Domestic Credit by Richard Freeman

Volcker goes for broke

Reserves are clamped while rates skid up, licking the economy, not inflation.

Interest rates at 18.5 percent are not at their peak. They will go up further. It is now clear that at the Federal Open Market Committee meeting in November, the Fed decided to enter a new phase."

This assessment by the chief economist of T. Rowe Price investment bank, Ben Laden and other credit analysts, was confirmed by the upward leaping path of the prime lending rate.

On Oct. 1, it was 14.0 percent, and it will be 19 to 20 percent before long.

The key mover of the prime is of course Fed chairman Paul Volcker, who has put the federal funds rate up to 18 percent to make the prime leap higher.

In a speech to the Tax Foundation in New York City Dec. 3, Volcker confirmed market opinion, warning that "the likelihood of a squeeze [on credit] is apparent; we see a taste of it now."

In fact, according to Laden, Volcker's increase in federal funds rate sets off a cycle that will push the prime rate to 20 percent or higher. "The banks can't simply stop at some fixed level and say that is the peak," reported Laden, "because the momentum of the federal funds rate increase pushes them further upward."

The question then is how serious Volcker is in making the higher interest rates cut into economic activity.

After plunging the economy into steep recession with the March imposition of credit controls this year, the Fed then reversed itself—lest the recession get fully out of hand—and pumped reserves into the banking system. Between July 2 and Nov. 5, adjusted bank reserves grew at an annual rate of 11.1 percent. This kept the economy afloat, compared with what would have happened otherwise, but nothing more.

However, within the last several weeks, Volcker has combined his tight interest rates with a policy of slamming his foot on any new reserves going into the system. Since the start of October, adjusted bank reserves (essentially the reserves held at the Fed by commercial banks plus currency held by commercial banks) didn't budge. On Sept. 24 they stood at $51.3 billion, and on Nov. 12, they were $50.4 billion, according to figures supplied by the St. Louis Federal Reserve Bank.

Interest rates are already at 18.5 percent, at a time when the economy cannot sustain the impact.

The soft figures for new housing permits for October (down 4 percent) will translate into collapsed housing starts in November and a rout of the housing market starting this month and January.

The Christmas retail sales season will be decidedly off, and the retail and service sectors of the economy will undergo what happened to the industrial sectors of the economy earlier this year: a big downturn.

What is important is that Chairman Volcker plans to keep credit out of the hands of the productive sectors of the economy into the first quarter of 1981.

"Volcker is out to prove himself," stated James O'Leary, chief economist for the U.S. Trust Company. "Volcker wants to show people that he will knock inflationary expectations out of the system. Right now," O'Leary added, "consumers would borrow at high rates if they thought that inflation would continue. The credit policy will have to bite."

O'Leary also foresees Volcker's policy leading to new foreign investment into the United States, in areas like real estate.

O'Leary is not alone. Many in the U.S. investment community are now championing Volcker's supercharged interest-rate policy in the interest of fighting inflation.

The interest-rate hikes of the last six weeks should give credit-market analysts and investors alike a doubly errie sense of déjà vu, however.

Didn't Paul Volcker promise to wring out inflation in October 1979, and then again when he applied credit controls in March of this year? It didn't work then.

Will simply adding some federal budget expenditure cuts in, say, early 1981 to a tight credit policy do the trick, when twice before such a policy failed?

Not likely. Yet such sheepishness on policy matters by investors has allowed Volcker to pursue his policy. Perhaps the hoary saying of showman P. T. Barnum should be modified: "a supporter of Volcker's policy is born every minute."