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Fed Interest Rate Hike Plays Into London's Hands

The U.S. Federal Reserve Board's Jan. 6 decision to hike its discount rate, which was subsequently followed up by other credit-tightening moves, has kicked-off a deflationary unraveling of the nation's credit markets and productive economy. Although Fed spokesmen justified the new tight-money policy as necessary to help stabilize the beleaguered dollar — since higher interest rates will ostensibly attract more investment funds into dollar-denominated securities — the Fed is not-too-smartly playing into the hands of London merchant bankers who are poised and ready to buy up the U.S. economy at bargain-basement prices once the markets hit bottom (see *International Report*).

BUSINESS OUTLOOK

Blame for the discount rate hike has generally been laid at outgoing Fed chief Arthur Burns's door, but the Jan. 10 issue of the Paris daily *Le Matin* reported that in fact Treasury Secretary Blumenthal made the decision. With Carter's appointment of G.W. Miller as Burns's replacement, the Blumenthal faction of the Administration — itself allied with London — moved to subject the conservative Federal Reserve Board to its control — and, according to *Le Matin,* the rate hike was effectively the first act of the "Miller Fed."

The first business day after the Fed's announcement, the *Wall Street Journal,* which curiously enough, has recently been lending its voice for the "British" view, called on the Fed and Administration to stop printing dollars as the best way to defend the endangered currency. The coupon-clippers at the *Journal* argued that if money supply growth and inflation were curbed by a tight-fisted Fed, the U.S. trade deficit would be offset by increased foreign investment in high-yielding dollar-denominated bonds, "our chief export."

The disastrous implications of the Fed's policy turn — the collapse of the fragile U.S. industrial base — were not lost on the New York stock market, however. During the first seven trading days of the new year, the Dow Jones industrial average plunged over 54 points to 775.90, due to the dollar instability and interest rate developments. Following the rise in the discount rate, the rate at which banks borrow from the Fed, commercial banks were forced to jack up their own prime lending rates from 7-3/4 to 8 percent. Moreover, the Fed continued this week to drain reserves from the banking system, pushing up the bellwether short-term Fed Funds from 6-½ to 6-11/16 percent. This rattled the bond market, causing a sharp fall in government and corporate bond prices.

Government Refinancing Crunch

The *Wall Street Journal* itself hinted at the actual depth of the credit crisis in a Jan. 11 column, quoting from money market analysts Alan Lerner of Bankers Trust and David Jones of Aubrey Langston. These experts say that, because the Fed and Treasury will be intervening heavily in support of the dollar in the coming months, foreign central banks will no longer have to accumulate large reserves of dollars and therefore will no longer be purchasing U.S. Treasury securities. Last year, foreign investors, largely central banks, purchased a whopping $31 billion marketable U.S. Treasury issues. With the foreign central banks now out of the picture, the Treasury will have to depend on private investors to finance its burgeoning deficit, and will have to pay higher rates so as to draw funds away from presently more-attractive private securities. According to Salomon Brothers general partner Henry Kaufman, the combined Treasury and Federal credit agency borrowings will reach an estimated $84.2 billion in 1978, "almost as big as the record Federal borrowing of $87.8 billion in 1975."

The effect of this immense Federal borrowing operation and the tightened credit conditions will be to squeeze private industry out of capital market, and make new spending on plant and equipment unprofitable. Savings institutions will suffer loss of deposits as funds are drained away into higher-yielding government paper, leaving little for investment in new housing construction. Even *before* the dollar intervention policy and discount rate hike were announced, Kaufman had written in a feature for the *Money Manager:* "In 1978, the American Credit Markets will face their most difficult challenge since the current economic expansion began in early 1975."

Crocodile Tears

The flip-side of the *Wall Street Journal* tight-money line appeared in the *New York Times,* whose Jan. 11 editorial "Bringing the Dollar War Home" self-righteously inveighed against the Fed's placing "a higher priority on exchange rates than on domestic economic recovery." The Fed's "regrettable," but "understandable," approach might be mitigated, the *Times* suggests, by imposing energy conservation at home and by forcing the West German government to reflate its economy.

Similarly, the Jan. 7 London *Economist* was gleeful over the American "conundrum" of a tight-money, economy-wrecking "defense" of the dollar versus "full-employment" and "Argentina-style" hyper-inflation and currency depreciation — as if the proproduction, gold-backed monetary system alternative did not exist.

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