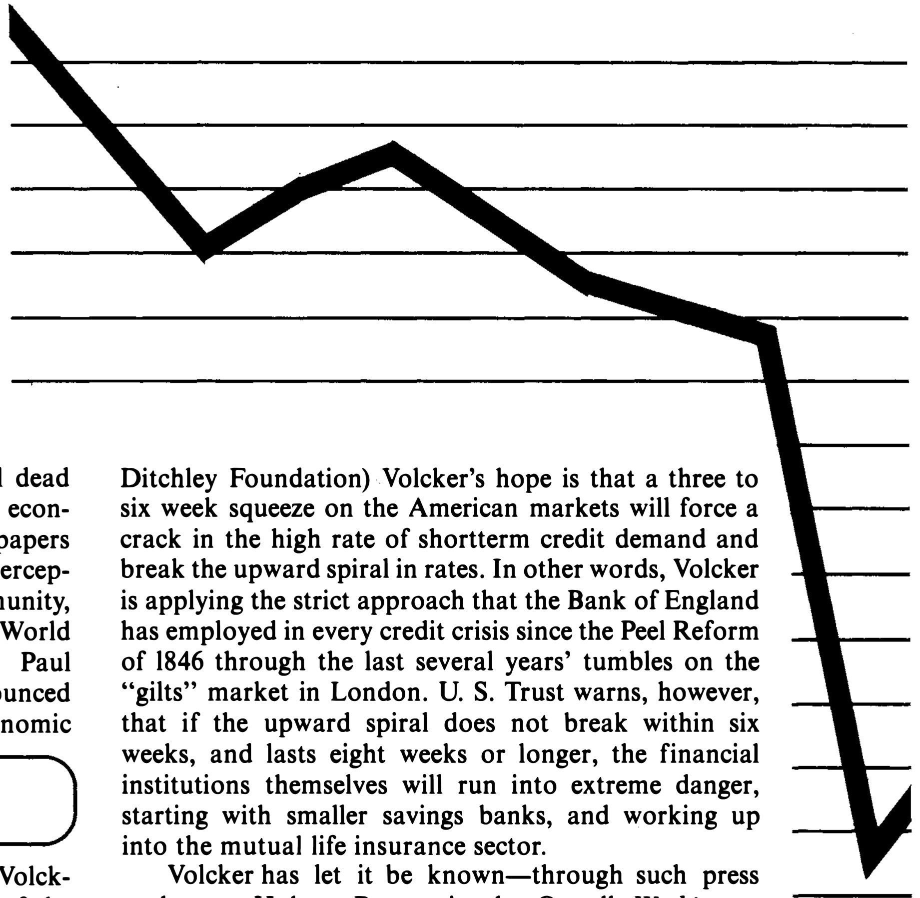
The 'long run' is here



"The long run in which Keynes said we are all dead appears to have arrived," Dresdener Bank chief economist Kurt Richebaecher told the West German papers this week. Richebaecher's grim joke reflects the perceptions of a majority of the world's economic community, including Wall Street bond traders and Third World financial officials. Federal Reserve Chairman Paul Volcker's three-part credit austerity package announced last Saturday night, has started a worldwide economic

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shakeout whose consequences are still not clear. Volcker's motto has been "controlled disintegration" of the world economy. According to sources close to the Fed Chairman, Volcker's risky gameplan involves a controlled collapse of the American economy and a controlled squeeze on the international lending markets.

Will it remain in control? *EIR* correspondents in New York, Chicago, Paris, Frankfurt, Zurich and Mexico City interviewed dozens of bankers, corporate executives, and government officials. The consensus view is, "No." The only dissenters are large commercial banks and academic monetarist economists of the type that predominate at the St. Louis Federal Reserve Bank.

Much depends on whether Volcker holds to his vow and keeps American monetary aggregates under control, with little to the upward movement of interest rates. A frequent comment among analysts is that the White House, fearful of the sharpness of the economic downturn Volcker is likely to provoke, will step in and force some reversal of Volcker's plan in order to give Carter a fighting chance in the 1980 elections.

