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Stock Market Rise Blinds Commercial Banks

The euphoric, 12-point rise of the New York stock market on May 11 after the Federal Reserve raised the discount rate another notch to 7 percent can only be described as foolhardy. The intention of Federal Reserve Chairman G. William Miller is to bring on an early recession in the U.S. economy, not fight inflation.

BUSINESS OUTLOOK

This reality has already begun to dawn on credit-dependent small and medium-sized businesses in the regions and the regional bankers who serve them. For the moment, the money center commercial banks are blinded to the inevitable impact of steadily increasing interest rates on production and investment by the illusory short-term profits accruing to them from the spread between the discount rate — even at 7 percent — and the now general 8.25 percent prime rate.

The steady rise in interest rates since Miller took over at the Fed this April and began "out Burns-ing Burns," in fact, has significantly raised financing costs throughout the economy, thus fueling inflation in the immediate term and blowing up the bubble that is to be burst. So much for Miller's homilies about fighting inflation.

Thanks to Miller's deliberate monetary manipulations, the Federal funds rate, the key interbank rate which determines all short-term interest rates, averaged 7.32 percent in the week ended May 10. The news that M-1 (demand deposits and currency in circulation) had jumped $4 billion in the week ended May 3 — pushing to a 14 percent annual rate the growth of M-1 over the latest eight-week period — confirmed many analysts in their belief that the Fed now "has grounds" for raising the Fed funds rate further to 7.5 percent.

In a "concession" to savings banks, which are worried that money will now bypass them for high-yielding Treasury securities, Miller and the nation's other banking de-regulators have offered savings and commercial banks two new six-month and eight-year savings certificates pegged to the Treasury bill rate to halt disintermediation. However, this offer drew an appropriately skeptical response from Saul B. Klaman, president of the National Association of Mutual Savings Banks, who pointed out that the certificates would mainly encourage depositors to switch funds out of regular savings accounts into the higher yielding certificates — thus feeding the overall rise in the interest rate structure. Klaman said the principal effect of the certificates would be to raise savings banks' cost of money, forcing them to pass on their own costs in higher mortgage rates.

The average effective rate on conventional mortgages rose to 9.30 percent in April, the highest level since January 1975 — while the average price of a new home rose to $61,600, from $53,400 in April 1977. Large savings and loan institutions were forced to increase mortgage rates to 10 percent in the first week in May, after Miller hiked the Fed funds rate target to 7 percent moments before the Treasury's May financing.

Crisis of Profitability

Ironically, the objective economic basis for the steady rise in interest rates and thus the misguided euphoria on the stock market is the crisis of profitability which has hit the U.S. corporate sector. Beginning in the fourth quarter of last year so-called operating profits — that is, profits adjusted to exclude illusory profits stemming from the revaluation of inventories due to price increases and to take into account underdepreciation — began seriously eroding. Lacy Hunt of Fidelity Bank of Philadelphia estimates that operating profits totalled $55.9 billion in the first quarter, down from $71.5 billion in the fourth quarter. These figures differ sharply from the generally accepted estimate that after tax corporate profits were running at a $101 billion annual rate in the fourth quarter.

This devastating erosion of real profits — which is expected to worsen, not improve in the second half of the year — means that corporations' internally generated funds are falling very far short of their requirements for funds — funds needed merely for financing receivables and moderate inventory accumulation and embarassingly low levels of capital spending — merely for the replacement of worn out equipment, pollution control devices, etc., not plant expansion.

Thus, in the first quarter of the year, short-term credit demand from corporations (commercial and industrial loans and industrial commercial paper) advanced at a 12.1 percent annual rate, compared with a 10.9 percent increase in 1977. Lacy Hunt estimates that corporate cash requirements in 1978 could total over $59 billion — compared with $34.7 billion in 1977, $21.5 billion in 1976, and $7.2 billion in 1975. David Jones of Aubrey G. Lanston reports that whereas a great deal of liquidity was concentrated in the hands of large corporations until very recently, now even they are beginning to feel the crunch and are turning to the credit markets for cash. He estimates that short-term borrowing by corporations will expand by 18 percent this year, compared with half that

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in 1977.

