Price of Money Is Up, Too — 62 Per Cent Since First of the Year

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U.S. Steel and the Chase Manhattan Bank are both huge corporations, and both exist for the same purpose: To make money.

The only difference between them is how they do it: The one company manufactures and sells steel, the other accumulates and rents out dollars.

When U.S. Steel announces a price increase, it is big news—it generally means the whole steel industry is going to raise its prices—and the same two things are always said about it.

First, the price increase is always expressed in percentage terms—the increase itself as a percentage of the old price—as a 4 per cent price increase, for example, or 5 per cent or 6 or whatever.

Second, the point is always made that this price increase is important because steel pervades the entire economy, and that its price is reflected in other prices, the price of cars, for example, or washing machines.

The same things could be said when Chase Manhattan raises its prices—the interest rates it charges on loans. Almost always, when one big bank raises its rate, the rest of the lending industry follows suit—and nothing, not even steel, pervades the economy as much as credit.

In the lending industry, though, price increases are not expressed in the same way. All you are told is the old price and the new—that the prime lending rate went up yesterday from 6.5 per cent to 6.75, or 9.5 to 9.75. But you are not told the percentage increase.

It doesn't sound as much that way; it is, though.

In the last eight punishing months of inflation in this country, the price of money—some kinds of it, at any rate—has gone up even more than the price of food.

The prime lending rate charged by Chase and the rest of the nation's big banks has gone up from 6 to 9.75 per cent.

What that means is that the price of short-term loans to big corporations—the money that companies always are borrowing to modernize or expand or otherwise do business—has gone up 62 per cent since the first of the year. From the companies' standpoint, that is a cost increase like any other. Some of it is going to be passed along to the public in the form of higher prices.

The cost of most of the money the U.S. government borrows has also gone up more than 60 per cent since January, and that cost, too, is going to be passed along—if not in higher taxes, then in a bigger deficit, which is also inflationary, or in cutbacks in

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other government spending and government services.

In addition to these effects, the cost of loans the average citizen takes out himself—a mortgage loan to buy a house, a loan to send children to college—has also gone up, though not as much.

The cost of these loans—the price or interest rate—has gone up for the same reason any other price does, because the demand has been outstripping the supply.

ever, there are some important differences.

The first is that the supply of money, unlike the supply of most other commodities, is controlled by the government, or at any rate by the Federal Reserve Board. (Some people think the Reserve Board, whose members are appointed by the President to 14-year terms somewhat in the manner of judges, is too independent of the government, by which they mean the White House and Congress.) The Reserve Board has the power, in various complicated ways, to expand or contract the supply of money and credit in the economy at any given time, and thereby, indirectly, to raise or lower the prevailing interest rates.

The second important difference is that, even though rising interest rates, like any other rising prices, are inflationary, the Federal Reserve Board has been driving them up all year long on purpose — and its purpose has been, in the long run, to reduce the rate of inflation.

The theory is that the harder it is to borrow, the less everyone will buy. If a loan is easy to get and cheap, you will buy that new car you've been wanting; if it isn't you won't. A big corporation is likely to behave in the same way. The less everyone is buying, the less general demand there will be in the economy, and the less upward pressure there will be on prices.

The delicate part of all that is how not to overdo it A lot of the buying in the United States every year, by corporations as well as consumers, is done on credit. Too great a crackdown on credit, and thus on demand, can create a recession. That is one of the things that caused the recession in 1970. The Reserve Board cracked down so hard as to cause what you now hear referred to as a "crunch," meaning basically that there was no credit to be had anywhere. This time around, the Board has tried to deal with the problem in a gentler way. Loan demand has been going up sharply, as it always does in boomtime. The Reserve Board has let the money supply go up, too, but not as much; it has tried to drive up interest rates without drying up credit, and discourage borrowing without quite cutting it off. The idea is to cool the economy off, but not chill it.

The big question, though, about even this more limited use of the Board's great power is whether it is worth it — whether tight money, with all the pain it causes, is really a good way, or the best way, to cool off an economy.

In part, that bcomes a political question. High interest rates are unpopular, but they are something that politicians can blame bankers for. The other way of slowing down demand, which is to raise taxes or cut government spending, is also unpopular, and it is something the politicians have to do themselves.

Arthur F. Burns, the Federal Reserve Board's chairman, has been saying for months now that too much of the burden of fighting inflation has been shoved off on the Board and its powers. He has urged the President and Congress to take more of the burden on themselves, most notably by raising taxes. They haven't.

In his press conference last week, while listing the steps being taken to combat inflation, the President started to take credit for having tightened up on the money supply, then thought better of it. "We are tightening up on the Federal Reserve," he said, "we are — Arthur Burns is, in his independent capacity with the Board members are, I should say."

Politics aside, however, tight money is a quirky thing. Like a powerful drug that doctors prescribe, it has the effect it is supposed to, but it has some strange side effects as well.

Businesses do most of the borrowing in this country. (At the end of last year businesses owed a little more than half of the debt outstanding; governments—federal, state and local — owed about a quarter, and consumers ailittle less than a quarter. About two-thirds of the debt owed by consumers was in mortgages on homes.)

Business borrowing, moreover, is the area where the demand for loans has gone up the most this year. It is this demand the Reserve Board would most like to dampen, and that is why the prime lending rate has been driven up to 9.75 per cent, an all-time record.

