Interest Rate Hikes Will Dry Up Capital Investment

The skyward course of short-term U.S. interest rates is threatening to dry up liquidity from U.S. capital investment and consumer borrowing markets, with potentially devastating repercussions for the U.S. economy.

BUSINESS OUTLOOK

Over the past month Federal Reserve Board Chairman Arthur Burns has engineered interest rate increases as a necessary measure to stem the flood of money-supply growth and the daily weakening of the dollar on the international exchanges. But the attempts of the British-linked investment houses to wreck the dollar, combined with the sharp imbalances in the U.S. credit markets, are blocking Burns's stabilizing moves. The net result is even more pressure to raise the interest rate, pressure that is expected to push U.S. prime rate to an excessive 8.25 percent by year's end.

Under this self-feeding cycle of interest rate rises, industry and the housing sector will be driven from the markets, with predictably nasty ramifications.

The Markets

This week, the federal funds rate — at which commercial banks borrow excess reserves — hit 6.50 percent, up 50 basis points from four weeks ago, and up nearly 200 basis points since April. At the same time, Wells Fargo's rise in the prime rate to 7.5 percent one week ago is the third such increase in the last six weeks.

Further, for the first time this year, medium-term interest rates moved up steeply. In the Treasury's latest sale of $3.1 billion in 52-week Treasury bills, the average yield rose to 6.618 percent, the highest yield in two years. It was up from 6.156 percent at the previous sale only four weeks earlier.

Every sign indicates that interest rates will go much higher. According to David Jones, market economist for Aubrey Lanston, the Treasury financing for the fourth quarter of this year will hit $19 billion with $4 to $5 billion in short-term bills. This amount of new reserves entering the banking system, added onto a whopping $4.9 billion increase in M-1 money supply figures for the week ending Oct. 14, plus the heavy M-1 increases anticipated for the next few weeks, will cause further Fed tightening.

Where the interest hike will stop is now anyone's guess. Lacy Hunt, chief economist for the Fidelity National Bank, said Oct. 13 that he expects a 8.25 percent prime lending rate by year's end.

It is certain, though, that unless some of the deep imbalances that caused the surge in money supply are cleared away, and unless a Federal Reserve two-tier credit window lending policy is instituted, that favors business with low-cost loans, the economy will soon be severely crippled.

Why The Money Supply Bulge?

The two most significant reasons for the current money supply jump have long-standing roots. First, the excessive overreliance of the U.S. economy on a "consumer-spending-led recovery"; second, the draw-down of U.S. commercial bank domestic deposits to facilitate Eurodollar lending.

In August, new consumer installment credit (the amount of new credit minus payments on old credit) ballooned by $2.5 billion. Moreover, for the first eight months of the year, new consumer installment credit exceeded $17 billion. According to David Jones at Aubrey Lanston, the levels of consumer credit are twice those of last year. He includes in consumer credit some percentage of mortgage credit that is not going to finance housing purchases or repair. People have put up their mortgages as the best security they have in order to obtain loans for consumer spending, Jones said.

The staggering increase in consumer credit and a steady growth in business borrowing since July have skyrocketed checking account money aggregates (Ml), and this has forced banks to increase reserves held at the Fed in order to cover their deposit base. This is the lawful inflationary effect that excessive reliance on a "consumer-spending-led recovery" must have after 30 months of such spending.

The other side of this inflation process is commercial bank feeding of funds into the Eurodollar market. Since the beginning of the year, large N.Y. commercial banks have been increasing the transference of deposits to foreign branch accounts, and to replenish contracted domestic deposits, they have prevailed upon the Fed to pump new reserves into the banking system.

Statements of 10 Largest N.Y. Weekly Reporting Commercial Banks

(in millions of dollars)

	Domestic Deposits	Foreign Deposits
Jan. 12	75,215	88,159
Aug. 3.	72,546	94,901
Sept. 28	68,635	101,740

As can be seen in the table, as domestic deposits decreased, the Fed rushed in with reserves so that the overall banking system would have a basis for domestic lending.