To a certain extent, that issue has already been decided. According to analysts at U. S. Trust Company, the New York financial house closest to the Fed Chairman's views (through mutual participation in the elite Ditchley Foundation) Volcker's hope is that a three to six week squeeze on the American markets will force a crack in the high rate of shortterm credit demand and break the upward spiral in rates. In other words, Volcker is applying the strict approach that the Bank of England has employed in every credit crisis since the Peel Reform of 1846 through the last several years' tumbles on the "gilts" market in London. U. S. Trust warns, however, that if the upward spiral does not break within six weeks, and lasts eight weeks or longer, the financial institutions themselves will run into extreme danger, starting with smaller savings banks, and working up into the mutual life insurance sector.

Volcker has let it be known—through such press outlets as Hobart Rowen in the Oct. 11 *Washington Post*—that "additional austerity measures" are in preparation should the game-plan appear to flag off. According to corporate and banking sources, the Fed has already passed out word that informal but tough "voluntary credit controls" will be put into effect throughout the commercial banking sector sometime during the week of Oct. 14, once the markets settle down (assuming that they do settle down). In effect, banks will be asked to do what Treasurv Secretary Miller and Chairman Volcker have already alluded to in public addresses, namely to restrict credit extensions to "domestic economic purposes." According to bankers, that means a sharp cutback in consumer loans; reduction of the activity of the mortgage market far more sharply than the 15 percent dropoff from current levels projected by Federal Home Loan Bank Board Chairman Jay Janis in an Oct. 10 speech; a major cutback in loans to the developing sector; and a reduction in lending for so-called speculative purposes, e.g. tender offers. In practice, this means that the lower 500 American corporations and troubled first-tier companies like Chrysler will take it on the chin.

Volcker is gambling that a significant increase in

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unemployment, to around the 9 percent mark reached during the 1974 to 1975 downturn, will be sufficient to choke off short-term credit demand. There are a dozen reasons why this gamble has an icicle's chance in hell of paying off. But Volcker's big selling point is not money-market logic. The comment correspondents heard most is that Volcker represents the only functioning political institution in the United States. With the White House held in contempt by most of the country, and Congress deadlocked over petty issues, corporations are looking for someone to deal with. The commercial banks many of them locked into fixed-interest loans and vulnerable fixed-income securities portfolios—are backing a plan that will hurt them badly because they have no-one to deal with outside of the redoubtable Mr. Volcker.

According to bankers, the most obnoxious elements (from their standpoint) of the Volcker package will be smoothed out. For example, Chase Manhattan President Willard Butcher warned that the 8 percent "special reserve" on excess borrowed funds (the so-called managed liabilities) might disadvantage American banks in favor of foreign banks, who still might be able to book loans from their foreign head offices in dollars to American-domiciled corporations. However, the Fed has given assurances that the 15 to 20 percent withholding tax on interest paid to foreigners will prevent the foreign banks from opening a gate into the U. S. They have also been assured that there will not be much difficulty meeting short-term credit requirements of their prime-quality clients.

What about demand?

Can Volcker deliver? The demand for short-term credit could explode at virtuallv anv moment. The most important interest rate in the dollar sector, the 6-month Eurodollar deposit rate, rose to almost 15 percent on Oct. 11, one of the many all-time records scored this past week. Corporations pushed off the bond market, which has fallen a staggering four and one-half points (or $45 on a $1,000 face value security) so far this week, will have to rely on the short-term markets. The basic liquidity of the consumer and housing sectors, the ones that the Fed proproposes to toss overboard, is not strong; consumers have been compensating for post-tax and post-inflation real income losses by borrowing to cover current expenses. The level of predictable defaults will be large. During the past recession, it was not at all clear whether the commercial banks would have the capital base, following the predictable shakeout, to finance a recovery. Now it is even less certain.

Many analysts are dead sure that Volcker's concern is less the American economy than a counterattack againt the monetary plans of Western Europe, which became a political issue in the American election campaign this week. "Remember that the Eurodollar market is a two-bit affair compared with the American market," said a partner of one of New York's most prestigious investment firms. "All of the West German banks, the ones that have been booking dollar loans like crazy during the last several months, depend on dollar reserves. Volcker is putting the international markets under control." Another banker, A. and S. Bleichroeder's Senior Vice President Erwin Shubert, was more blunt. "Volcker's playing hanky-panky with the Europeans and the South Africans," Shubert said in an interview, referring to American opposition to the progressive remonetization of gold through the European Monetary System and allied arrangements. "The United States economy is going to blow out. What the Fed is doing is terrible." Shubert advocates the mobilization of America's gold stock of 65,000 ounces, worth almost $127 billion at current market prices, to back up the credit of the United States government. Under a plan Shubert submitted to Chairman Volcker, the United States government would offer bonds convertible into physical gold.

