Volcker's 'organized chaos'— the next shoe drops

Capitol Hill, banking, Federal Reserve and administration sources are unanimous that the United States economy will be subject to what one official called "all kinds of controls" before the end of 1979.
commercial banks published by the *New York Times* Oct. 25, Fed Chairman Volcker invoked the Credit Control Act of 1969—under which the President has the power to take comprehensive control over all domestic credit flows—as the motivation for bankers to

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follow the guidelines he proposed
basis. Thus far, the Fed chairman has done no more than to show the banks the instruments of torture, to short-circuit the borrowing and lending spree that erupted immediately after his Saturday night austerity message. The implications of Volcker's letter are, however, much broader.

Britain's move to abolish exchange controls is a good watermark of the state of Volcker's regime. "These British are really smart," said a Senate source close to Volcker. "Volcker and Carter people told them what they were going to do, and they said, 'Here's our chance.' They made the necessary moves to facilitate major cash and credit outflows, and prepare for battle. If the dollar goes as a reserve currency, the good old pound sterling will become important once again. We'll get currency blocs. The U.S. has been dictating economic policy for years. Maybe we should let the British do more, like they used to. This is all 1931 in reverse."

America is getting Britain's controls and inflation rate, and Britain is getting America's free capital market and inflation rate. In the Oct. 25 *Financial Times*, columnist Samuel Brittan proposed "the launching of the petro-pound," predicting a major return by sterling to reserve status.

Volcker is trying to rule through uncertainty, and allowing, in the process, the scavengers of "controlled disintegration" to make their big play. The consequences for the U.S. credit system will be terrifying.

"Organized chaos" was the deadly accurate phrase used by London brokers last week to describe the conditions which have prevailed in the U.S. financial markets since Volcker unveiled his new "tight money" program.

The federal funds rate, the cost of overnight interbank loans, has been fluctuating wildly in the range of 6 to 18 percent on a given day—and 20 percent and higher for "lower quality" regional banks. On Oct. 23, the Fed injected reserves into the banking system when Fed funds were trading over 17 1/4 percent, indicating that the nation's money managers wanted the key short-term interest rate lower. "But no one knows what the Fed means any more when it conducts its open market operations," one government securities dealer remarked candidly.

The $3.9 billion issue of two-year notes sold by the U.S. Treasury on Oct. 23 carried a record-smashing 12 5/8 percent coupon. The average yield had been estimated at 12 1/4 to 12 1/2 percent just the day before, and the actual rate was an astonishing 2 1/2 percentage points higher than the record set on such notes three weeks earlier.

With the Treasury's borrowing costs shooting up so uncontrollably, all projections of the federal budget deficit are being discarded. "Volcker cannot deal with the fiscal chaos unleashed by his monetary policy" is the way one well-placed source described the situation. He predicted that the $33 billion projected deficit for fiscal 1980 would rise to $40 billion and probably much higher

The nation's portfolio of fixed income securities has lost upwards of 10 percent of its previous market value since Oct. 6, a much more telling indicator of the disintegration of the credit markets than the near 100 point drop of the Dow Jones industrial average since the highs of last summer. A small minority of corporations had planned equity offerings even before the new credit squeeze. However, a long list of corporations and municipalities were getting ready to enter the bond market in the hopes of shifting some of their heavy short-term borrowing to the long-term market. Prior to the Fed's moves, some $3 billion in bonds were expected for October. The actual borrowings will be at least 20 percent below that.

Total uncertainty exists about the future availability

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of long and short-term credit, and businesses are adjusting accordingly. Even before the Fed's latest tightening binge, the Conference Board had estimated that capital spending by manufacturers would drop by 8 percent or more in real terms in 1980. However, since Oct. 6, the future of capital spending looks a lot worse. In the meantime, current production schedules are being cut back. The executive of a leading truck manufacturer said that his company plans to cut back production by 15 percent in December.

