

Domestic Credit by Richard Freeman

Interest rates will fall, then climb

Private-sector financing needs will remain too heavy for rates to fall below 10 percent, despite the recession.

Federal Reserve Board Chairman Volcker will have his hands full in attempting to implement his dictum that he will hold tight on money supply and interest rates, and keep the economy from relitigating the way it did partially in July-September 1980, following the onset of credit controls in March 1980.

Those who remember that period will recall that after reaching a prime rate level of 20 percent during the second week of April 1980, interest rates fell to an 11 percent level during the first week of August. The sharp decline was preceded by a production drop of 8 percent between March and July.

All other rates followed suit. Ninety-day certificates of deposit at large money-center banks fell from an 18 percent level reached on April 4 down to about 8.5 percent the last day of July. Corporate Baa bonds, which were 13 percent for the month of March, fell to 10.5 percent in June, but never lower.

It appears that there is little chance that the U.S. will escape a production drop as sharp as the March-July 1980 period. With a production drop that sharp, borrowing levels would have to contract. The decline in steel output is symptomatic.

Steel production for the week ending Oct. 10 was 71.6 percent of capacity; for the week ending Oct. 31, it was 65 percent. As steel-capacity utilization dissipates, two Fortune 500 companies are on the brink of sharp contraction, at the

very least. Kaiser Steel, the ninth largest steel producer in the nation, announced Nov. 2 that it will cease all production of raw steel and rip out its coke oven and blast furnaces from its Fontana, California plant. Since the plant was built during World War II to provide steel for ship-building, it was one of the relatively more modern in the United States.

International Harvester, the nation's second largest farm-implements producer, with sales of nearly \$10 billion per year, and one of the top 50 Fortune 500 companies, announced Nov. 2 that it will shut down 16 U.S. plants and 3 Canadian plants starting Dec. 14, and keep them closed until Jan. 4. It will lay off 20,000 of its 50,000 employees. But Harvester still has to find ways to satisfy the claims of 220 lending institutions that hold \$4.15 billion of Harvester debt. Harvester lost \$240 million for the fiscal year 1981, has retained a bankruptcy attorney in the event that it cannot make ends meet in a farm-equipment market whose sales are 20 to 25 percent below 1979 levels. It is possible that some of the Harvester plants will only partially re-open after Jan. 4.

Add the 20 percent drop in auto sales, for October below last year's levels, and the continued collapse in housing and home-appliance sales, and total U.S. production may drop from August of this year, when production output fell 0.3 percent, until sometime in 1982 could be great-

er than 8 percent.

This means corporate borrowing will finally peak and begin to contract, which should ease down rates. The amount of commercial paper borrowed during October finally fell, although corporate borrowing at banks is still strong. Some investors are beginning to lock into 91-day Treasury rates, figuring that they are the highest they will be for a few months. Likewise, long-term Treasury bond rates may also be attractive right now.

The question is, will the falloff in corporate borrowing because of the recession lead interest rates below 10 to 11 percent on the short side of the market by Christmas? If this were a "normal" economy, even in the sense of the economy of the 1960s, the answer would be that interest rates should fall all the way to 4 to 6 percent, and there would be no problem.

But this is not a normal economy. Not only must corporations try to convert their short-term debt into long-term debt, thereby keeping up the pressure on long-term rates, but going into the recession, businesses are still faced with involuntary inventory buildup and huge short-term financing needs. For example, the inventory-to-sales ratio for September, at 1.63, was the highest in 12 months, despite the fact that production fell by 0.8 percent in September.

Other things being equal, the collapse of production will continue to bring rates down through to the end of 1981. Then illiquidity pressures will take over, pushing rates back up again around the start of 1982. The illiquidity of the economy will thus aid the Federal Reserve in holding interest rates above the 10 percent barrier.