

Interest rate hikes bring instabilities forward

by Chris White

Alan Greenspan's Board of Governors of the Federal Reserve System rocked credit markets this week, first raising its discount rate, and then, by Thursday, Aug. 11, jacking the Fed Funds rate back over the 8% level. As a result of the credit tightening accomplished over the last three months, the commercial banks' prime rate is again at 10%, with further increases expected.

Much play was made in the financial columns of the strange conjunction, that now we have a Federal Reserve Board, with six sitting members, all appointed by Ronald Reagan, acting unanimously to tighten credit and undermine the election campaign of George Bush. The credit tightening was identified in financial circles around the world as the Fed's governing board signaling its so-called "independence" from the political process, and other institutions of government. In other words, forget the preposterous "fight against the threat of inflation takes priority" garbage, the Fed is signaling that the United States' foreign creditors come first, internal political arrangements a distant second.

For others, the latest round of credit tightening is bringing back the memories of August 1987, when, under the direction of the Swiss-based Bank for International Settlements, the central banks, led by the Bank of England, set off the credit tightening which led to the New York stock market meltdown of last October. Time will tell whether such will again be the case. For sure, however, what is being called the "interest rate war" among the shapers of monetary policy in the United States, Britain, and West Germany that has been under way since early July, has once again detonated the explosive combination of instabilities which make the present bankrupt dollar-based monetary and credit system what it is.

Foreign creditors dictate

In two areas, the Fed's actions accomplished that much, to the supposed benefit of those foreign creditors. First, Tuesday, Aug. 9, the unanimous Board of Governors, with the support of 11 of the country's Federal Reserve Districts, increased the discount rate by half a percentage point, from 6% to 6.5%. The discount rate is the rate at which the Fed lends to financial institutions. Unusually, the announcement—which seemed to catch markets awaiting another increase in the Fed Funds rate, the rate set by the Fed for inter-bank lending for account settling, etc.—by surprise, was not made at the end of the trading day. The Fed chose to act first thing in the morning, on the very day the James Baker-run Treasury Department was going to market with the U.S. government's quarterly debt auction.

The Fed's action highlighted the reality that the creditor agencies which buy U.S. government debt are insisting on higher yields in the form of debt service, and will stay out of the market until they get them. Yields on all classes of U.S. government bonds and notes soared back to year-high levels as the big buyers kept aloof. After the first day of the three-day auction, it was widely reported that the Japanese, whom U.S. authorities count on to take half of the offering, had only chipped in \$1 billion, against the \$5 billion that was expected. Thus, it was made clear that stability in internal credit markets will be sacrificed to the creditors' demands for an increasing share of the take in the form of higher debt service.

Second, it was becoming clear that the Fed's tightening actions are undermining the bankrupt banking system at one of its most vulnerable points. And thus, that the demands of foreign creditors are also to be put ahead of the protection of

assets of domestic institutions and individuals. Up until this week, those responsible for the regulation of the insolvent savings and loan institutions seemed to have been content to let it be understood that their operation, while losing \$1 billion a month, was under control. Their loss numbers ran through the end of May, before the Greenspan credit squeeze began to bite. Now, as June numbers become available, it is also becoming clear how misleading their reports have been. The Dallas district of the Federal Home Loan Bank Board reported that Texas thrifts alone had lost \$2.14 billion during the month of June.

Since the Volcker high interest rate regime of the early 1980s, the thrifts have been reduced to insolvency as they were forced onto money markets to borrow funds to offset losses incurred on lower fixed interest revenue streams. The increase in borrowing costs for these outfits will push the number of insolvent cases up, from the level of about 500 out of the 3,000 total in the country, to well over 1,000. The effect of that increase will be felt throughout the financial system. Here, no doubt, the foreign creditors are licking their chops over the windfalls to be made when the U.S. thrift system, and the chunk of banking in general that comes down with it, is finally put into liquidation.