Other American economists favor concessions to Europe's gold remonetization efforts, including Citibank's Harold Van B. Cleveland, who is quietly lobbying for the establishment of Federal Reserve gold swaps in the context of Europe's gold plans. There is also a less pleasant variant of this approach under discussion by some of John Connallv's campaign advisors, including Brookings Institution affiliate Rita Hauser. Hauser is telling corporate executives privately that Carter will throw the United States into a depression, leading to the former Texas Governor's election. After this, she says, Connally will bring the United States into a gold system.

Will Europe act?

However, it is likely that Western Europe will preempt discussion of these matters by taking unilateral action. At the present, Europe has not fully digested the impact of Volcker's actions. The French media, including *Le Monde* and *Le Figaro*, have roundly denounced the Federal Reserve for risking a world recession and major bankruptcies, in the words of a front-page *Le Figaro* editorial Oct. 10. According to a French business weekly, *Lettre de l'Expansion*, French prime minister Raymond Barre proposed the creation of an official gold pool as a means of dealing with the crisis. West Germans, by instinct sympathetic to the monetary austeritv aporoach, agree for the most part with Deutsche Bank Chief Wilfrid Guth's statement Oct. 9 that "the West German tradition shows that recession is a good way to deal with inflation." However. as the investment banker cited above pointed out, the West Germans' own banking reserves are on the line.

Although initial West German response has been positive, the real moment of truth will occur when West German bankers survey their loan portfolios with the developing sector. This is perhaps the most dangerous feature of the entire Volcker package. This year, by the

Carter: no need to stabilize dollar

At President Carter's news conference Oct. 9, Executive Intelligence Review's *Washington, D.C. correspondent Susan Kokinda queried the President on his administration's monetary policy:*

EIR: Mr. President, further on the Fed's tight money policies, figures such as the West German Finance Minister and Democratic Party presidential candidate Mr. LaRouche have charged that this is leading us rapidly towards the crash of '79. Will you move to stabilize the dollar and the economy by collaborating with Europe on their move to remonetize gold, as LaRouche and others have suggested?

President Carter: I doubt that that's in prospect, certainly not for this year. We do cooperate with allies and friends and trade partners in order to stabilize the worldwide monetary system including, at times, the interrelationship between currencies from one country and another and sometimes the basic metals.

I don't see any threat to the well-being of any American because of a rapidly increasing price of gold—except those who have sold early or bought late. But as far as the average citizen's concerned, the price of gold—whether it's $200 an ounce or $400—has very little impact.

Recently, the Federal Reserve Board has decided to raise interest rates and I think that—and take other steps concerning the Reserve's supply of money to be kept on hand by banks. This has resulted in a strengthening of the dollar—which had already begun to strengthen. And I believe that it's well within the bounds of management—it's stable.

I had noticed an analysis that showed that in the last year the price of the dollar, as compared to currencies of all our trade partners has increased substantially among the OPEC nations and their trade partners. The value of the dollar, even before we'd made the recent move, had increased 8 percent over the last year.

So I believe the dollar is stable. I believe the world economy is stable. And I see no prospect of shifting to a rigid price of gold and a gold standard.

International Monetary Fund's estimate, the Third World will suffer a $43 billion balance of payments deficit; private estimates are closer to $50 billion. At $200 billion, the private debt of the developing sector now carries an annual $30 billion interest charge, given 15 percent six-month Eurodollar rates. At 20 percent, the annual carrying charge rises to $40 billion. This is the volume of new loans that the commercial banks will have to extend to the developing countries merely in order to maintain the loans on their books. The last rise in oil prices has already thrown many third world economies into chaos. There is apparently a further rise in the price oil in the works, possibly as drastic as the first. That will add further to the burden.

