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CAN AND SHOULD FED "GO IT ALONE"?

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ST. LOUIS — The unprecedented, spectacular increase in both short and long-term interest rates since the end of February forces us to ask whether another money crunch is here.

Are the money and financial markets now at the threshold of those disorganized and chaotic conditions that characterizes a financial panic? When interest rates were last at their current levels, economic activity was very strong. The only really strong thing about the economy now is the two-digit inflation rate.

The current explosion of interest rates may well be a reflection of the underlying weakness of the financial structure, not of the strength of the economy.

Near Panic

Only a Pollyanna would argue that a financial panic cannot now occur. Twice in the past eight years — in 1966 and in 1970 — the United States experienced near panics, and the financial structure of the economy is substantially more fragile, more ripe for a crisis, now than it was even a short four years ago.

The first near panic of the post World War II era occurred in 1966 and financial weakness centered around the Savings and Loan Associations and the effort by the commercial banks to acquire reserves by selling positions in municipal bonds. The second occurred in 1970 when the failure of the Penn Central triggered a run on the commercial paper to refinance their debt by borrowing from banks. Both near panics followed soon after the Federal Reserve entered upon an effort to fight inflation by slowing the rate of increase of the money supply.

Fed Reacts Promptly

On both occasions, the Federal Reserve System reacted promptly to abort the developing financial crisis. In both

1966 and 1970, the Federal Reserve System's reaction took the form of opening the discount windows to member banks. This, in effect, expanded the available supply of reserve money to commercial banks. In the 1966 episode, this meant that banks no longer would need to try to sell municipal securities in order to fulfill their commitments. In the 1970 episode, opening the discount window meant that

commercial banks were in a position to supply bank credit to those organizations whose ability to fulfill their obligation was being threatened by the run off of their commercial paper.

In these prior mini-panics, the resolution of the crisis situation involved not only an immediate increase in the availability of reserves but

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also a subsequent period of rapid growth of bank reserves, money supply and bank credit.

The 1966 credit crunch and the 1970 liquidity squeeze led to only slight pauses in economic activity which were quickly followed by a resumption of expansion and inflationary pressures. It may well be true that in a fragile financial environment such as now rules the Federal Reserve, if it truly acts as a lender of last resort and protects the economy from the depressing repercussions of a financial crisis, is incapable of acting as a meaningful brake on inflation.

Starting in late February signals have been emanating from the Federal Reserve, and most particularly from Chairman Burns, that they are determined to fight inflation by permitting "only a moderate growth of money and credit."

One can well understand the Federal Reserve's views: In the current climate of economic policy, if a serious effort is going to be made to fight inflation, it will have to be made by the Federal Reserve System.

Economic Report

It is evident from the Economic Report of the President and the Budget for 1975 that the Nixon Administration has virtually given up in the fight for price stability. Economic controls by the Nixon Administration have been an exercise in futility. They have been more of a device for administering inflation than for controlling inflation.

In truth, the Federal budget is substantially more inflationary than the administration's interpretation allows. The automatic escalator clauses in government salaries, Social Security, and veterans pension payments attenuates if it does not eliminate the constraining influence of the budget upon inflation.

With an inflationary budget and the imminent end of controls, the Federal Reserve may well feel an obligation to try to do the entire job of fighting inflation on its own.

However, the repercussions of the Federal Reserve trying to do the entire anti-inflationary job in the situation now ruling can be serious. There is ample evidence that liquidity and cash flow problems are besetting many organizations. The New York Times of Saturday, April 6, reported that the Consolidated Edison Co. of New York has severe cash problems and that management made a presentation to the governor of New York that it will require "hundreds of millions of dollars in state assistance within the next year to remain solvent."

Tip of the Iceberg

The disruption of the long-term security markets in the first week of April, as signaled by the rapid rise in interest rates, indicates that Consolidated Edison's cash problems may be but the tip of an iceberg. Utilities that are engaged in investment programs initially borrow short term and then fund their short term debt by issuing long term debt. If the rising long-term rates lead to a reluctance by underwriters to take on new issues, such refunding will be either not available or very expensive. Thus, the dependence of utilities on short term and especially bank financing might very well increase even as the Federal Reserve tries to constrain the amount of bank financing that is available.

A similar increased depend-

ence upon bank financing by REIT's is apparent. Evidence is readily available that some REIT's are now finding it more difficult to sell their commercial paper. An inability to market commercial paper forces REIT's into borrowing more heavily from banks.

However, banks expect the lines of credit they extend to be open a good part of the time. As a result, REIT's may be very well forced to sell assets out of their portfolios in order to free bank lines of credit.

Any divestiture of a portion of the portfolio, by the very nature of the refinancing deal involved, will tend to lower the prices of the assets owned by the REIT's and lead to some deterioration in the average quality of the residual assets in REIT portfolios.

Consumer Credit Houses

Consumer credit houses are dependent upon banks, the commercial paper market, and the bond market for their financing. Some evidence is developing that these houses are trying to protect themselves against possible liquidity problems by stretching the average maturity of their commercial paper debts.

It is evident that cash flow problems are affecting both ordinary business and financial organizations. Any deficiency of cash receipts from product, factor, or financial markets will have to be made up by bank loans if other, fringe, banking markets, such as the commercial paper market, are under pressure.

The \$736 million rise in commercial and industrial loans in the statement week ending April 3 is second only to the rise of \$733 million in the week ending June 17, 1970 — which was the time of the Penn Central related crisis.

The rise in loans may well signal a rather massive refi-

nancing of extra bank debts through banks, rather than an accelerated recovery. This may explain the recent large increases in loan demand at banks.

It is quite clear that to the extent that financial instability is a real possibility and the Federal Reserve is determined to avoid a financial crisis, the power of monetary policy as an anti-inflationary weapon is limited.

In the broader context of a world in which the Federal Reserve has support as well as control functions, the Federal Reserve finds that it can fulfill only one but not both of these responsibilities when the issue is to constrain inflation within a fragile financial structure. The Federal Reserve — and the country — may be in a serious policy dilemma. The policy choice may be between two-digit accelerating inflation and two-digit and prolonged unemployment rates.

Friedman Statement

Professor Milton Friedman, the Mahatma of monetarist economists, in the March 1974 "Review of the St. Louis Federal Reserve Bank", writes that "there is literally no way to end an inflation that will not involve a temporary, though perhaps fairly protracted, period of low economic growth and relatively high unemployment."

The above statement has to be amended to recognize that the ending of inflation by constraining monetary growth involves substantial risks of financial disturbances. Then if these financial disturbances ~~are quickly abated after a~~ pause, inflation will proceed apace. On the other hand, if these financial disturbances are allowed to run at least a partial course, the ensuing slowdown will have all of the attributes of a depression.

Effective System

If our current inflationary situation is to be resolved without running strong risks of serious financial market dislocations and a subsequent deep depression, it may be necessary to construct an effective system of controls and to eliminate the strong inflationary bias introduced into the budget over the past decade. The underlying analysis for public policy prescriptions will need to be deeper than the simplistic monetary analysis which today receives a "hard sell."

In particular we will have to recognize that the emphasis upon growth and investment, the contract system of government spending, and the attempt by Social Security and other transfer schemes to shift greater portions of income to the inactive portion of the population are, in and of themselves, inflationary.

In many ways the Federal Reserve has become a favorite whipping boy for inflation. But the truth may well be that the Federal Reserve is really operating in a situation in which it will be damned if it does and damned if it doesn't.