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Domestic Credit by Richard Freeman

Interest rates: up, up and away

The Fed has been shoveling funds into the economy as if there were no tomorrow, but Volcker can't keep monetizing the debt.

With the U.S. economy hanging by a thread, the increase in short-term U.S. Treasury bill rates will surely be the sharp instrument that cuts that thread, producing a severe economic drop that will distress the Reagan White House no end.

The U.S. Treasury announced March 22 that three-month Treasury bill rates had risen to 8.58 percent, up from 7.66 percent on Jan. 14. Most of that increase has been registered within the past three weeks. The short-term Treasury bill rate will move up the rate that banks pay on short-term Certificates of Deposit, as well as the rates that banks pay on savings accounts, which are pegged to a floating average of the Treasury bill rate. As the cost of money for the banks goes up, so will they charge borrowers.

The Treasury bill rate must continue to go up because of the tremendous Treasury deficit, and the competition for borrowed funds between the private sector and the Treasury. In fact, all interest rates would be much higher, were it not for the Federal Reserve's behavior over the last six months in attempting to finance the federal budget deficit and provide some funds for the real physical economy at the same time. Once this ceases, the U.S. economy will collapse.

The Federal Reserve has been shoveling funds into the economy as if there were no tomorrow. Adjusted reserves, the raw stuff out of which monetary base is produced, which in turn is the substratum from which money supply is generated, have grown from $50.3 billion on Jan. 12 to $53.4 billion for the week ending March 9, a stunning 30 percent rate. The short-term effect: M-1 money supply has grown by 20.6 percent during the period under consideration. Suddenly worried, Treasury Secretary Donald Regan called together a group of reporters on March 21 to tell them that he is "concerned" that the rapid growth of money supply might rekindle inflation. "Looking at the percentage increase [in money supply]," Regan said, "you do get concerned that there is more there than meets the eye."

Of course there is. Fed Chairman Paul Volcker has been bailing out the U.S. economy, with the blessing of both Treasury and the White House; because if he hadn't, the White House would not have been able to brag foolishly that "the recovery is here." Don Regan must have known that M-1 money supply has grown at a 16 percent rate between November 1982 and February 1983, and that M-2 money supply grew at a 21 percent rate in the same period. The recent pumping of credit into the U.S. economy has been going on since at least last July, and therefore is not the sort of development that would have taken Don Regan unaware.

What is going on is simple: had Volcker not pumped money in at the frantic rate he has, the federal funds rate would have shot up from its current level of 8.75 percent to the 10 or 11 percent level, because of the heavy demand for funds. Since the prime rate is usually pegged at 1½ to 2 points above the prime rate, this would already have moved the prime rate to 12 or 13 percent, instead of its present 10.5 percent. Had Volcker allowed that to happen, even the rigged, short-lived improvement in the government's statistical indices during January and February would not have occured.

The Fed is up against a formidable problem. The Treasury borrowed $217 billion in the fourth quarter of 1982, while state and local governments borrowed $70 billion in the same period, making a grand total of $287 billion. The $287 billion for the fourth quarter of last year represents 60 percent of all funds issued in that quarter. Six cents out of every 10 cents borrowed went to either the federal, state, or local governments.

Volcker got around this problem by "monetizing" Treasury debt, and by buying existing Treasury debt from banks on the federal funds market. This had two effects: first, it pumped a large amount of liquidity into the banking system. This was lent out and kept corporations, farms, and consumers liquid enough that they could spend at the rates that they did to allow the "upswing". Second, it allowed this huge amount of Treasury debt to pass through the system, without crowding out private borrowers.

But Volcker's efforts must come to a halt. He indicated as much in March 6 congressional testimony. Don Regan's criticism was the sign that the White House may no longer be able to continue to pressure the Fed into money printing. Since the second week in March, the Fed has been passively "leaning against the wind," refusing to accommodate all Treasury borrowing needs, but refusing to tighten as yet. In the next few weeks, Volcker will have to start tightening up in earnest.

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