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How far will interest rates rise?

Another two points will blow out the banking system, and bankrupt another thousand thrift institutions.

City of London observers characterized the Federal Reserve's discount-rate increase on Sept. 5 as "too little, too late." Certainly, purchasers of U.S. government bonds agreed, knocking down the price of long-term Treasury securities by almost 2% upon their return from the Labor Day holiday.

However, the brokerage-house pundits who want a sharp rise in interest rates, supposedly as a guarantee against renewed inflation, want too much, too soon, given the weakness of the U.S. banking system.

The only important change in capital flows during 1987, was the $70 billion created by foreign central banks to support the dollar during the first half of this year. That translates into $70 billion of foreign central bank purchases of U.S. Treasury securities, taking care of the entire U.S. trade deficit, and most of the U.S. Treasury financing requirement, during that period.

That won't happen twice, laments Salomon Bros. in a recent special report to clients:

"In West Germany, a long-anticipated income tax cut of DM 13 billion will be introduced in 1988, but the authorities have rejected calls to adopt additional measures in response to lower-than-expected economic activity. Japan has already implemented a supplementary budget for the current fiscal year, but tax reform proposals under consideration are expected to be revenue neutral . . . attempts to maintain the current target zones through exchange market intervention without the U.S.'s overt support are likely to fail; the amount of intervention required would imply continued central bank loss of control over domestic money supply expansion."

That enabled the United States to sustain an "unsustainable" deficit at relatively low interest rates. In 1977, British Prime Minister Jim Callaghan, facing roughly the same economic circumstances, but without the friendly help of other central banks, had to raise sterling interest rates to nearly 20% in order to prevent the complete collapse of the pound sterling.

Depending on the extent to which the Japanese and Germans cut back on their subsidy to the United States, U.S. interest rates will rise some part of the way to 20%.

The problem now is that unlike Callaghan's Britain, or the pre-Volcker American banking system, a moderately higher level of interest rates will crash the domestic financial system.

As *EIR* has reported, Federal Home Loan Bank Board specialists calculate that a mere 2% rise in interest rates will wipe out an additional 1,000 savings and loans, bringing the total number of insolvents to close to 1,500.

Put simply, the S&Ls now enjoy a more than 2% spread between their cost of funds, and the interest rate on their mortgage portfolios. Many have switched almost entirely to adjustable-rate mortgages; roughly 1,000 of them are stuck with fixed-interest portfolios.

Despite the favorable interest spread, the thrifts as a group are running at a loss, because bad loans are wiping out too much of their income.

If the cost of funds moves up a percentage point or two, the bailout-bill facing the penniless Federal Savings and Loan Insurance Corporation will rise from a mere $50 billion at present, to $100-150 billion.

Consider, additionally, the huge bond-trading losses suffered by Merrill Lynch and First Boston during the second quarter. It is not merely the S&Ls which will fall as interest rates rise. The entire banking and brokerage house system has held together since 1982 by speculating on rising securities prices.

Falling securities prices will cause gigantic losses across the board.

The "securitization" of the banking system has created conditions resembling 1929, when commercial banks played the stock market with depositors' money.

Departed Fed chairman Paul Volcker never hesitated to warn Congress of the consequences of trying to finance in perpetuity a trade deficit exceeding $150 billion a year, proposing, instead, that the United States cut consumption through fiscal means, by drastic reduction of federal spending.

Foreign central banks' refusal to imperil their banking systems by continuing the monetary subsidy suggests that the drastic reduction in consumption will be forced upon the United States by the most chaotic and destructive means.

The Sept. 23 cliffhanger around the latest expiration of the most recent short-term extension of the federal debt ceiling, will contribute to the chaos.

Observers suggest that a continued stalemate in Congress will produce a series of short-term extensions of the federal government's authority to spend money, stretching into next December.

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