All these pressures — the credit market imbalances caused by the heavy consumer borrowing without compensating capital spending, and the commercial bank feeding of the unregulated Eurodollar bubble — caused an inevitable run-up in banking reserves. Reserves held by Federal Reserve banks at the Fed have increased since June 8 by 13.2 percent, going from $103.9 billion June 8 to $109 billion Oct. 5. In turn, the increase in Adjusted Federal Reserve Credit pushed up the monetary base, which rose from approximately $123.7 billion June 8 to $128.4 billion Oct. 5.

It is thus completely predictable that the basic money stock (Ml) leapt from $321 billion June 8 to $334.3 billion Oct. 14.

Furthermore, effect of the ongoing British operation to wreck the dollar — now (see article this issue) pressure at the dollar system's weakest point — is to destroy confidence in the U.S. currency and institutionalize an upward interest rate.

The uncontrolled upward spiral of U.S. short-term interest rates promises to be deadly for the economy. Hardest hit by this assault is the U.S. housing market. As the *Wall Street Journal* wrote Oct. 12: "Housing has been one of the few things we've had going for us," a top administrator reported this week. "We're getting closer to the point where we would see heavy outflows of funds from the thrift institutions, and a drying up of money for housing."

As interest rates go higher, a disintermediation of funds out of savings and loan associations will occur in mass. Currently, on a deposit of two years' maturity, S and L's can't pay more than 6.5 percent interest, while U.S. Treasury securities of a comparable maturity are paying 7.02 percent. To compensate, S and L's will raise the interest rate on home mortgages as an offset to a scarcity of funds or a higher price paid to obtain scarce funds. This could wreck the housing market, which operating at a rate of 2.1 million starts per year, is one of the two areas of activity holding up the U.S. economy (the other area is auto production).

The simultaneous collapse of the stock-market, a traditional haven for raising equity capital, is aggravating the near impossibility of corporations to get funds, especially if interest rates go much higher. Between 1952 and 1967, the appreciation of U.S. stocks, adjusted for inflation, was over 300 percent, while in the last 10 years, the appreciation of U.S. stocks is sharply negative. Further, according to a study by Becker Securities, between 1972 and 1976, the annualized return on bonds amounted to 7.5 percent, compared to a miniscule annualized return of 0.3 percent on common stocks in the same time period.

In response corporations have been terrified to go to the market with new issues. For the second quarter of 1977, equity financing — the offering of new stock — ran at an annual rate of only $4.5 billion, a stark contrast to the $15 billion in new stock financing in 1971.

The collapse of the market this week to 8.23, a loss of 22 points for the week, could be the death blow to equity financing.

There are enormous consequences for U.S. industrial firms. Debt to equity ratios for all industries have escalated steeply in the last five years. With a stock market collapse, the entire burden of industrial expansion will fall on bank loans, commercial paper, and bond syndication — where interest rates are shooting toward the moon. Within this context, capital spending plans become a fairy tale.

The fall-back option recommended by the crowd in Congress, led by Vice-President Mondale, is even more of a dream. These Keynesians want more consumer spending, which would send money supply figures skyward at an even greater rate than at present.

Banker Worried About Money Supply

In an interview this week, Lacy H. Hunt, a vice-president and economist at Fidelity Bank in Philadelphia, presented his analysis of the rapid growth of the U.S. money supply and accelerating interest rates.

Q: U.S. interest rates are rising faster than anyone expected. What accounts for this?

A: I am much more concerned about the rapid growth of money supply. Current rates of money supply growth are excessive — faster than in 1968. This development stems fundamentally from the growth of loan demand. In the third quarter, in spite of the business slowdown, total bank loans are estimated to have risen at a 15 percent rate. The savings and loan institutions, mutual savings banks, and, starting in July, the commercial banks have been selling Treasury securities to accomodate the loan demand. The Fed has acquired too much Treasury debt as a result. This increases the monetary base and the money supply...

We must not be guided by the expediency of holding interest rates down. People who want the Fed to keep interest rates down by allowing rapid money supply growth don't recognize that the acceleration of money supply growth will build in more inflation and set the economy up for a hard landing. Excessive money supply growth will lead to a new severe recession.

Q: To what extent are the recent speculation against the dollar and the flow of money into Eurodollar deposits exacerbating the rise in interest rates?