The profitability of U.S. industry has been wiped out by inflation, which presents itself to the individual corporation as the steadily rising cost of replacing inventories and plant and equipment used up in a given quarter. U.S. businessmen are acutely aware of how inflation cuts into their profit margins, but the primary source of this inflation is usually misidentified.

Anyone who still thinks that wages are the main problem and that an incomes policy or good old fiscal conservative wage austerity is the solution should consider the following. In

present the Japanese economy showed the highest rate of increase of productivity and the sharpest decline of unit labor costs, even though wage increases were the highest of any country. The Japanese success story was due to the fact that the ratio of fixed investment to GNP (excluding residential construction) was upwards of 30 percent during the period — by far the highest of any country. In the U.S. by contrast, which was only surpassed by Great Britain in its record of eroding productivity and rising unit labor costs, the ratio was half that.

The fundamental source of inflation in the U.S. economy today is chronic underinvestment in productivity-improving plant and equipment and new technology, combined with Fed Chairman Miller's malicious high interest rate policy. The corporate sector as a whole is feeling acutely the effects of eroding productivity — due to the dilapidated condition of plant and equipment, rigged price increases of selected materials like steel, and ever-rising financing costs. Miller's "solution" to inflation will not only raise those financing costs further, but will further suck funds out of productive investment, that would actually begin to reverse the inflation problem, into inflation-producing speculative investments.

— Lydia Dittler

Accounting-Pad Folly — Ottawa Borrowings, Bundesbank Statements

As economic-development agreements begin to draw much of the world into a 21st century defined by the politics of peaceful high-technology proliferation, certain central bankers are still operating according to the synthetic 19th-century British categories of balance-of-payments equilibrium and interest-rate manipulations.

FOREIGN EXCHANGE

The two most recent cases in point are the mammoth Canadian state borrowings to stabilize the Dominion's dollar and the May 10 pronouncement by Otmar Emminger, president of the West German central bank, the Bundesbank, that the way to stabilize the American dollar is to further widen the gap between low West German interest rates and high U.S. ones in order to draw footloose funds into dollar holdings. While less-developed countries are breaking out of the International Monetary Fund's boxes and moving — with Western European governments' backing — toward economic growth on the basis of a net expansion in global investment and trade, the Anglophiles in Ottawa and Frankfurt openly proclaim that their currency and interest-rate gimmicks would produce no material national benefits, and these nonbenefits will accrue at the expense of other national sectors.

The upshot is a competition for funds between speculative refinancing operations and a sufficiency of productive trade credits: both cannot prevail.

The Canadian Sinkhole

For three months, as the Canadian dollar reached the 86-cent level in mid-April, Canadian monetary authorities have been piling up credit lines for fresh reserves to be used in currency-market interventions — totaling the biggest privately managed sum on record. On top of a $1.35 billion (U.S.) drawing on a $2.5 billion kitty assembled by Canadian banks, a $750 million (U.S.) bond, an $820 million (Canadian) Eurodeutschemark credit, and $2.2 billion in domestic cash-raisings in the first quarter of this year, there now exists a new $3 billion credit line, which has not yet been utilized. This loan was put together by Citibank and other New York commercial-bank managers; the Toronto *Globe and Mail* chuckled May 5 that they were glad to get the $2 million commission. These borrowings have multiple effects, one being the Canadian central bank's ability to dump large piles of dollars into the market as it intervenes; traders cited these interventions as the chief reason for the U.S. dollar's May 4 weakness, for example. The domestic borrowings are absorbing as much as 45 percent of total credit flows, crimping the productive areas of the economy, while the New Democratic Party calls for capital controls against investment outflows and penalties against U.S.-controlled corporations.

Most of all, the borrowings implement the overwhelmingly tried-and-failed notion that sheer adjustments of reserve positions and payments accounts have anything to do with the health and future prospects of an economy. The vast amounts of pre-Citibank borrowings failed to help the Canadian dollar at all. And insiders attribute its current moderate $.89-level strengthening to the possibility of the Trudeau "small is beautiful" government's replacement by an ostensibly more probusiness regime.

Even the dullest-witted Canadian subjects are not pointing to the silver lining of cheaper exports, since more expensive imports have more than offset this benefit — which, as not-too-distant British experience