Click here for Full Issue of EIR Volume 6, Number 38, October 2, 1979

Fed ignores warnings on interest rates

U.S. interest rates are now at the critical threshold: one more upward nudge by the gentlemen at the Federal Reserve Board and rates shift from being negative—lower than the official rate of inflation—to positive.

As long as interest rates were trailing inflation, corporations, like consumers, tended to regard borrowed funds as "free" money. The most recent figures show that corporations are continuing to borrow at a near-record clip, despite the unprecedented 13.5 percent prime rate. Over the last thirteen weeks, short-term business loans expanded at a more than 40 percent annual rate at the large New York commercial banks.

The question on everyone's minds is whether Fed Chairman Paul Volcker will cut this borrowing short—and pull the plug on the U.S. economy—by pushing short-term rates significantly above the 13 plus percent annual rate of inflation.

This decision is being determined more by international political considerations than by the figures on the U.S. monetary aggregates.

There is no doubt that Volcker, who is a member of the Ditchley Foundation—a key Anglo-American policy making body—would like to impose a full dose of monetary "discipline" on the U.S. economy. However, international considerations may dictate otherwise at this time. Can Volcker afford to plunge the U.S. economy into a prolonged recession at a point when the European Monetary System is fostering economic growth in Europe, and when the EMS pwrtners are forging expansive trading relationships with the nonaligned and East bloc countries?

Policy differences

The *New York Times*, the daily outlet of the New York Council on Foreign Relations, is telling Mr. Volcker to go slow. "The Federal Reserve is hitting the monetary brakes too hard," the paper wrote in its lead editorial Sept. 25 ("A Leaden Foot on the Monetary Brakes"—was this an uncomplimentary reference to the hefty six foot four Mr. Volcker?). The *Times* editorial board appears worried that "when the Federal Reserve tightens the belt so tight that the economy threatens to collapse," the U.S. will be knocked out of the international political arena.

As of this writing, however, the Fed appears determined to pursue its high interest rate course—whatever the consequences. In his appearance before the Senate Banking Committee Sept. 28, Volcker defended high interest rates as a critical "anti-inflation" tool, and reportedly won the praise of Sen. William Proxmire. On Thursday, Sept. 27, the Fed tightened the Federal funds rate—reserves traded among banks—another notch; the target range is now between 11.75 and 12 percent.

Every financial market is expecting higher rates.

Within a 24-hour period last week, the March 1980 contract in the Treasury bill futures market dropped a whopping 59 basis points. The T-bill market has been especially vulnerable because of expected heavy new issues to finance the growing Federal budget gap.

Corporate bond prices are dropping because investors are refusing to commit money to the long-term market when they think there are still higher yields to be had in the offing.

Shift to credit rationing?

Dr. James O'Leary and Thomas Synnott of U.S. Trust believe that Volcker's high interest regime has come pzrilously close to endangering the savings banks and other vulnerable sectors of the U.S. economy. Dr. O'Leary's concerns are especially noteworthy in that he sits on the board of Ditchley with Chairman Volcker.

"The Fed is close to the limit in the Federal funds rate," Tom Synnott said in an interview last week. "We expect a move on reserves soon." The thinking of the U.S. Trust economists is that over the next two to three weeks the Fed can be expected to shift its emphasis from an across-the-board tightening of interest rates—which could precipitate major savings banks and other bankruptcies—to a more differentiated squeeze on credit availability. Synnott said that one likely option would be for the Fed to reimpose reserve requirements on U.S. banks' borrowing from their Eurodollar branches.

The issuance of Eurodollar certificates of deposits has been a principal source of increased liquidity for the U.S. banking system since last November. At that time the Fed lifted reserve requirements on banks' Eurodollar branch borrowings to encourage the "repatriation" of dollars to the U.S.

Synnott speculated that the Fed will impose higher reserve requirements on the banks' *incremental* borrowings—borrowings over a selected base period—a move that would force banks to weigh marginal loans against the marginal increased cost of funds.

—Lydia Schulman

© 1979 EIR News Service Inc. All Rights Reserved. Reproduction in whole or in part without permission strictly prohibited.