Domestic Credit by Richard Freeman

Rates will continue to rise

A debt crisis, Fed money-printing, a dollar decline, and interest-rate leaps is the likely sequence.

Short-term declines in interest rates have, throughout this year, followed the completion of Treasury borrowing schedules; the Federal Reserve must precede each borrowing period with a rise in rates, in an effort to convince lenders to the U.S. government that the worst is over before the Treasury comes to market.

The importance of the August decline of rates is that it aborted within two weeks. Although bond prices rose, virtually no retail buying was evident; the major traders simply passed paper around their narrow circle at somewhat higher prices. The charade ended the week of Aug. 28, as most of the major commercial banks' funding departments had projected. Large commercial banks assume that rates will be up 50 to 100 basis points by Sept. 30.

No one is more humiliated by the renewed decline in the bond market than the Veterans' Administration, which hastened to drop its lending rate from 13.5 percent to 13 percent the moment long-term rates had fallen by half a percent. This indecent haste betrayed administration fears concerning the evaporation of the entire phony economic recovery. During the next week or so, the VA will have to move back up, making all the more evident how fast the housing uptick must evaporate.

Two other matters must be taken into account, however, to gauge where rates might go. The banks' 50- to 100-point estimate represents a floor for the increase. The ceiling is established by the emerging international monetary crisis.

By not much later than the last week of September, the bank analysts will have discovered that Brazilian arrears (which cannot be accrued as gross interest income after 60 days) will cost most of the big money-center banks the equivalent of a Drysdale or Penn Square in second-quarter earnings. That, of course, is the least of the problem; the banks' "best case" at the moment is a 60- to 90-day Brazilian moratorium, which would force smaller creditors to stay in the game, and open negotiations for creditors' seizure of Brazilian raw materials and state-owned industries.

As the London *Financial Times* acknowledged on its front page Sept. 2, the Brazilian parliament is likely to reject the IMF package. (It might have added that the U.S. Congress is not much more friendly to the IMF.) In this case "the Eurodollar yield curve will stand up like a flagpole," as one bank's international economist warned.

If the Fed reacts according to existing contingency plans (and Volcker's profile), i.e., throws in enormous amounts of money to dampen the shock effect, the next step may be a severe drop of the dollar and liquidation of private investments in U.S. securities. This will produce higher, not lower, interest rates for all instruments with the possible exception of short-term Treasury securities.

The other area to watch is the so-called economic recovery. All current indications support the contention of *EIR*'s July Quarterly Economic Report that the fake recovery will evaporate during the September–October period. Thinly based on a government-subsidized housing uptick, and vastly exaggerated by official statistics, the "recovery" will founder in the fall.

About four-fifths of the total reported improvement in industrial output (inflated to a considerable extent by Federal Reserve fudge factors) stems from the auto and housing upticks.

The disappearance of the latter is already clear in scattered reports, including single-family home sales and the big drop in July durable goods orders. An *EIR* survey of auto plants around the country shows less planned overtime for critical parts plants, indicating a declining rate of auto output by October at the latest.

At a certain point, a further round of U.S. economic collapse will produce a nasty fall of rates. But the impact of this collapse on federal revenues (which never recovered) as well as on foreign inflows into the U.S. will either delay the decline in rates, or even push rates higher in the short run.

As the political calendar now stands, it does not appear that there is any prospect for lower rates until early next year, and this after the international banking crisis and the domestic economic shakeout have already taken their toll. However, the combination of banking and military crisis at a global level renders all such calculations moot. The overriding point is that rising interest rates represent a nasty intrusion of reality into Paul Volcker's stage-set recovery, an introduction to even nastier intrusions to come.