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Who's driving up interest rates?

If anyone still believed that interest rates are determined by abstract "supply-demand" market forces, then last week's developments should have thoroughly demolished that delusion.

As of this writing, the drop in the prime rate to 11.5 percent initiated by Chase Manhattan on Jan. 29 is still catching on at banks across the country. The impetus for lower domestic interest rates actually came from Europe — from the founders of the European Monetary System. Their successful efforts to stabilize the dollar in the first weeks of 1979 forced a liquidation of short positions against the dollar, which in turn took pressure off short-term Eurodollars and then domestic interest rates.

However, there are other political forces acting to push interest rates in the opposite direction — up. As a result of their efforts, the bottom fell out of the U.S. bond market early last week and yields on 8-year Treasury notes bounded above 9 percent — higher than anyone expected and than "market conditions" warranted.

What had happened?

The key to unraveling the mystery begins with Bank of England Governor Gordon Richardson. On Feb. 5, Richardson told the Overseas Bankers Club in London that world economic and financial stability depends on U.S. adoption of "appropriate" monetary and fiscal policies, understood by his audience to mean still higher interest rates and larger cuts in government spending. In the same speech, Richardson touted his own scheme to have the International Monetary Fund "cofinance" and impose conditionality in future international lending. He roundly criticized all efforts to limit the "efficiency and scope" of the international banking system and Euromarkets — a direct reference to recent calls by West German financial officials Karl-Otto Pöhl and Hans Matthöfer for "greater transparency and control" in the Eurodollar market. The West German plan consists in introducing stability into the Eurodollar market by creating a second tier of low interest rate productive loans and thereby isolating the volatile money flows. Richardson's design is to straightjacket the U.S. economy.

The credit-crunch prophecy

The Richardson approach was served up for the lower echelons of the banker public in the annual report on the U.S. credit markets released by Bankers Trust last week. Bankers Trust economist Donald Wooley predicted that total borrowing in the U.S. credit markets will shrink to $344.3 billion in 1979 from 1978's $354.6 — about a 10 percent sheer drop, taking into account inflation.

Wooley is talking about a situation in which there is to be a deliberate cutoff in credit availability in the U.S. followed by a deep recession. Under the pretense of making their annual credit market predictions, Wooley and other members of the Bankers Trust credit market committee like Disque Deane of Lazard Freres and Henry Kaufman of Salomon Brothers sit down at the beginning of each year and attempt to rig interest rates — decide what the availability of credit should be at what price. To the extent that Wall Street gives credence to these oracular mutterings, the predictions become self-fulfilling prophesies.

Last week the Wall Street sheep allowed themselves to be stampeded in the direction of the latest London-directed high interest rate scenarios.

One of the factors unsettling the credit markets, we were told, was the situation in Iran. Interestingly, it is Disque Deane and one of his associates, economics columnist and scenario spinner Eliot Janeway, who are currently warning the loudest of the threat of a default by Iran on its outstanding foreign debt, which, they say, could trigger an international credit markets panic.

U.S. Federal Reserve Chairman G. William Miller, who drove up the key Federal funds rate over four percentage points in 1978, is naturally in on the recent new run up in interest rates. At the New York Economic Club last week, Miller made a renewed call for tight money, complete with recommendation that something be done to prevent Eurodollar deposits from returning to the U.S. and undermining the Fed's efforts to restrict U.S. credit.

Miller's speech was calculated to create expectations of renewed interest rate tightening by the Fed — expectations which, as always, had the effect of actually bidding up rates.

With Miller's prophecies well broadcast, the Fed leaked to the wire services on Feb. 6 that the monthly meeting of the Federal Open Market Committee to take place that day would decide on (1) a higher target for the key Federal funds rate, and (2) a major revision of M1, the basic measure of money supply. A major fracas has developed.

Money supply watchers say that in the wake of automatic account transfers and other banking developments, M1 (defined as checking accounts and cash in circulation) is no longer a reliable measure of the funds available for immediate use in the economy.

Miller may want to put the squeeze on the availability of credit in the economy — as his predecessor Arthur Burns did in 1974 when he helped precipitate the last recession — through redefining M1 or some such move, but he does not have the political clout to effect such an economy-collapsing measure. Even a former Fed official admitted to EIR last week that it will take the "right atmosphere" to pull off a credit crunch now. That's where the market "predictions" come in.

—Lydia Schulman

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