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Domestic Credit by Richard Freeman

Just around the corner?

Volcker's puff-up in bank reserves does not mean a recovery is in the making. The essential economic signals are red.

The announcement by the Commerce Department Aug. 31 that the index of leading economic indicators rose by 1.3 percent in July—its fourth monthly increase—and that new factory orders for manufactured goods rose 2 percent in July would normally be taken as a small but positive sign.

However, even with the recent—and perhaps temporary—steep fall in interest rates that saw the three-month Treasury bill rate come down from 12.81 percent for the week ending July 2 to 7.42 percent for the week ending Aug. 27, a stupendous fall of 540 basis points, there is no indication that the U.S. economy is in a position to "recover."

It is important here to define what constitutes a "recovery." From July 1981 until July 1982, industrial production in the U.S. fell by a staggering 10.3 percent. The production of business equipment has fallen by 17.7 percent in that period. Construction-supplies production has fallen by 16.0 percent. Steel, auto, and housing production are down by 30 to 40 percent from the levels of three to four years ago. In short, the United States is in a depression.

Therefore, were the industrial output index of the Federal Reserve to blip upward by 7 or 8 points, that hardly constitutes a "recovery," because that would mean that the U.S. hadn't even reached the levels of output of July 1981, which were below the levels of late 1979.

Moreover, consider the following developments:

- For the week ending Aug. 22, the number of business failures soared to 572, the highest level, reports Dun & Bradstreet, which keeps the figures, in fifty years.
- U.S. import levels have been plummeting, to a level of $20.45 billion in July—down 8.1 percent from the month before—not because oil imports are falling (they rose 8.4 percent in July) but because imports of industrial goods, ranging from telecommunications equipment and steel to aerospace and electronics equipment, have collapsed.
- Sales of single-family homes fell 4.9 percent in July from June levels, to 353,000 sales, the Commerce Department announced Aug. 30. This is the third lowest rate in two decades.
- Orders for machine tools fell to $107.5 million in July, down 14 percent from the month before and 44 percent from July 1981.

Then there is the question of what effect Reagan's tax policy will have. Maury Harris, economist at Paine Webber, has pointed out that the President's 10 percent personal tax cut, which took effect in July, helped swell personal after-tax income in July by 2.1 percent, which is more than double the normal increases of *pre-tax* income for that month, and therefore is a large amount. Yet auto and home sales did not improve, and these are the items which would have to increase were there to be a consumer-led recovery (the idea of an Atari games-led recovery being unworkable). The plunging level of machine-tool orders and business equipment output confirm that there sure as hell is not a capital-goods-led recovery.

Therefore, the Reagan administration has to lay particular stress on the fact that interest rates have come down. But within the last week of August, short-term rates started back up. With the Consumer Price Index increasing in the second quarter at a 9.3 percent annualized rate, it is possible that Fed chairman Volcker may once again begin raising interest rates to "quell resurgent inflation."

It must be recognized that the lowering of interest rates since late June, and the accompanying stupendous increase in bank reserves were not based on Volcker's desire to promote a recovery—although President Reagan may have asked Volcker to lower rates for this reason. Over the month ending Aug. 11, reserves into the banking system increased at a torrid 23.6 percent annualized rate, yet precisely at the point corporate borrowing fell off flatly to a zero growth rate.

Why precisely did Volcker pump in the reserves? He pumped in reserves as a mechanism to lower interest rates and to bail out a failing banking system. As a result the banks are raking in quick profits, needed as a quick-fix infusion, in the form of the spread between the cost of federal funds and the discount rate of roughly 10 percent—the cost at which banks borrow funds—and the prime lending rate of 13.5 percent, or the level at which banks earn on lending this borrowed money. The spread is 3.5 percent, and allows the banks to temporarily reliquefy their balance sheets.

Once this interval of bank reliquefaction is over, or perhaps because the condition of the banks and the U.S. dollar weakens as Third World governments default on their dollar-denominated external debt, Volcker may thrust interest rates back up above their still murderously high levels.

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