The trouble is that, no matter what it says on those pieces of paper they sign at the bank, in real terms most businesses are not paying anything like 9.75 per cent.

One reason is the very thing the Reserve Board is trying to get at, the rate of inflation. The other reason is the way the tax laws are written.

It works like this. Suppose a coproration borrows $100 for a year at 10 per cent interest. That means that at the end of the year it will have to pay back $110. Suppose also, however, that the rate of inflation is 6 per cent. That means that, in terms of its purchasing power, each dollar will be worth only 94 cents in a year, and the $110, only $103.40. In these real terms, therefore, the corporation is paying only $3.40 in interest on its $100, or 3.4 per cent.

Add to that the fact that, while the tax rate on corporations is close to 50 per cent, a corporation, like an individual, can deduct interest payments in computing its taxable income. That means that the corporation saves in taxes close to half of whatever it pays out in interest. And that cuts the real interest rate on the loan once again, this time to something close to 1.7 per cent. At real rates like that, few corporations are going to be deterred from borrowing. The Federal Reserve can diminish demand, but not always the demand it wants to. It is armed with a club when what it sometimes needs is a knife.

Another and simpler example of the same fact has to do with food. Food prices are the main source of the present inflation. The government, meaning the White House this time, wants to drive them down, and the method it has chosen is to

increase food production and thus food supplies. To do that, it has released millions of acres it previously had held out of production.

It wants farmers to farm them.

To cultivate extra acres, a lot of farmers will have to borrow money; a farmer may need another tractor, for example. The Federal Reserve Board, which is also trying to fight inflation, has made that money more costly. The farmer is thus less likely to borrow it.

If the farmer does borrow the money, however, he is going to want to recover its higher cost in the form of higher prices, and that is the thing that is most perverse about tight money: It causes inflation in order to cure it.

How much it causes exactly — how much, for example, this year's rise in interest rates has caused the over all cost of living, the government's consumer price index, to rise — none of the experts seems to know.

The price index will tell you what has happened to the prices consumers pay directly; it doesn't tell you the hidden prices they are paying. It will tell you, for example, how much the price of clothing has increased. What it doesn't tell you is how much of that increase stems from higher interest rates being paid and passed along by the companies that produced the clothing.

As to the interest rates consumers pay directly, one kind has risen and one hasn't.

The loans on which rates have not gone up, or at least have not gone up that much, are the smaller ones. Auto loans are the leading example. Loans like these rarely change much in price. They stay high all the time. The Federal Reserve Board says the rates charged by banks on auto loans have not gone up all year — but they started the year at about 10 per cent. The same is true of bank rates on loans for other consumer goods. They haven't changed, but they were about 12.5 per cent when the year began.

The loans on which the rates have gone up are the big one, mortgages. Mortgage interest rates were averaging about 7.5 per cent at the start of the year. They are averaging more than 8 per cent now, and where state laws permit, they have gone past 9.

The hard thing to explain about mortgage rates is not so much why they have gone up—they have gone up for the same reason as other interest rates, because supply is short of demand—but why they are still lower than the prime rate. The prime, after all, is the rate that banks give the big corporations that are their best customers. How can a homeowner get by for less?

The answer is that mortgage loans are long-term loans, and loans at the prime rate, generally are short-term. Long-term rates, by their nature, don't fluctuate as much as short-term do. If you're lending long-term, you're not as excitable. You're looking ahead 20 years instead of 90 days, you figure the short-term ups and downs will even out, and you're more philosophical.

That only holds true up to a point, however, which is why mortgage rates, while they haven't gone up as much or as far as the prime rate, have still gone up a lot.

There are different types of loans and lenders—long-term and short, for example —but they are all dealing in the same big money market. The borrowers are all bidding for the same dollars. If money gets tight, all rates go up some. If short-term rates get high, and stay high, they lure money out of the long-term market; a man can be only so philosophical. And the less money left in the long-term market, the higher the long-term rates become.

That is what has happened this year to mortgage rates. Most mortgage loans are made by savings and loan associations. The savings and loans attract money by offering to pay interest on it; then they lend it out at a little more interest, and live off the difference. For various reasons, most of them legal, there are limits on how much interest they can pay.

When other interest rates get a lot higher, and stay that way, as they have this year, money seeps out of the savings and loans. That means there is less money for mortgages, and sometimes no mortgage money at all.

That in turn has two further effects. One is to drive up mortgage interest rates. The other is to choke off residential construction. The housing industry, a big one, is generally the first to feel the effects of tight money; where tight money breeds recessions, housing is one of the places where they start.

The question left is who is getting rich in all this. If we're all paying higher interest, who is getting it? The quick answer is that the banks are, but that is only partly true. The banks and other big lenders are hardly hurting—they are prospering nicely—but they are having to pay higher interest rates themselves, to attract the funds they need to keep on lending. In the long run most of the interest comes back to the public—those members of it, at least, with lendable money saved up. Those that have the most are making the most.

There is one other thing to be said about this year's high interest rates, one other difference between the prices charged by the Chase Manhattan Bank and U.S. Steel. When steel prices go up, they generally stay up. Interest rates don't. No one is sure how long it will take, but one day—someday—they will come down again.