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 by Richard Freeman

When the economy snaps, let go

Without action from the new administration, there's no real interest-rate relief in sight.

Rates will not come down by any sizeable amount until there is news that the economy is showing weakness. I think that the 21.5 percent prime and an 18 percent Treasury bill rate are the peaks.

"But for the first three to four weeks in January, I think that we'll see rates go up and down until we know that the economy is heading downward. Then rates will fall."

With that comment on Dec. 30, Ben Laden, economist with the T. Rowe Price investment house, cut across much of the fluff now being debated in the financial press on "whether interest rates have finanally peaked." Until the economy shows that it is buckling, Federal Reserve Board chairman Paul Volcker will not let up on interest rate levels. The prime may drop. But more likely, Volcker will hold the prime at a level of 18 percent or higher, which is sufficiently high to strangle economic activity. Once the patient—in this case, the economy—begins to slump over in its chair, Volcker will perhaps ease off on interest rates, but very slowly.

However, it is to be emphasized that the rate of U.S. industrial credit demand is sufficiently high that Volcker could send interest rates higher before they go lower. For example, on Dec. 29, the large New York banks, led by Chemical Bank, took the prime down from 21.5 to 20.5 percent, while federal funds traded in the middle of the day at 17.5 percent.

The credit markets were ecstatic. "Treasury Bill Rates Off Sharply" read the lead story of the *New York Times* business section Dec. 30.

But within 24 hours, the euphoria wore off. Volcker moved back into the market, pushing the federal funds rate to 20.5 percent on Dec. 30 and letting it close at 22 percent. The morning of the same day, Morgan Guaranty Trust decided to raise its broker loan rate to 20.5 percent, up 0.5 percent.

The message is that despite the fact that the Federal Reserve is succeeding in contracting the amount of new reserves placed into the system, there is no way it can stop the amount of business borrowing at commercial banks. Commerce and industry loans have grown at a whopping 20 percent rate since Oct. 1. While the Fed has been crimping reserves going into the banking system, it has also directed, in an internal memo, many of the large banks to bring funds back into the United States from Europe, in order to control the domestic money supply.

This has had the effect of providing banks with funds to lend to corporations. These credit-starved businesses are desperate for money to keep themselves afloat, and are now forced to borrow at the record interest rates.

So strong is the credit demand that the Federal Reserve is now resorting to other contractive means, including slapping "voluntary credit controls" onto the economy. According to one Fed official, "Volcker is circulating inside the Federal Reserve system a letter we call the Martin-Burns letter." The source continued, "This is a version of the letters that two former Fed chairmen, William McChesney Martin and Arthur Burns, sent out to the banks asking them to control credit allocations. We are trying to get compliance with the letter."

After Burns sent out his letter in August 1974, the banks pulled in credit, and the United States went into the worst industrial tailspin since the 1930s depression.

This would be Volcker's intention. If he finds that the "voluntary controls" do not have their effect through the first few weeks of January, *then Volcker will push rates back up again.*

Otherwise, in the meantime, he will keep rates up around the 18 to 20 percent level.

This is precisely the point emphasized by T. Rowe Price's Ben Laden. "Anyone putting their money into the market would have to be prepared to see rates go up and down," Rowe stated.

The single positive way out of the perspective of months-long high interest rates until the economy snaps is an intervention by President-elect Ronald Reagan to force Volcker to back down. "We have felt that interest rates would remain high," stated Smith Barney brokerage house analyst Michael Dahood Dec. 29.

"We continue to hold that belief," he continues, "although with somewhat less conviction, because the Republicans can exert pressure on the Fed as the inauguration approaches."

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