'Uncontrolled disintegration'

The same West German banks whom Volcker plans to squeeze out have been disproportionately carrying the burden of financing the Third World. The lower tier of these countries is on the verge of economic holocaust (see TRADE). *EIR*'s special report of last July on the consequences of the oil prices increase found, on the assumption that the Fed would respond with monetary stringency, that the economies of many of these countries would cease to exist in meaningful form by the end of 1980—and that several advanced sector countries would follow by the end of 1981.

The London *Guardian* warned Oct. 9, in a column by Hamish McRae, that the current monetary environment might trigger a wave of Third World debt defaults. That looks increasingly likely; the International Monetary Fund has no lendable resources in proportion to the need, and the private sector cannot keep up its previous rate of lending, much less increase it as required, under Volcker's program. Already, according to the London Financial Times Oct. 9, private banks are abandoning Turkey, something of a test case for willingness to lend to Third World countries.

The central bank governor of Mexico warned Oct. 10 that Volcker's plan would decrease the exports of the developing sector and potentially lead to serious economic consequences. What is most dangerous for the third world in the short-run, however, is not the absolute level of import demand from the advanced-sector countries, but the uncontrollability of short-term interest rates under the Volcker program.

Volcker has unleashed consequences which would better be described as *uncontrollable* disintegration. According to Democratic Presidential candidate Lyndon H. LaRouche, Jr., "Volcker will only push the Europeans to act on gold faster." The dollar is now functionally unusable as an international lending currency (see FOREIGN EXCHANGE). The fall of the dollar despite the extraordinary interest rates available indicates that the currency has, indeed, become an "exotic currency like the Brazilian cruzeiro," as one senior Swiss money dealer put it.

Europe might well be forced to activate some of its contingency plans well in advance of plans. The final alternative is to make the gold-backed European Cur-

rency Unit (ECU) an actual currency, issued against gold backing, to assume monetary functions left vacant by the dollar. A simpler possibility would involve a European banking consortium issuing securities in gold denomination at an extremely low interest rate. Under present circumstances the European banks could assume as many cheap liabilities as they wanted. This plan would depend on action by European central banks to stabilize the gold price within a certain range of fluctuation—but the Swiss monetary authorities deny Europe's intention to do this. At this point, any bank that failed to join in this procedure would immediately go bankrupt, and the world would be back on a sort of gold exchange standard. In either case, Europe's will and ability to turn Volcker's offensive back against him should not be underrated.

—David Goldman

What is Volcker's policy

On November 9, 1978, Paul Volcker delivered the Fred Hirsch Memorial Lecture at Warwick University in England where he outlined what in less than a year has become the Federal Reserve's monetary policy. Fred Hirsch, a New York Council on Foreign Relations economist, authored the Council's Project 1980 economic sections before his recent death. Volcker's speech, excerpted below, was published in the January 1979 issue of the London monthly The Banker.

... I was tempted to take as my text today one of Fred Hirsch's last dicta: "A controlled disintegration in the world economy is a legitimate object for the 1980s. ..." The phrase captures what seems to me the prevailing attitudes and practices of most governments in this decade, as they struggle with two central issues that bedevil so much of our negotiations and our actions, not just with respect to money, but over the full range of international economics....

... Let us be aware of the difficulty of controlling disintegration, once fairly started....

I do not suggest that we stand on a knife's edge forced to choose between integration and autarchy. But I would much rather take as my rallying for necessary negotiations, as an ideal from which to measure progress, the challenge of "managing integration" rather than disintegration....

... The happy days of Bretton Woods, often viewed today with nostalgia, were a special case, workable because of a particular economic and political setting....

The system held together for a decade and more after the first signs of weakness, despite the resistance to more fundamental adjustment measures...

'Inherent contradictions'

But in the end, the inherent contradictions in the system were too great. With the benefit of hindsight, it would seem that an erosion of the United States competitive position was implicit in the postwar arrangements. First Europe and later—with even greater momentum—Japan brought its industrial capacity and efficiency close to United States standards. It took some 20 years, but eventually the United States payments position was irreparably undermined....