The instabilities

European financial insiders point out that there is an added twist to the above. While increasing rates of interest within the United States have, because of the differential maintained by U.S. authorities—between especially U.S. rates and those which prevail in Germany and Japan—sucked speculative funds from around the world into the dollar, taking the currency back to the \$1.90 level to the deutschemark, the U.S. monetary wizards have thereby made their plight that much worse. The money they have so attracted has stayed out of both the U.S. stock market and the U.S. bond market. By some accounts, \$50 billion such funds have been sucked into the United States from West Germany in the first six months of this year, twice the level of 1987 as a whole. Instead, such funds have been placed as cash instruments within the banking system. Suppose then, conservatively, that about twice the German level of inflow has been attracted from around the world. What happens inside the United States when those who were encouraged to put their cash into higher yielding instruments inside the United States complete the calculations which lead them to conclude that they are losing money by staying?

While increasing U.S. interest rates have provided the short-term incentive, the speculation has been encouraged by the administration's rhetorical campaign on the reduction of the trade deficit. Yet, by increasing the exchange rate of the dollar, those responsible for attracting the speculative inflows have proven that reducing the trade deficit is not actually on their agenda. They are thus increasing outstanding U.S. obligations to the rest of the world, and not reducing those obligations, or offsetting an increase in one category of such

external indebtedness with a reduction in another such category.

Chief among the instabilities brought back to the surface by the Fed's actions will be the question of what exactly the controllers of the disposition of those speculative funds are going to do. Thanks to the supposed financial orthodoxy of the Establishment's Federal Reserve money managers, a new detonator has been built up within the bankrupt monetary system, and control of that detonator has been placed in the hands of the world's speculative hot money merchants.

By Thursday, Aug. 11, when the dollar had broached the \$1.90 level to the deutschemark for the first time in the last 18 months, as a result of the continuing upward trend in interest rate within the U.S., German Finance Minister Gerhard Stoltenberg, and central bank President Karl-Otto Poehl yelled enough. Further increases in the exchange value of the dollar, they warned in the customary circumlocutions of the technocrats from the Group of Seven industrialized nations, "could be counterproductive." In the aftermath of their remarks, the dollar fell, back down to the \$1.87 range.

But meanwhile, it became clear that the Federal Reserve was actually beginning a new round of money tightening. Since the commercial banks increased their prime rate after the Fed tightened the discount rate, it is assumed that the one caused the other. Not really so. The prime rate going up, again, marked the end of one cycle of credit tightening, set off in May and June. The increases in the discount rate and the fed funds rate actually marked the beginning of a new round of credit tightening which in the next weeks will take the prime rate back over the 11% level, and perhaps higher.

This reality was affirmed to the *Wall Street Journal* Friday, Aug. 12, by Gordon Pye, the chief economist at Irving Trust. "Banks typically maintain a margin of at least 1.15% between the prime rate and their own cost of funds, reflected in 90-day certificates of deposit. The rate on 90-day CDs surged to 8.45% from 8.05% last week, and when banks include the cost of federal deposit insurance and their reserve requirements, that real cost hovered at about 8.9%. Obviously, 'banks weren't keeping their traditional margins with a prime at 9.5%,' Pye said."

Equally obviously, the increase to 10%, looked at the way the bankers' would, was a minimum. The Fed's actions guarantee it will go higher, in the not-too-distant future, to maintain what the bankers' call "the differentials."

No doubt some wizard, tucked away in a closet somewhere in the Federal Reserve's headquarters, has a set of charts and numbers, from which trend lines can be adduced that show there is a three- to four-month lag time from the beginning of a cycle of interest rate increases to the generalization of its effects throughout the financial system. Phase I: May, June, July. Phase II: August, September, October. Since the effects are calculable in other ways too, the geniuses might well have just ensured that the next blowout, which they are demonstrably incapable of dealing with, may well occur some time this fall.