Click here for Full Issue of EIR Volume 10, Number 49, December 20, 1983

Domestic Credit by Richard Freeman

Why rates are moving up

It's not because a recovery has created new demand for credit, look at the deficit picture.

When long-term bond rates jumped 22 basic points to 11.92 percent on Dec. 8 from the week earlier, and on the same date bank certificates of deposit due in six months stood at 10.05 percent, up 25 basic points from the day before, this column's warning four months ago of a rate hike in the last quarter of this year began to be fulfilled.

The reasons for this increase have been misinterpreted, in some cases deliberately by Morgan Guaranty, Salomon Brothers' Henry Kaufmann, and other interpreters of interest-rate movements in the United States.

According to this crowd, there are two causes pushing up interest rates: 1) growing U.S. budget deficits and 2) the alleged, nowhere-to-be-seen "overheating of the U.S. economy." Point 1 has some validity; point 2 misidentifies the process of corporate financing of interest debt service with borrowing for economic growth. In any case, according to each of these two arguments, the U.S. government and corporations are crowding out the market and pushing up interest rates.

It remains for one of the greatest enemies of the United States at this time, former West German Chancellor Helmut Schmidt, to actually indicate what is causing the rates to increase. In a speech before a Washington, D.C. executive group on Dec. 8, Schmidt blamed the U.S. budget deficit for the current problems over the European Community budget, the disunity among EC nations, and the problems in the European economy. He said that "the United States is living at the expense of the rest of the world," and that "the world outside will not continue to finance your deficit." The regime of capital inflows to finance the American deficit "will not last. . . . Eventually the Europeans will regulate capital outflows through controls."

In narrow terms, Schmidt's formulation is accurate. Federal Reserve Board chairman Paul Volcker imposed the current high-interest rate regime as policy in October 1979 when the dollar had crashed to barely DM 1.80. Since then, rates have strengthened the dollar to a record DM 2.75 cross-rate as of Dec. 9, and the United States has absorbed most of $100 billion in Ibero-American flight capital as well as a huge amount of European flight capital, especially since September 1982.

This flight capital financed the U.S. federal budget deficit as well as the widening trade deficits which reached $70 billion in 1983.

But flight capital from Ibero-America dried up, especially starting in May of this year, leaving Europe as the only source of flight capital funds. Europe's loss of flight capital leaves Europe *de facto* bankrupt, i.e., without any visible source to finance its growing external indebtedness and its internal budget deficits.

OPEC, which had provided funds to both the United States and Europe, is now running a deficit and thus draining funds from the world liquidity pool. British Prime Minister Margaret Thatcher's nasty attack on U.S. budget deficits on the floor of the House of Commons Dec. 8 presages intense U.S.-bashing in Europe that could, as Schmidt warned, lead to exchange controls and deep rifts in the already fractured U.S.-Western European alliance.

The U.S. budget deficit is real and large enough, but its source has been misidentified. Council of Economics Advisers chief Martin Feldstein has claimed, along with Morgan and the rest of Wall Street, that defense spending has "busted the budget" and must be cut, thus crippling U.S. defense at a time when the Soviets are most bent on war (see article, p. 4). An honest audit of the U.S. budget, conducted by this magazine earlier this year (see *EIR*, March 22) shows that, on the contrary, Paul Volcker, the biggest advocate of defense cuts, is the real culprit. Of the $200 billion fiscal year 1983 budget deficit, *EIR* proved that 70 percent was attributable to Volcker's brutally high interest rates, including tack-ons due to extra interest on the public debt, lost personal and corporate income taxes, and extra payments for unemployment, food stamps, and other benefits.

As for the hooey that heavy corporate borrowing reflects "overheading the economy," the actual biggest cause of corporate borrowing is interest debt service financing. According to one published report, 48 cents of each dollar of corporate cash flow in the second quarter went into interest debt service. The ratio of short-term to long-term debt barely budged for the corporate sector during the "recovery," meaning that most debt is still short-term and very costly.

© 1983 EIR News Service Inc. All Rights Reserved. Reproduction in whole or in part without permission strictly prohibited.