Finally in August 1971, the United States did move decisively to promote the adjustments that seemed

The reaction in Europe

French press reaction to the Federal Reserve hike of interest rates to 14.5 percent are exemplified by Le Figaro, *which headlined: "The West threatened with a recession" in its Oct. 10 edition. The article, quoted below, warns of the possibility of an international interest rate "war."*

International financial circles were expecting, at the same time dreading, such a measure: it is the logical consequence of the plan of anti-inflation and defense of the dollar announced last Saturday by American monetary authorities. Like a spot of oil, it will further exacerbate the war of interest rates between industrialized countries. At the end of the road, a major risk for the United States and the Western countries: a recession. Already the experts don't hesitate in predicting bankruptcies. And not only among the "small."

... At first glance, one could interpret the new threshhold crossed in the inexorable increase of American interest rates as the continuation of a movement begun months ago. But that would be to misjudge its real importance. It is in fact a new monetary policy in America. Or rather an attempt to implement a real monetarist policy....

In the short term, the effects on Europe will first concern interest rates. In a first stage, we can hope

that the Germans will not react by increasing their own rates. They would want to avoid the accusation of feeding a world war of interest rates....

In France, on the other hand, the monetary authorities will undoubtedly not be able to allow the differential between interest rates on the other side of the Atlantic and our own to increase. ... If the German rates do not increase in the immediate period, we can hope to avoid a real escalaton. If they go up, the necessity of defending the Franc-Deutschmark parity will force French monetary authorities to again up the cost of renting money, with all the dangers that this would entail.

"But the most preoccupying consequences are more long term. If a serious recession occurred in America it would spare no one, and least of all the European countries. The danger is clear. But if we take seriously the threat of world inflation ... we must know that we can't bring it down without taking risks.

From an interview with an official of the West German Bundesbank:

Personally I think it's a step in the right direction. Inflation must be cut or there will be no dollar stability. The third world? Would it be any better for them if the inflation went on? We must have real interest rate levels above inflation. It's the relation that matters, nothing else. Look at the German example. When we had 8 percent inflation, we had to put up our interest rates above that, and it worked.

From an interview with a West German banking official:

We see Volcker as the man who is doing what the Germans have been telling the U.S. to do, though we doubt that the crunch will last—it being an election year. ... The new minimum reserve requirements will put U.S. banks at a competitive disadvantage and prevent U.S. banks from dealing out all those worthless dollars in the world. ... Making money scarce is the most effective way to cure inflation.

From an interview with a Swiss banking official:

We're very worried about the U.S. situation. Volcker took drastic steps, and he had to. Now we all have to fight together to support the U.S. currency authorities.

Romero Kolbeck, head of the Mexican Central Bank, as reported in the Mexican press Oct. 10:

It is not very encouraging that the advanced countries have decied to grow less next year, because as long as those countries do not transfer resrouces, at least seven percent of their gross national product, resources for the developing sector countries will be limited. (Kolbeck further explained that Mexico's foreign debt, which is denominated in European currencies and Japanese yen, has increased by 3 to 4 percent as a result of the fluctuations of the dollar. The Mexican peso is pegged to the dollar.)

necessary....

... We have had plain enough warning of the fact that international money, any more than domestic, will not manage itself. It will deliver neither the promised autonomy nor integration if we fail to deal with some of those issues that were unresolved in earlier efforts at more structured reform....

As Fred Hirsch emphasized some years ago, the transition toward a European system could pose difficult problems. I hope we will all be alert to dealing with the complications that the transitional period could present for international cooperation on a wider scale, to protecting the legitimate role of the IMF, and to the implications of decisions within Europe for the monetary system as a whole....

All of this raises questions of governance—if the system is to be managed, who will do it and how. The obvious institutional focus is the IMF, and it plainly has a full plate of work ahead. I have long felt that, if that work was to proceed with full effectiveness, the effort of the international bureaucracy—however able—and it is very able—needs to be reinforced by more active regular participation by politically responsible officials of member governments. That is, of course, the rationale of the council authorized by the new articles. To a degree, the function has been performed on an interim basis by the advisory council. But it would seem to me useful, more than symbolically, for that body to assume now full legitimacy by transforming itself formally into the council, and renewing the sense of commitment to develop its surveillance function (along with) more or less continuous consultation among the "trilateral" countries: Japan, Europe, and the United States. And the consultation must extend to the highest level. The recent practice of "economic summitry" points that way.