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Domestic Credit by Lydia Schulman

The Fed's dilemma

Driving rates up will mean a blow-out in the U.S. corporate sector, but offsetting or easing those rates will mean a blow-out of the dollar.

Interest rates on the Eurodollar market dropped an average of one-quarter percentage point on all maturities on April 9. The easing of rates in recent days has been the most dramatic at the short end of the market. Rates on one-month deposits, for example, fell to 18⅝ percent from an all time peak of 20½ percent on March 31.

Traders atrributed this significant easing of rates to a combination of technical factors—principally the availability of cheaper sources of financing for banks in other markets—and the fact that investors are now betting that dollar interest rates have peaked.

On the second count, expectations are now rife that the U.S. economy is in the throes of a deep recession, and that demand for credit and interest rates will ease in response. Citicorp chairman Walter Wriston put out this line at a Houston press conference April 8. "My stomach tells me that if the prime rates are not at their top, they are so close as not to make any difference." This view—or new strain of stomach virus—quickly spread through the financial markets last week.

Much more interesting and suggestive are the so-called technical reasons for the easing of Eurodollar rates last week. The principal factor behind the sudden rise in short-term Eurodollar market rates at the end of March was a scramble for funds by cash-short banks. Many banks were and are in the unlucky position of having to fund long-term fixed-rate loans with very dear money. Now it appears that the banks are seeking cheaper money in the federal funds market, the domestic interbank overnight market, where rates came down from 19 3/8 percent on April 7, to 17 1/2 percent on April 8, and even lower April 9, bank settlement date.

The Federal Reserve itself brought down the rates by buying government agency coupons (long-term bonds) and injecting reserves into the banking system, offsetting the marginal reserve requirements which went into effect in the April 9 reporting week.

These off-setting moves by the Fed point up the insoluble dilemma that the central bank faces: how does it carry out its credit austerity policies without triggering major bankruptcies throughout the U.S. economy. The alarming deterioration of U.S. corporate liquidity, in fact, made the front page of the *Wall Street Journal* on April 8.

At the same time, by allowing interest rates to ease as it has done, the Federal Reserve set the stage for last week's run against the dollar. Swinging back the other way, it is possible that concern about the plunge of the dollar—which lost nearly 4 percent of its value against the West German mark between April 7 and 9—could prompt Fed Chairman Volcker to tighten credit domestically yet another notch in the weeks ahead.

In an interview last week Schroder Bank economist William Griggs commented that he believes the dollar is now headed to the 1.8090 level. Dr. Griggs believes that the Fed is not considering raising rates to firm the dollar. But international political considerations, namely the desire for a strong nation and dollar to anchor the disintegrating NATO alliance, have weighed heavily in the deliberations of Council on Foreign Relations member Volcker in the past.

The rapidly deteriorating condition of U.S. corporate liquidity will undoubtedly put more upward pressure on interest rates. Many economists have suddenly become concerned about a precipitous drop in the "quick ratio"—cash and liquid assets to short-term debt—in many sectors of the economy, which could force a multitude of corporations to rush to borrow money short term merely to meet their financial obligations.

The overall liquidity situation of U.S. non-financial corporations is now worse than in 1974 on the eve of the worst economic blow out since the 1930s. The corporate strategy industries like paper, steel and rubber have opted for—shutting down unprofitable capacity and shrinking their industrial operations—has not even succeeded in improving their balance sheets.

The growing worry is that any added bad shock to the illiquid sectors of the economy could lead to a wave of 1930s-style bankruptcies.

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