What drop in interest rates?

Interest rates aren't really falling; it wouldn't do any good if they did. The crash prospect is the reality.

When the stock market chose to rally 39 points on the Dow Jones average on the same day, Aug. 17, that the *Wall Street Journal* revealed that Chase Manhattan had trouble selling its certificates of deposit on the market (as visibly upset Chase officials confirm), events simply demonstrated that the U.S. stock market, given present debt-equity ratios, has leveraged itself into a position similar to that of Hong Kong, where fortunes triple or disappear overnight.

The fact that Chase now pays 150 basis points more than other banks for funding should put a damper on the enthusiasm of the market for falling interest rates, for the simple reason that the rates corporations, consumers, and an increasing number of banks must pay have either remained high or actually moved up while Treasury bill rates have collapsed.

Federal Reserve officials speak of "lower rates for the U.S. government, but not for anyone else," noting that troubled banks (including Chase and Continental Illinois) may be paying 4 to 5 percent more for their money than the Treasury, instead of a percent or two, as is usual.

For banks that funded loans pegged to the London interbank rate (LIBOR), i.e. LIBOR plus 0.5 to 1 percent, falling rates do not help, since many of them cannot borrow at LIBOR, or less than 1.5 percent above LIBOR.

In fact, the reason for the trends in interest rates has to do, principally, with the pre-panic state of the market and with the collapse of the underlying economy, and secondarily with the pre-panic frame of mind among central bankers. In this singular world, the market phenomena are read by sophisticated investors as cause to dive for the cellar before the twister hits.

First, the "rush for quality" takes the form of a huge rise in the demand for Treasury bills at the expense of virtually all other kinds of paper; investors and even large commercial banks are so fearful for their liquidity that they are willing to invest in short-term Treasury bills even at substantially reduced interest rates, as a matter of safety. That is why Treasury bill rates fell 6 percent since June, and the prime lending rate of commercial banks fell only 2 percent.

Second, as the London *Financial Times* noted in an Aug. 18 editorial entitled, "Depression Finally Overwhelms Rates," the underlying economy has collapsed. Overall lending has dried up; as the Bank for International Settlements figures for the first quarter show, the rate of lending to Eurodollar market borrowers dropped sharply for the first time since the depression began, and the past six weeks' numbers for American commercial and industrial loans show no increase whatever.

Third, the composition of lending has changed drastically, Fed officials and market analysts believe. Corporations are no longer borrowing to finance inventory or pay suppliers, but to repay debt service. This form of distress borrowing does not increase "money supply," unlike normal business borrowing, which multiplies checking accounts: borrowers take their money from one window and hand it over at another. This accounts for the reductions of the money supply in the past several weeks. In that sense, the drop in rates represents "the only silver lining in a very black cloud," as the *Financial Times* editorial chose to put it.

There is another nasty element in the process, as Chase Manhattan economist Ronald Liesching explains: the Fed is using the Bank of England's ancient "Grand Old Duke of York" routine to market $50 billion per quarter of federal debt, luring retail investors by letting rates fall and creating hopes of capital gain upon purchase of long bonds, then jerking rates back up—until the next wave of suckers decides that rates have "peaked." Barring an all-out collapse, rates would rise again later this year.

In all this tumble there is a new element: the fact that central bankers see the present collapse in bank lending, which they earlier engineered, turning into a giant snowball which could crush the banking system. The Fed's willingness to permit rates to fall, and bring its own discount rate down along with them, reflects such fear. Fed officials speak of an informal agreement between the Fed and the European central banks to gradually reliquefy the banking system.

However, since the magnitudes of the problem are potentially much greater than any normal growth in monetary aggregates could cover—London and Swiss banks speak of $100 to $150 billion of busted assets this year—and since the circulation of monetary reserves provided by the central banks is frustrated by the "rush for quality," it is difficult to see how this might help matters.