentage points above the federal funds. Were the fed funds rate to hit 10 percent by the above formula, the prime rate would rise to 11.5 percent.

The rate on government Federal Housing Administration (FHA) mortgages has risen from 11.5 percent seven weeks ago, to 13.5 percent on Aug. 2. And at the same time, U.S. Trust Company announced that it is raising its broker loan rate to 10.25 from 10 percent. The rate is the fee charged securities dealers on loans backed by stocks. Securities dealers, in turn, pass along their increased costs to customers buying stock on margin. This increase will take the remaining wind out of the Dow Jones industrial average, which fell 50 points for the five days ending Aug. 2.

The shake-out from Volcker's action, which *EIR* has warned of for weeks, is that the $700 billion of Third World and East bloc debt becomes harder and harder to service as rates rise. On the domestic side, the construction boomlet that accounted for most of the alleged recovery will expire.

"Housing is going to take a beating in the third quarter," commented Ray Michalski, economist for Bank of America, on July 29. "When conventional home mortgages came down to the 12.0 percent level earlier in the year, they were just low enough that people would borrow to buy homes. But Bank of America's conventional mortgage loan rate has gone up from 12.50 to 13.75 percent just in the last five weeks. Most of the population, by which I mean most of the middle class, won't be able to buy homes."

The other big element of the recovery, as Michalski said, has been auto. "But there is no way that General Motors can keep finançing car loans at 9.9 percent, when because interest rates have moved up, the cost of their commercial paper is 9.25 percent and on top of that you must add 1 percentage point for administrative costs."

The increase in rates could lead investors to dump securites in panic, sending rates still higher.

Then there is the U.S. Treasury, which brought to market $15.75 billion in notes and bonds on Aug. 1-4. The cost of servicing the public debt will rise even further. Volcker's coupon-clipping friends in Geneva, London, and Wall Street, who make such pious attacks on the U.S. deficit, don't mind at all.

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