

Domestic Credit by Richard Freeman

A new rise in interest rates?

The bond and stock markets' dependency on foreign flight capital shows vulnerability to another rate rise.

Some commercial bank money analysts are now speaking of another sharp rise in interest rates, and the fear of a rate rise apparently produced the poor results on the stock market Nov. 10 and 11. According to the standard scenario, the fact that the annualized rate of increase of the narrowly defined money supply jumped from 10 percent in August to 20 percent in October threatens the Federal Reserve's "credibility," and the Fed will have to react by raising rates—at which point the Duke of York will march up the hill again.

However, the situation is considerably more complex than this might suggest: first of all, the money-supply explosion has little to do with either Federal Reserve creation of monetary reserves (which have been flat for months), or with excessive commercial bank lending (lending fell during October); it appears to be principally the result of inflows of foreign money. Since the Fed and Treasury have no accurate means to track such inflows, particularly foreign purchases of securities, the precise amount cannot be estimated; but process of elimination leaves no other credible conclusion.

The conclusion is reinforced by the estimate of Manufacturers Hanover Trust (in its *Financial Digest*, Nov. 8) that 99.5 percent of the total volume of domestic savings will have been absorbed by federal financing during 1982. This compares to 50.5 percent of domestic savings absorbed into federal debt financing in 1977. (The total

volume of financing estimated by MHT is \$213 billion, including \$117.6 billion of direct Treasury borrowing; off-budget borrowings brings it to \$134.9 billion; federally-sponsored agencies to \$172.9 billion; and guaranteed loans to \$212.6 billion).

Since credit expansion, i.e., monetization of debt, represents a negligible sum, the critical factor in financing the debt clearly shifts from Euro-dollar market deposits, foreign portfolios, and so forth into Treasury securities.

Since, as Manufacturers Hanover Trust argues, the federal deficit next year "would absorb more net savings than the economy is likely to generate next year, and comprise a record proportion of total funds raised in the credit markets," this appears to be a hard act to follow.

First, since the main source of foreign funding for the deficit was the deposit base of offshore banking centers, the result of the "successful" financing of the deficit has been a collapse of international lending, and a resulting collapse of international trade.

Secondly, since the contraction of internal trade and foreign economies has reduced global liquidity and investible funds, starting with the now-extinct OPEC oil surplus, the funds are no longer out there to be brought into the United States.

This means that the ease with which the deficit was handled is, to a great extent, illusory: the financing of

the deficit depended on a speculative bubble whose continuation has certain obvious limits.

It is difficult to say what might trigger a collapse of the bubble, whose result would be a sharp increase in long-term interest rates, and the virtual extinction of the corporate bond market for the succeeding period. Should the Fed feel compelled to raise interest rates, that alone might set the first stones falling down the mountainside.

Another consideration is the political campaign on the part of George Shultz, David Stockman, Martin Feldstein, and other administration officials, who are now seeking to persuade the President that he must cut the defense budget. Feldstein sermonized Nov. 9 that there could be no recovery as long as the deficit remained at present record-breaking levels.

This suggests that the Fed might be inclined to give the market a couple of test shocks, in order to send a strong message to the White House concerning the defense budget. However, such shocks might become amplified, rather than dampened, in the supercharged atmosphere of the current markets.

More likely is that the foreign interest will, at a certain point, take their profits and run, and wait for the down-phase of the dollar before moving additional funds into the United States. The dollar is highly vulnerable (see article, page 4), and the sharp rate of contraction of international trade implies a sharp fall of the dollar sometime during the next several months; the timing of such a move is, however, utterly incalculable.

In either case, the long-term markets must show a major rise in interest rates, with the obvious consequences for the domestic economy.