Shock treatment for U.S. inflation?

by David Goldman

A private advisory group to the International Monetary Fund met in Charlottesville, Virginia last week following the Fund's Annual Meeting in Washington, to debate whether Federal Reserve chairman Paul Volcker would succeed in his program of gradual monetary contraction in the United States. Known as the Consultative Group on International Economic and Monetary Affairs, or more simply the Group of 30, the Virginia gathering studied proposals from several economists to abandon "gradualism" in favor of what Prof. Friedrich von Hayek likes to call a "stabilization crisis": a sudden, all-at-once contraction of credit availability.

The events in Virginia put in focus where the industrial nations stand following the International Monetary Fund's travesty in Washington at the beginning of October. The bottom-line content of the meeting's decisions was to continue contractionary, monetarist policies in the West for the next five years, bleeding off the credit resources of the industrial economies to make possible financing of a developing-world deficit of $80 billion in 1981 and perhaps even more in subsequent years.

Since the developing nations' deficit is entirely due to the combination of higher oil prices and higher debt service charges on those nations' more than $400 billion in foreign debt, and not to capital goods imports that might enhance the ultimate viability of those economies, the IMF proposal, formulated by Managing Director Jacques de Larosière in his opening Sept. 30 speech, is the worst of all possible worlds. In an Oct. 14 interview with the *Wall Street Journal,* de Larosière hinted that the IMF's role as "economic policeman" bodes "a deeper IMF involvement in the policies of more nations, possibly including the U.S.," in the *Journal*'s words.

This global endorsement of Milton Friedman-style monetarism unfortunately coincides with a terrific impasse for monetarism in the two countries which have systematically applied Friedman's theories during the past year, namely the United States and Britain. Britain is presently undergoing combined depression and threatened hyperinflation, with an apparently uncontrollable 22 percent per annum rate of money supply growth despite all efforts of the Thatcher Conservative government to control it. The shambles of internal British economic policy, which coincidentally has brought industrial output *below* the 1975 depression low, forced the early departure from the IMF meeting of British Chancellor of the Exchequer Sir Geoffrey Howe for emergency consultations back in London. So far, no news of a Thatcher government response has emerged from London.

The Anglo-American dilemma

America's position is analogous to that of Great Britain, merely in a less advanced stage of the same disease. One year ago, *EIR* asked editorially, "Is Volcker Insane?" arguing that higher interest rates and credit contraction would promote higher inflation levels at lower levels of real output. The Federal Reserve chairman now faces exactly the predicament we warned of. With the American economy hardly off the floor it hit at the end of the second quarter, money supply, interest rates, and business lending began to rise out of control during September. The present stabilization—*not decline*—in interest rates merely indicates that the traditional largest user of credit in the U.S. economy, the housing sector, is falling back down to the June low of less than 1 million single-family units built per year, against the 1.3 million of August.

Interest rates are now fixed to a ratchet movement, in which interest rates rise spectacularly with every trifling increase in productive-sector credit demand, but do not fall back when output declines. A year of Volcker's monetarism has thrown the nonfinancial corporate sector and households into the worst illiquidity position, as *EIR* has reported during the past several weeks, since statistics were first counted. The credit demand arising from refinancing of outstanding debt is sufficient to maintain high interest rates, irrespective of the events in the real economy. Fed chairman Paul Volcker has pushed monetary inflation out of control.

Precisely the same course of events struck Britain as a result of the same policies. The uncontrolled rise in the British monetary aggregates is due to high rates of commercial borrowing by the private sector, now running depression losses.

A Group of 30 proposal

Since the Group of 30 is, on paper, one of the world's most prestigious collections of economists and bankers, chaired by former International Monetary Fund managing director Johannes Witteveen, its deliberations on this subject are noteworthy. They tell us that the monetarists have learned nothing from their predictable blunders in the U.K. and U.S., and are prepared to replace them with even greater blunders. The central discussion paper at the Virginia meeting was offered by Prof. Stanley Fisher of the Massachusetts Institute of Technology. Fisher proposed what might be called the "Argentine model" for the United States: provoke a crash, sharply devalue American tangible and financial assets, and encourage foreign dollar-holders to hunt for bargains. Instead of applying gradual pressure to the availability of credit in the U.S. economy, as the Fed is now doing, Fisher wants to crush monetary growth all at once and eliminate inflation through general bankruptcy, should Congress refuse to balance the Federal budget.

Of course, the Group of 30 has not taken a formal position on this matter, even if a core of its economists, including Austrian School octogenarian Fritz Machlup and former Council of Economic Advisers chairman Herbert Stein, favor the shock approach. Endorsement of any policy by the Group of 30 does not ensure its adoption by the Federal Reserve or other government agencies. However, these gentlemen have given us a usable preview of the blunders the monetarists will make next, if the policy embodies in the IMF Managing Director's speech holds sway over the industrial countries. In their own blinkered view, this is the only way forward.

The Group of 30's "stabilization shock" would blow up in the faces of the monetary authorities. The United States is not Argentina, able to improve its credit rating by converting the national economy into a vast bargain basement. For one thing, the gross liabilities of the United States to foreigners are nearly $1 trillion (including $150 billion in official obligations and $800 billion in gross Eurodollar deposits). An inflow of even a small part of these liabilities into the United States to purchase financial or tangible assets following a deflationary shock wave would create an inflationary counterwave of staggering proportions.