Hyperinflation

Fore the moment, the principal effect of the Volcker package has been to unleash a monetary hyperinflation in the United States. Faced with the prospect of zero credit availability down the road and the liklihood of mandatory credit controls, corporations have begun a mad scramble for existing credit lines, which has been bidding interest rates up beyond all expectation. On Oct. 24 the Federal Reserve announced that business loans declined nationally in the week ending that date. However, investment bank sources closely tuned in to the conditon of corporate finances say it is premature to call this decline a trend for the reason that the corporate sector is "hooked on" short-term credit.

The liquidity problems of the corporate sector are more serious than in 1974 on the eve of the last recession, Wall Street analysts say. Whereas that time around coorporations had accumulated short-term debt to finance the build up of inventories—which were subsequently liquidated along with the debt—this time corporations have been borrowing short-term merely to cover operating expenses and to finance purchases of sorely needed capital equipment. The high interest rate regime initiated by former Fed chairman William Miller increased corporations' credit dependency by triggering the cycle of interest rates chasing inflation chasing interest rates.

This situation has prompted widespread expectations that the next phase of the "Volcker revolution" will be imposition of controls—wage-price controls, credit controls, and capital controls—of a severity that will make 1971 look like a test case.

A private seminar in Washington D.C. in mid-October attended by members of the Brookings Institution, investment bankers, and corporate leaders discussed the inevitability of the imposition to rein in the current hyperinflationary tendencies in the economy—which the group emphasized are being aggravated by Chairman Volcker's latest "tight money" gambit. According to one attendee, the consensus of the group was that the Fed's present policies will not make a dent in the record growth of credit in the economy; corporations will continue to borrow for their survival no matter how high interest rates go and, as long as they can, pass on the additional borrowing costs in the form of price increases.

The group also foresaw that to the extent that Volcker's current policies increase unemployment, they will trigger a huge rise in transfer payments for unemployment and Social Security (Volcker has already said he would like to outlaw future cost of living increases for senior citizens and unionized workers), a widening of the federal deficit, and unexpected new borrowings by the Treasury, which would have to be supplied by the Federal Reserve's printing presses. The monetization of federal debt by the Fed would in turn accelerate money supply growth and set the stage for the imposition of de jure controls on credit issuance and wages and prices.

Rudy Oswald, research director for the AFL-CIO was highly critical of the Fed's current course in an interview, but said the labor organization wants the full implementation of the Credit Control Act of 1969—a law on the books which permits the President to authorize the Fed to allocate credit as it sees fit. Oswald said he believes this will promote "equality of sacrifice."

Speaking from a different perspective, Henry Kaufman, of Salomon Brothers, the guru of the credit markets, told a seminar of the Conference Board in Frankfurt on Oct. 23 that once a recession develops, the U.S. must impose capital controls to stop the flow of dollars abroad and force a repatriation of dollars back to the U.S. Otherwise, said Kaufman, the domestic money supply will be unbearably tight, as tax cuts and other fiscal measures would be unable to quell the deflationary tendencies.

De facto controls

A system of informal controls on the issuance of credit already exists, in the view of some commercial bank economists, who cite the pressure by the Fed on the banks against raising the prime rate too fast or high on the one hand, and the sharp rise in the banks' cost of funds, on the other. The rise in the prime lending rate to 15 percent on Oct. 23 was miniscule compared to the run up in the banks' cost of funds. After adjusting for the reserves requirements, the effective cost of new three-month certificates of deposit has been between 16 and 18 percent in recent days.

According to Donald Woolley, chief economist of Bankers Trust, the Fed's "jawboning" has forced banks to reevaluate their lending policies. "Since Oct. 6 loan appraisals have taken on a new light," says Woolley. At that point senior management at the banks took a more active role in scrutinizing, making day-to-day loan decisions. Loans to long-standing business customers are being favored over mortgages, brokerage loans, consumer loans, and loans to lesser quality businesses.

—L. Schulman and D. Goldman