

## Treasury spokesman out-Feds the Fed

by David Goldman

Treasury Department Undersecretary for Monetary Affairs Beryl Sprinkel, the administration's senior monetary policy official, dropped a bombshell during his first major public appearance April 8, in testimony before the Joint Economic Committee. For the first time, an administration official urged the Federal Reserve to adopt a *floating discount rate* as a principal instrument of monetary control. A week previously New York Federal Reserve President Anthony Solomon made the same proposal, to the immediate consternation of European leaders. The administration endorsement is ominous.

Initially raised by Heritage Foundation board member Lewis Lehrman, a member of the supply-side mafia, the proposal says that the Fed should not create any new money *except* through the discount window, and then only at a penalty interest rate of 2 to 3 percent above market rates. Fed chairman Paul Volcker, no monetary dove, attacked the plan in January congressional testimony on the grounds that it would push interest rates up "like a dog chasing its tail." In other words, if banks can only borrow money by borrowing at a higher interest rate, every increase in credit demand automatically translates into higher interest rates. The present discount rate acts to a limited extent as a stabilizing factor in interest-rate movements, although it permits large banks to obtain relatively low-cost money for relending whenever market rates rise significantly above the discount rate.

The "floating discount rate" plan is, in effect, a prescription for zero growth of credit. It appears at a moment when the Federal Reserve has taken the tough-

est line on the interest-rate issue since October 1979, when Volcker first started the monetary process that led to the present depression. The release last week of the February minutes of the Federal Open Market Committee proposing a 15 to 20 percent trading range for federal funds, after this key interbank lending rate had already fallen to about 13 percent, produced an immediate panic on the bond markets. Although no major bank has moved the prime rate yet, it has become clear to market participants—as we emphasized last week—that long-term interest rates *will not fall* in the course of the present renewed economic downturn.

Otherwise, Sprinkel said that he and others in the administration "back the Federal Reserve to the hilt in its efforts to control money supply," and that "we will squeeze, squeeze, and squeeze again" to get money supply under control.

### End of the phony debate

Exorbitant amounts of financial press column space have been devoted this year to a debate between Friedmanite monetarists (including Beryl Sprinkel), the supply-siders (who support the Lehrman approach), and the "Federal Reserve pragmatists." The first two criticize the Fed for the past year's wild swings in money supply, but the supply-siders argue that Friedman-style conventional methods of monetary control don't work as well as the more drastic formulation they propose to introduce.

In fact, there was never much disagreement. Milton



*Now that Volcker has wiped out mortgage demand and other consumer credit, the Treasury proposes an even wilder regime.*

Friedman endorsed the "floating discount rate" plan in January. The *Wall Street Journal* attacked Friedman for arguing that the Fed should have created more money supply after its growth rate went negative in the second quarter of 1980, leading to (in Friedman's words) "a more severe recession than we need have suffered." Friedman wrote to the *Journal* that he was only concerned about "an inflationary overreaction in an attempt to counter the recession—leading to yet another inflationary surge."

The great reconciliation occurred when Sprinkel publicly embraced the Lehrman plan, putting the administration and Federal Reserve jointly on course for the most brutal credit crunch possible. Belatedly, the commercial banks are publishing rationalizations, e.g., this from Manufacturers Hanover on April 6:

"The sagging of mortgage credit demands has, in turn, heightened speculation that the financial markets may be better able to accommodate this year's massive federal government borrowing requirements, without significant upward pressure on interest rates. The facts, however, indicate otherwise. . . . If current trends persist, the red ink total in the current fiscal year could reach almost \$87 billion, just about equal to the total deficit of the two preceding fiscal years combined. . . . As a result, slack in the mortgage market will be offset by a rising tide of federal debt, still ensuring that a renewed interest rate upturn later this year remains a distinct possibility."

However, the only reason that the deficit looms so

large is that the combined lost tax revenue and additional interest and transfer payments *resulting from* the Volcker interest rate policy cost about \$35 billion a year. The deficit is the result, not the instigator, of the Federal Reserve's policy profile.

What is most dangerous in the present context is the instability of the administration itself. Before the assassination attempt against President Reagan, he and close associates in the cabinet were discussing how to best get rid of the Fed chairman, noting that Volcker had pretty well destroyed the prospects for avoiding a deeper recession during 1981. The illusion that the budget cuts would automatically bring interest rates down was starting to wear thin, although Reagan and his closest aides were not yet prepared to take Paul Volcker on directly.

A major indication of presidential concern, as we wrote April 14, was the fact that the negotiations for the April 10 Group of Five meeting to discuss the interest-rate problem among the top industrial countries came not out of Treasury, but out of the National Security Council, on White House initiative.

With the President temporarily disabled, the Treasury monetarists are much more sure of themselves. Reagan managed to surround himself with subcabinet aides like Stockman, Sprinkel, Ture, Roberts, and Kudlow, who are more than willing to throw the country into a major recession, and who agree with the President in nothing but rhetoric. This poor selection reflects the President's own inexperience and ignorance of basic economics. But the ability of the Mont Pelerin Society loyalists inside the administration to make events is substantially greater with the President out of the picture, at least for the moment.

### **The budget issue**

An additional deflationary factor to be considered is the probable discrepancy between the timing of the budget and the tax cuts. There seems to be little question that the House and Senate will pass a package of budget cuts somewhere in the range of the \$40 billion the administration requested, but little prospect that the administration's tax package will come through. That implies a sharp cut in the rate of government spending increase while taxes are actually rising (due to inflationary bracket creep) in real terms.

Under different conditions this might have meant that the private sector would borrow and use the funds that the federal government will not borrow. However, the difference between the credit rating of the government and the private sector is enormous in this case. Most of the private sector, as shown in the disastrous state of affairs in the mortgage market, cannot now afford to borrow (see page 6). Therefore the budget cuts without tax cuts will have an almost entirely deflationary effect.