Professor Fischer, former CEA chairman Stein, and their colleagues apparently have not taken into account the effect of a U.S. domestic bankruptcy crisis on the Eurodollar market. Were the Federal Reserve to close off normal bank credit availability, U.S. corporations would frantically repatriate dollar deposits from the Eurodollar market in order to meet obligations at home. Repatriation of deposits by U.S. multinational corporations would reduce Eurodollar lending capacity by about $4 for every $1 deposit withdrawn, if the Federal Reserve's estimate of the Eurodollar banking multiplier is accurate. At present, the Eurodollar markets are able to avert a crisis in the refinancing of developing countries' debt to the Eurodollar banks only by very rapid and very risky expansion of short-term "bridge" loans to countries who are unable to obtain sufficient syndicated medium-term credits to cover their debt service.

Possibly, the Eurodollar market could survive outright default by a debtor the size of Brazil. Under no circumstances could it survive a deflation shock in the United States economy. The bigger commercial banks have already taken into account the possibility of a general freeze of the Eurocurrency market—which implies the insolvency of their foreign branches—by preparing to withdraw their international business to domestic-base "International Banking Facilities," should the Federal Reserve permit their formation (see *EIR*'s Oct. 21 Special Report).

Does the Group of 30 propose the breakdown of the world into contending currency blocs, and the "decoupling" of large parts of the developing sector as world trade shrinks? Leave alone the grievous consequences for the United States, this would be the immediate result of the proposed deflation therapy.

EIR has drawn attention to the genesis of this form of monetary thinking in the proposal for "controlled disintegration of the world monetary system during the 1980s" issued by the New York Council on Foreign Relations in the "Agenda '80s" series issued by the Council last year. Perhaps, although the Group of 30 economists who spoke to *EIR* insisted that this was not the case, the Group's organizers are prepared to take the worldwide consequences of such actions in their stride. If that is true, we must consider the consequences of a leadership composed of proven mediocrities attempting to "control" a world crisis of more devastating proportions than that of 1929-1931. Like the beleaguered chairman of the Federal Reserve Board, these men are in over their heads. But the ultimate alternatives are this, or putting the theories of Friedman and von Hayek in the casebooks of abnormal behavior where they belong.

INTERVIEWS

The Group of 30 discuss options

EIR *interviewed Dr. Fritz Machlup, Professor of Economics at New York University, and since 1923, a leading member of the Vienna School of monetarist economics. Machlup is a member of the Group of 30.*

EIR: Dr. Machlup, what is the difference between gradualism and the "shock treatment" approach?
Machlup: Monetary policy can be tightened in two to four steps, and I call that gradualism. The problem with that approach is that whoever is instituting that policy usually backs out after the first couple of steps. I favor a one-step approach in which the rate of monetary expansion is brought down in one fell swoop.

When you pull such a big step contraction of the money supply you have to prepare for certain consequences. We might have another depression like the 1930s when unemployment was 25 percent. I couldn't comment on whether such a rate of unemployment is acceptable, but that is what may happen and that is up to the markets.

EIR: You complain of outside forces like constituency groups affecting the policy of monetary affairs.
Machlup: There should be a focus on monetary policy and such things as money supply and nothing else. This means that you don't pay attention to industrial growth, trade, capital movements or whatever. You just concentrate on the money supply. You let other things take care of themselves and you don't let other, outside forces interfere.

EIR: In the 1920s and 1930s, did you know [Nazi Finance Minister] Hjalmar Schacht?
Machlup: Yes, he was a friend of mine. We had our disputes. I wrote a 1928 paper criticizing Schacht. But I think that on the whole his post-1934 policies were good. Look, he did the *Rentenmark*, which worked. The collateralization of the *Rentenmark* with land was a lot of buncombe; it was mostly public relations, but it worked.

Dr. Herbert Stein chaired of the Council of Economic Advisers under President Nixon, is a fellow of the American Enterprise Institute, and adviser to Ronald Reagan. He is a member of the Group of 30.

EIR: Mr. Stein, what were some of the options discussed at the Group of 30 meeting?
Stein: One idea that came up was a plan to abolish the dollar and replace it with a new dollar or currency. The idea is to operate as was done after World War II. Then we got rid of the old Austrian and German currencies and gave them new ones. This idea was offered as one way to bring down the inflation rate. We also discussed other options along the lines of the March 14 application of credit controls that [Federal Reserve Board chairman] Volcker used. . . . I think that the Thatcher model has to be brought to the United States. . . . I think wages are out of hand and Thatcher has not been stern enough in handling public and private wage negotiations.

From an interview with Dr. Stanley Fisher, Professor of Economics at MIT:

EIR: You prepared one of the study papers for the Group of 30 meeting, on the subject of new dollars. How would that work?
Fisher: At a certain date, new dollars would be issued on a par basis with old U.S. dollars. Then every year the old dollars would be allowed to devalue against the new dollar by some percentage which would represent the anticipated rate of inflation on the old dollars. This would allow old debts or labor contracts undertaken at high wage increases or high rates of debt to be in effect renegotiated with the inflation taken out in new dollar terms. I first heard of this idea from Robert Hall of Stanford University.

EIR: Why was the new dollar idea brought up at all?
Fisher: Well, some of the participants at the meeting favored sharp deflation and wage-price controls combined. When Nixon tried wage-price controls, he let the supply of money grow at 8 to 9 percent, and this wrecked everything. Other people want the sharp deflation but are thinking of the new dollar to accompany it and replace the wage-price controls component.