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# Carter-Reagan deal to maintain recession

by David Goldman

In November 1979 this publication released a set of computer econometric forecasts for the American economy, predicting that Federal Reserve Chairman Paul Volcker's credit stringency measures would result in a 15 percent falloff in industrial output, starting in the second quarter of 1980 and leveling off at the end of 1981. The announcement of a 2.4 percent drop in industrial output for the month of June puts the first-half 1980 production drop at 7.5 percent, and the consensus forecast is that the production decline will continue at a more gradual pace and level off towards the end of 1981, corroborating our original estimate.

Last May *EIR* projected that the American economy would lose sufficient productive capacity through the present recession to make a recovery in the usual sense of the word impossible. In effect, over the past week the Carter administration has not only confirmed this estimate, but added that no recovery should occur—a position also shared by the leading economists in the Reagan camp. The implications of these admissions are devastating ones.

On July 21, Council of Economic Advisers Chairman Charles Schultze and Budget Director James McIntyre issued the Carter administration's equivalent of the "let them eat cake" comment about the French economy. Despite an official projection of 8.5 percent unemployment through the end of 1981, a budget deficit in fiscal year 1980 of about $60 billion and a swing into deficit of $46 billion (from a projected $16 billion surplus to almost $30 billion deficit), the administration proposes to do nothing in particular.

"Policy measures to increase investment, productivity, and economic growth—with beneficial effects on unemployment and inflation in 1981 and later years—will be developed carefully in close consultation with the Congress and others in the months ahead. It is quite likely that a tax cut will be desirable in 1981. But it is not appropriate to propose one now. The administration believes strongly that the last months of a congressional session, in an election year, are not the time to make the judicious decisions needed for a skillfully designed tax program to improve economic performance," McIntyre said. In House testimony July 22 Secretary of the Treasury G. William Miller played the same theme.

"If the Treasury really wanted a serious discussion they would give us some proposals," said an angry Senate Finance Committee staffer. "But they haven't told us a damn thing about what kind of tax cut they want."

### Why Wall Street supports do-nothing approach

Although a few commentators like Data Resources chief Otto Eckstein (who earlier this year was forecasting a "mild recession") and the Conference Board's Michael Levy are warning that the economic situation may get out of hand, the administration has overwhelming support from large financial community institutions. In their own narrow way, the financial community



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has realized what it means for the economy to be operating below breakeven: the financial system cannot take the strains of recovery.

Sources close to Volcker at the major commercial banks, and sources at U.S. Trust who are Volcker's colleagues at the Ditchley Foundation explain it this way: even the extreme peak of interest rates achieved through monetary restriction at the end of the first quarter was insufficient to deter corporate and consumer borrowing, which pushed the inflation rate up towards 20 percent. The credit controls were necessary to shut down borrowing and break the inflation cycle, no matter what the consequences for the economy, because a disaster would have ensued in the financial sphere.

The structure of the entire financial sector, particularly that of the large life insurance companies and the savings industry, depends on the long-term bond market. A further burst of inflation would have turned the already dangerous level of disintermediation out of these institutions into a flight, while simultaneously devaluing their holdings of fixed-income securities.

The entire national financial structure would have come unstuck, U.S. Trust economist James O'Leary believes, and most Wall Streeters agree with him.

The next administration, according to the financial community, must avoid any "quick fix" supply-side tax cuts of the type widely advertised by the Joint Economic Committee and organizations like the Business Roundtable earlier in the year, and adopt a much more cautious, gradual approach instead. In addition, the consumer sector, already battered by the collapse of the auto and housing sectors, must stay that way indefinitely, reflecting a basic, long-term drop in the American standard of living.

That is the position of the Committee to Fight Inflation—the organization put together by former Fed Chairman Arthur Burns and former Treasury Secretary Henry Fowler—inside both party camps.

Paul Volcker, testifying July 22 before the Senate Banking Committee, promised a regime of monetary stringency over a period of years, including similar targets for money supply growth. Close friends of Volcker on Wall Street say that he will be willing to adopt credit controls once again should economic activity proceed too fast.

What lies at the root of the problem, as *EIR* documented in a survey published in May, is that the American economy has been operating below breakeven levels since the last recession, after deducting the maintenance requirements of both capital and labor inputs to the economy. The economy is now producing insufficient capital and consumer goods either to maintain the capital stock or to build the required skilled labor pool; as of 1979 the economy was investing $50 billion per annum less than required for essential maintenance, and will probably invest a solid $15 to $20 billion less in real terms during 1981.

## Economic deficit breeds hyperinflation

This translates, in financial terms, into a deficit of private-sector savings of households and corporations, and consequent strains on the financial markets. The strains turn into a self-feeding spiral when the Federal Reserve prevents the consumer sector (as it did last October) from making up its income gap through extensive borrowing, and prevents the corporate sector from making up its gap in terms of investment resources through the same process, as it did last March. The financial gap, in turn, is deducted out of real economic activity, in a spiral that will bring the American economy past a point of no return.

The financial community's perception, shared by the Carter administration, of the danger of a renewed burst of inflation once a "recovery" begins is entirely correct. The economy does not have sufficient skilled labor, machine tool capacity, steel capacity, energy-industry equipment capacity and other essential items to recover without a gigantic inflow of imports.

Whether inflation results from bottlenecks and scarcities, or from a collapse of the dollar due to an explosion of the trade deficit, the actual state of collapse of the economy in real terms does make an aborted recovery an extreme danger. Thus far, the administration is correct.

However, the longer the economy remains prostrate, the more physical and human capital will be lost by attrition. Since the actual rate of physical depreciation of the capital stock is higher than even the 1979 investment rate, any delay in recovery actually worsens the prospects for recovery in the future.

It is foolhardy and dangerous to believe that lowering consumption levels will make up the margin of investible resources; investment-goods capacity and consumer goods capacity are not entirely substitutable in the first place, and, much more important, the economy's worst shortage is in skilled labor. Reduction of living standards invariably leads to a reduction in availability of skilled labor.

The economy's only hope would be, not a "supply-side tax cut," which would throw money around fairly aimlessly, but a directed investment program combined with appropriate tax breaks for investment which would boost productivity in key areas of the economy, e.g. nuclear energy, agriculture, computer-controlled machine tools, and so forth. To let the recession take its course indefinitely is to guarantee that the economy will perish by attrition.