A: The dollar is getting banged because money supply growth has been excessive. This feeds inflation and the trade deficit. The bond market and the equity market have also gone off sharply as a result. Higher interest rates should have stabilized the dollar. The interest rate differentials are well in our favor. But today the yen surpassed its 1973 high against the dollar...The flow of funds into the Eurodollar market is part of the mechanism. International loan demand is large. The commercial banks liquidate securities, sell CDs (certificates of deposit — ed.), or borrow federal funds in response. This process has the same effect as domestic loan demand — it swells the monetary base and money supply and pushes up the interest rate structure.

Q: Where do you think the prime rate will be by the end of the year?

A: We expected the current developments; we didn't equivocate. But they have happened faster than we anticipated. I expect that the prime will hit 8 percent or 8.25 percent by the end of the year...At this stage in the 1972-73 expansion, the business credit demand wasn't as great as now. And government credit demand was low. Remember, Nixon had balanced the federal budget. He did it by impounding funds. Now we have a $45 billion federal deficit; next year it will be $65 billion. Business and the government are competing for credit and that is pushing up rates...

West European Gold Operation Takes Jabs At London

Gold prices this week reached a two-year record of $158 an ounce as a result of West European and Arab intervention on the international markets. The run out of the dollar and into gold was limited only by the awareness from the West European bankers that a speculative gold bubble would run out of their control and further the worldwide economic collapse to the benefit of the City of London, in the absence of a gold-pegged international monetary system alternative.

GOLD

The operation into gold is organized from Zurich and the West German-dominated Luxemburg market. According to sources in Zurich, French-Swiss-West German banks are helping the Soviet Union and South Africa restrict their gold sales as much as possible. On the other hand, they are conduiting money — notably Arab funds — into bullion. According to New York's Credit Suisse-White Weld, "The Swiss and their friends are making money both ways, withholding bullion from the gold market with cooperation of gold producers, and helping buying it up altogether." New York's Sharps and Pixley, close to the House of Rothschild, added that Arab money shifted out of the dollar into gold on a large scale last week. Bache, Halsey, Stuart identified West European and in particular Swiss banks as acting on behalf of Arab customers on the New York bullion market.

London Gets Short End

The choice of New York has undoubtedly been made by the Swiss banks against London, out of necessity. The Luxemburg market is not yet large enough to bear the brunt of an entire gold operation, and the Zurich market has not fully recovered from the dirty trick engineered by the City of London against the Swiss banking community, known as the "Chiasso scandal."

New York prices are now leading London, rather than the other way around. As opposed to only a few weeks ago, London's second gold fixing is almost every day under the final New York quotation. This in turn implies that the Swiss, West German, and French bankers have close and cooperative friends in the United States. In an unmistakeable sign of U.S. support the Oct. 10 editorial of the *Wall Street Journal*, entitled "Sinking Dollar," suggested for the first time that a gold-based monetary system would be preferrable to the present one.

This operation is potentially very dangerous for the City of London. The New York representative of Merril Montaigu, a parent company of London's bullion trader, angrily commented that no gold orders are coming from London. "It is European speculation; they have managed to manipulate their currencies so as to make gold inexpensive." The Swiss Central bank permitted the Swiss franc to appreciate significantly against the dollar in order to buy gold cheap. According to Reuter dispatches and rumors on the market, the Swiss sold dollars at the beginning of this week, probably to the West Germans, who were trying to contain the rise of the deutschemark.

What's at Stake

This week the *London Sunday Times* expressed its concern that "gold thrives on instability like this as the one edge against financial Armageddon." City of London fears are all the more acute because Swiss and West German banks are not only buying gold, but have started selling British gilts (bonds) and stock, triggering a sharp fall in the London stock market and threatening the bond market.

At this point it would only take a programmatic initiative for a new monetary system to direct the West European and Arab funds out of London control — a fact London knows only too well. But such a programmatic alternative has not yet appeared on Europe's official agenda. Western European bankers must therefore keep gold prices under control to prevent the formation of a purely speculative gold bubble that would ultimately threaten their own economies. This in turn would politically destabilize the continent to London's advantage. Gold prices have consequently stood still since Oct. 13 and one prominent Swiss bullion trader in Frankfurt confided that he is "not bullish on gold" and that the "South Africans and Soviets are now selling."