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What makes interest rates go up?

Fundamentals, not monetarist gobbledygook or "market management," are important.

The dip in short-term Treasury bill rates, which fell from about 8.64 before the Easter weekend to 8.38 on April 6, reflects the same "bouncing ball" pattern of increase which has prevailed since last January.

Although the fundamental pressures driving interest rates up, as *EIR* described last week, are continuous, the evolution of the financial futures market prevents their *effect* from being continuous.

To the extent that the majority of large speculators fix their attention on the Federal Reserve's perception of their own perception of the Federal Reserve, in the form of that esoteric discipline known as monetarism, such wild swings are inevitable.

Rates dropped the first week in April, partly because speculators took a bet on a less restrictive Federal Reserve monetary policy than they had earlier feared, based on a guess that narrowly defined "money supply" would not rise as fast during the second quarter as they did during the first quarter.

On this basis, the Fed will supposedly let interest rates drift down. More notable is the simultaneous sharp increase in the spread between Eurodollar and Treasury bill rates, reflecting a "flight to quality" among a certain section of the market. Taking into account Eurodollar rates, which actually rose on April 4 and 5 and then fell only marginally, the drop in rates is less confidence-inspiring.

All this supposes that rates intially rose on "expectations" that the Fed would tighten to contain money growth throughout March.

This is not true; as one monetarist who heads capital market research for a top brokerage firm notes, the demand for refinancing of American banks' short-term loans to foreign banks would, by itself, account for the rise in the Fed funds rate during March—whatever anyone else thought.

Not merely the volume of domestic Treasury financing, which the "market" takes into account, but the staggering volume of overseas refinancing, represents a continuing source of upward pressure on interest rates—even with flat commercial credit volume.

The Fed has, indeed, permitted what the St. Louis Fed calls the monetary base to grow at a 12 percent annualized rate this year; but is this the source of the 15 percent annual rate of M1 growth?

There has been no new lending to the private sector, the traditional source of the "money multiplier;" most lending has gone abroad. Why does it show up in M1?

The Fed (and the IMF staff) have one explanation, which I illustrate with excerpts from a conversation the second week in April with a Federal Reserve official.

Q: Why are interest rates going up?

A: I don't know.

Q: Couldn't it be that the combination of the Federal borrowing requirement $100 billion in excess of income flows plus the immense offshore rollover requirement are pushing rates up faster than the Fed dares lean against?

A: That's one explanation. It might be true. The other explanation is that people are scared.

What the Fed official was indicating is that investors terrified by the recent spate of oil industry, S&L, and related bankruptcies are holding cash to an abnormal extent. Since the Fed itself is the source of this uncertainty—as monetarist Dennis Karnowky of Conti Commodities points out—the notion that this should determine interest-rate developments is distressing.

Nonetheless, the Hayekians among foreign central banks, as well as their principal mouthpiece in Washington, Fed governor Henry Wallich, are using the spectre of excessive M1 growth to demand that the Fed tighten. Here is what one Belgian central bank official had to say on the matter:

"The problem is that they are not willing to take the measures that would be required, by which I mean reducing the immense fiscal deficit; and without a lower deficit, it is not possible to lower interest rates and control the dollar. And now the Fed will have to tighten monetary policy. They cannot permit the monetary aggregates to keep growing as they have."

The Fed and the administration, for different reasons, have resisted such perverse logic, the Fed because it hopes against hope for a "smooth" reorganization of the collapsing world banking system, the administration because it wants an economic recovery. The second week in April, together they beat back the speculative "overshooting" in the credit markets. But without a fundamental change in policy, the underlying pressures will defeat them.

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