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U.S. Economy

A deeper credit crunch proposed

by Richard Freeman

New York Federal Reserve Bank President Anthony Solomon called March 26 for a monetary policy that would produce an immediate blowout of the nation's credit markets. Endorsing a plan proposed by arch-monetarist Friedrich von Hayek, Solomon demanded cessation of all new credit creation by the Federal Reserve. If Fed Chairman Paul Volcker were to adopt such a policy, it would mean a 1929-style financial crisis in a matter of months—a precondition for the U.S. to emerge subordinate in the Eurodollar markets, eliminating the stable credit relations once enjoyed by U.S. industry.

A tipoff that monetary officials were looking toward a monetary crunch appeared several weeks ago, when OMB Director David Stockman told a background briefing of bank officers that "there may be a contraction of funds in savings and loans and second-level insurance companies that would make the 1930s look like a picnic."

This crunch perspective was given momentum with Solomon's March 26 speech before the annual banking symposium of the Financial Analysts Federation in New York. The New York Fed chief stated that simple reliance on monetary aggregates was insufficient; instead, there would have to be more budget cutting and a change in the Fed's policy of "procedures for setting the discount rate." This proposal amounts to the plan first enunciated 50 years ago by von Hayek for a "positive discount rate": the rate at which the Fed lends reserves to banks would be pegged 1 to 3 percentage points above the going money market rates. Banks would be unable to get funds from the Fed as lender of last resort, except at a sharp interest differential loss, which invalidates the very idea of a lender of last resort.

Solomon's radical fringe proposal was given some plausibility by the fact that Fed Chairman Paul Volcker tightened interest rates as fed funds moved to the 14.5 percent range from the 13.0 to 13.5 percent range they had hovered at for the previous two weeks. An argument to justify an emergency application of the Solomon plan, or at least a further tightening by Volcker, appeared in the March 23 *Financial Digest* of Manufacturers Hanover Trust, which posed the grounds for a tightened money supply: the imposition of reserve requirements on money market funds, now counted as part of M2-B.

> Since many people use these funds as checking accounts, it seems reasonable to assume that lower yields and/or no checking privileges might cause some funds to be shifted back into interest-bearing checking accounts (M1-B). A shift of only 25 percent would push its year-to-date annual growth rate to 8 percent, while a shift of one-third of such assets (about $35 billion) would push M1-B growth well above its upper target boundary. When considering that the money funds have grown by $30 billion since the beginning of the year, such shifts are not inconceivable. In this event, the Federal Reserve will have to decide whether a tightening of monetary policy will be called for.

Brave new credit markets

A crunch will simply accelerate tendencies that have surfaced in the U.S. economy since Paul Volcker's super-high interest-rate policy made money market funds and their volatility in the credit markets a going venture.

The growth of the money market funds is represented by the fact that $35 billion has been poured into the money market funds since the beginning of 1981, leaping to $109 billion total, with a growth rate of $3 billion per week over the last month. When Volcker took office in August 1979, money market funds were only $32 billion. The money market funds have been drawing savings deposits out of savings and loan associations and savings banks, bringing the thrift institutions to the threshold of bankruptcy and magnifying the potential for a money market blowout. They are also skewing the U.S. markets toward increased interest-rate volatility. The funds determine daily yields on whatever short-term instruments they can accumulate into their funds.

The Depository Institutions Deregulation Committee (DIDC), set up by the Henry Reuss-sponsored Depository Institutions Deregulation and Monetary Control Act of 1980, ruled last week that interest-rate ceilings will be lifted on commercial bank deposits, meaning volatile short-term rates and probably an eventual transition to granting commercial banks the right to issue money market-type instruments.

On top of this, various agencies such
National Mortgage Association (Fannie Mae) are proposing to create mortgage-backed securities to be sold on the Eurodollar market. According to the spokesman for the largest U.S. private home mortgage insurer, Mutual Government Insurance Corporation (MGIC), "We will see the largest pool of money in the world, the Eurodollar market, putting money into U.S. housing mortgages. But that means the mortgages will have to pay comparable rates of interest to going Eurodollar rates."

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