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DOMESTIC CREDIT MARKETS

IMF fuels high-interest rates in the United States

The current official unemployment rate in the United States, 5.7 percent, "corresponds to full employment," according to a confidential staff report prepared by the International Monetary Fund for its Interim Committee in early March. The report also claimed that the gap between actual and potential output of the U.S. economy was "virtually nonexistent" in the second half of 1978. In other words, the report intimates that the U.S. economy is now effectively facing the limits of full productive capacity and any further expansion of output will be wildly inflationary.

The IMF report which was leaked by the *New York Times* March 13 amid the growing atmosphere of Peanutgate, urged the Carter Administration in threatening tones to adopt tighter monetary and more stringent fiscal policies.

It is becoming apparent even to the foggiest economic observers, however, that Federal Reserve Chairman Miller's high interest policy has thus far only fueled U.S. inflation by prohibiting long-term capital investment and increasingly shifting credit demand to the short-term side of the market.

The Mexican solution

In recent weeks, both French President Giscard d'Estaing and a leading Mexican official have directly challenged the specious Philips Curve reasoning behind the IMF's dictates. The Philips curve maintains that rising employment and growth inevitably entail inflation. "To fight inflation, there is no way other than to increase production and productivity," Mexican Minister of Industry and Natural Resources Jóse Andres de Oteyza said in his presentation of Mexico's ten-year industrial development plan March 12. "We are fooling ourselves by thinking that we can solve inflation by increasing unemployment."

The best cure for the current double digit inflation in the U.S. argue those who accept the two leaders' reasoning, would be a large dose of low interest credit invested in capital-intensive production — following the "Mexican model."

It is the price and use of credit in any economy which make the difference between an inflationary bubble and noninflationary growth. Historically, high interest rates have been the principal engine of inflation in the U.S. economy over the last few years, not "overexpansion." Long-term rates have remained at the 8-percent-and-above level for AAA-rated corporate bonds since the 1974-75 recession. That condition hardly encourages the type of long-term, deflationary investments hailed by Minister Oteyza. Fed Chairman Miller's high-interest-rate "anti-inflation" policy has aggravated the condition of chronic inflation by sucking liquidity into short-term high-yield investments, thus fueling a spiral of short-term rates and further undermining productivity-increasing new capital formation.

The recently released Federal Reserve flow of funds data for 1978 indicates how this process has worked. The nonfinancial sector rushed to borrow a record amount of $285.2 billion in 1978, compared with $245.6 billion in 1977, before interest rates went even higher. Miller's monetary policy, which pushed up the prime rate for its 1977 average of 6.83 percent to 11.25-11.5 percent by the end of 1978, resulted in sharply higher financing costs on this record amount of new credit. These financing costs were then passed on in price increases that fueled the inflation rate.

Furthermore, the high interest rate environment left corporate treasurers no choice but to play the arbitrage game, and shift the funds under their management to different currencies and money market instruments in search of yields at least as high as the prevailing rate of interest. Given the resulting dearth of real capital formation in the U.S. economy, capacity utilization now reaches the 85 percent mark, and costly bottlenecks and breakdowns are inevitable. These are symptoms of *underinvestment*, however — not signs that the U.S. economy has overexpanded, as the IMF says.

In an interview with this news service, George McKinney of Irving Trust described the cycle of rising interest rates and inflation and weakening corporate liquidity which is now in full swing. Since the mid-1960s, corporate borrowers have avoided getting locked into high, long-term interest rates, and lenders have been unwilling to lend long-term at the low rates corporations were seeking. The result has been a shortening of the typical debt maturity and increasing pressure on short-term rates.

At this point in the current business expansion, said McKinney, we are witnessing an accelerating decline in corporate liquidity because of the mounting short-term indebtedness of the corporate sector. McKinney added that he would be very surprised if short-term rates had peaked for the present.

-Lydia Schulman

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