Domestic Credit by Richard Freeman

Volcker's third-quarter outlook

If high rates persist, the ominous May economic figures will be an outright disaster.

As economic figures pour in from across the nation, the U.S. economy is on the threshold of a third-quarter economic crisis. Already, the damage inflicted during the second quarter is far more significant than most people realize. If the Federal Open Market Committee (FMOC) of the Federal Reserve Board, under Fed Chairman Paul Volcker's direction, opted July 6 at its monthly meeting to keep credit expensive and the federal funds rate high—as is widely expected—then the consequences will be profound and far-reaching.

The economic casualties in the second quarter were broad based, ranging from auto to construction spending to home spending, and was foreshadowed by the May performance of the index of leading economic indicators. That index fell in May by 1.8 percent from its April level, the largest monthly drop in 12 months.

U.S. construction spending in May was $237.3 billion, 4.7 percent below the previous month's level. Public construction for roads, hospitals, etc. fell by 9.9 percent for that month, and the fall in new home construction was even steeper. But, indicating the real depth of the problem, when the May total private and public construction spending figures are put in constant 1972 dollars, the level is 5 percent below the May 1980 level, itself one of the lowest levels in post-World War II history.

In the auto sector, for the last 10 day period of June, sales of domestically produced U.S. cars averaged only 5.2 million on an annual basis. This is the lowest daily auto-sales rate for any period in June in the last 23 years. For the first six months of 1981, the average selling rate of domestically produced U.S. cars was 6.6 million—which is unchanged from the dismal rate for all of 1980.

Indeed, in auto, the problems Volcker has created have been self-feeding. The U.S. automakers, strapped for cash, raised the transaction price of new cars by 13 percent this year, thus pricing themselves further out of the range of consumers.

Moreover, in May, orders for new machine tools fell to $229 million, a staggering drop of 25 percent from April, and an amazing 47 percent drop from last year's levels. Since machine tools are crucial for all capital formation, the drop in orders simply confirms what is known: high interest rates are poisoning all attempts at industrial development. Not even the Reagan tax package will induce businessmen to spend for capital goods.

As this news came in, Volcker and the FMOC met behind closed doors in Washington July 6 for its monthly meeting. Over the last month Volcker and the FMOC, which is charged with administering the monthly monetary targets on a daily basis, kept the federal funds rate in the range of 19 to 21 percent. The federal funds rate, at which banks borrow excess reserves from each other on an overnight basis, because it constitutes the lowest cost of borrowed funds for the banks, when set at the 19 to 21 percent high range enforces a prime lending rate of 20 percent and up.

If the economy is weakening, and Volcker keeps interest rates high, then the stage is set for Volcker to pound business activity into the ground as he did in March 1980.

"The big worry around here," Robert Synch, an economist of the Wall Street investment house Bear Sterns reported July 6, "is that Volcker will overkill. That is, he'll tighten too long. Volcker kept the federal funds rate at high levels all during June on the expectation that money supply would grow," Synch said. "But in fact, the money supply was negative for the month. Now, the Fed is expecting a bulge in the money supply for July, with a predicted $5 billion extra in Social Security payments. If the Fed holds tight, the economy is going to be hit bad."

The gravest danger is that Volcker will detonate one of a half-dozen danger zones strewn all across the economy.

These danger zones include the money market funds, which have resumed a growth rate of $2 billion per week (now totaling $127 billion in assets) and which contain so much unsecured bad paper that one well-connected investor told *EIR* this week, "Some smart money people I know took $300 million out of money market funds over the last two weeks and put it in Treasury bills." Other danger zones are the financial side of the overbid housing and real-estate market.

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