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Domestic Credit by Richard Freeman

Double-digit rates for the decade?

Shifts in U.S. banks' sources of funds mean higher costs necessarily passed along to borrowers.

Fundamental changes in the U.S. credit system have set into motion a process guaranteeing that interest rates will move down very slowly over the next year and a half, and indeed may never fall below 10 percent over the entire decade of the 1980s and on into the 1990s, unless strong measures are taken.

This situation has been cited by both John McGillicuddy, Chairman of Manufacturers Hanover Bank, and William Donoghue, editor of *Donoghue's Money Fund Report,* which monitors the behavior of the $163 billion money-market funds, in an interview with *EIR* on Oct. 15.

Donoghue cheerfully cited the following information: "It used to be that banks could get lots of money in non-interest-bearing checking accounts or through passbook savings accounts that paid the saver between 5 and 6 percent. Not any more. The cost of funds to the banks is going up, and the amount they will charge for interest is increasing.

"Look," continued Mr. Donoghue, "you currently have to pay 14 to 16 percent for CDs if you're a bank. Then with the advent of money-market funds, which are booming, banks and S&Ls had to start offering something that can compete. So there are six-month money market certificates offered by the banks that pay Treasury-bill rates of 12 to 14 percent. Thirty-month small-savers certificates pay a comparable rate. And as long as money market instruments can pay 15 to 17 percent, the banks have to compete and pay consumers almost as much for their funds."

Donoghue said that money-market funds have become an integral part of the banking system, at least for the big banks. In effect, money-markets funds pull cash out of savings accounts, and from there, in part, into the CDs of the 20 largest banks. "But if banks must continue to pay this much for their acquisition of funds," argued Donoghue, "then they must charge at least that amount and more, when they lend funds."

Citing figures to show the dramatic change, Donoghue said that "by June of this year, there were $354 billion in passbook savings accounts, but $461 billion in money-market certificates, $150 billion in money-market funds, $112 billion in small-savers certificates, etc. In January 1978, $90 billion of accounts at banks or money-market accounts paid better interest than the rate on passbook savings accounts. By the end of June, according to the figures I've calculated from the Fed, that category had risen to $802 billion, the bulk of funds in the banking system.

"Let's face facts. This is a double-digit decade; things have changed so dramatically that interest rates won't be below the double-digit level for the rest of the decade."

Manufacturers Hanover's John McGullicuddy stated in an Oct. 13 speech before the American Gas Association: "The deregulation of consumer savings through deregulation of Regulation Q is also carrying a high price tag. Some $56 billion has shifted into interest-bearing NOW accounts, mostly from interest-free demand deposits. This adds another $2 billion in interest.

"Consumer surveys indicate that approximately $60 billion of the $160 billion now in money market funds came originally from depository institutions. To make up the deposit loss, banks have bought back approximately the same amount. But this conversion of core deposits into money funds is costing the banking industry something like $5 billion annually in additional interest expense."

McGillicuddy added, "Another extremely popular instrument is the six-month money market certificate tied to Treasury bill rates." He predicted that for this and related reasons, "short-term interest rates will necessarily be stickier on the way down than might previously have been the case."

Money Fund Report's Donoghue says that "many depositors will withdraw their money from passbook savings and at the same time transfer them into an instrument paying two or three times the interest rate. Consumers should do this.

"This will probably also mean a lot of bankruptcies of banks who can't compete in this environment, but that's okay, because bankruptcies clean out the weak sisters. In two to three years, we may not have any more passbook savings, but without cheap sources funds, banks will never lend cheap again."

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