

Domestic Credit by David Goldman

A set-up for the President?

Appointing Preston Martin as the new Fed chairman could have unexpected and unwanted consequences.

The period of monetary calm which the Fed bought through monetary largesse following the danger period at the end of March is now officially over. The warning signs include the following.

1) A 16-point decline of the Dow Jones average May 16, supposedly motivated by:

2) the \$4.2 billion rise in money supply on May 12. This is to some extent a matter of the Fed's discretion, since the seasonal adjustment on these numbers has been questionable all along, and by:

3) Salomon Brothers partner Henry Kaufman and New York Fed Bank President Tony Solomon's statements over the weekend of May 14 that the decline in interest rates was over and increases could be expected in the near future.

All this may be trivial relative to the threat of Brazilian default, but it is possible that an unpleasant charade will dominate the markets in the next three to four weeks, while the Brazilian business is temporarily pushed aside.

The Business Council meeting over the weekend also marked a turning point, of sorts. The Council announced that the recovery would abort sometime next year if the President did not reduce the budget deficit. This reached some extremes of absurdity, for example, the statement of Chrysler's Chief Executive Officer Greenwald that the auto recovery would not last unless the President reduced the deficit, e.g., by a gasoline tax!

What is ironic about this is that the

sudden loss of confidence came immediately after the announcement of a 2.1 percent April rise in industrial production.

According to sources close to Bank of England top management, the point is to force a major, if not decisive, White House concession on the budget, e.g., reduction of the tax cut to half its present \$30 billion level. "For the last several weeks, everyone has been optimistic, and all the news that has come out has been interpreted in this light. Now everyone will be pessimistic, and everything that comes out will be reported in that light," one source says.

According to the Bank of England circuit, the probable appointment of Californian Preston Martin to replace Volcker will be a trigger for a crisis, at least one sufficient "to force a trade-off on the budget to protect the administration's beloved recovery," with about a four-week time span. This will be preceded by some weeks of choppy stock and bond markets. Martin, according to our best available information, is in the Volcker camp, well-liked by the Fed staff, "but what they are saying about him here and in the European markets is virtually slanderous. He is seen as a lunatic Californian." This might make some trouble for the dollar at the same time that other markets were already in hot water.

The appointment of the next Federal Reserve chairman presents the sort of trap that President Reagan is not well-equipped to avoid. For various good and bad reasons, Paul Volcker is anathema to the White House.

The good reasons have to do with Volcker's semi-covert collaboration with such opponents of the President's defense budget as House Banking Committee Chairman Fernand St. Germain, not to mention the Managing Director of the International Monetary Fund, Jacques de Larosière. In the White House, Volcker is accurately perceived not merely as a major nuisance to the economy, but as a political conspirator against the Reagan administration's most fundamental objectives.

The bad reason is that President Reagan still listens closely to monetarists like Milton Friedman. Friedman et al. have argued that the horrible episode with 20 percent interest rates had nothing to do with monetary restraint as such—on which they and Volcker agree—but with the uncertainty produced by Volcker's supposedly inadequate methods of monetary management.

How the Federal Reserve's technical basis of monetary management is supposed to function while the U.S. balance of payments shows (for 1982) \$42 billion of "errors and omissions," i.e., transfers between the Eurodollar market and the domestic banking system, Friedman and his friends cannot explain. However, there is at least some sympathy at the Oval Office in the notion that the whole job might have been done better.

Since the President plainly wants Volcker to leave, the problem of succession becomes a potential trap. Preston Martin was Reagan's savings and loan commissioner during the latter's governorship in California. Less than a Reagan team player, Martin profiles as a West Coast edition of Volcker. The irony is that the President may pay twice for having appointed him, on the issues of policy and of "credibility."