The blackmailing of the President

by David Goldman

Treasury Secretary Donald Regan's extraordinary recantation of support for tax cuts regardless of budget cuts, followed immediately by a similar recantation by the President himself, makes formal and public what top bank executives have been saying for a week: the leading money-center institutions have succeeded in blackmailing the President of the United States into abandoning the aggressive growth platform on which he was elected.

At this writing, the decision is not yet cast in cement, but the trend is ominous. The Reagan and Regan statements Feb. 4 adopting the principle of "linkage" between tax and budget cuts include, in reality, a third feature of the same program: a free hand to Federal Reserve Chairman Paul Volcker, who is intent on throwing the American economy deeper into depression. That is the briefing that Office of Management and Budget Director David Stockman has given his staff. The depression scenario will proceed, according to the Hoover Institution's Rita Ricardo-Campbell, under the *personal direction* of cult leader Milton Friedman, the man responsible for reducing Britain to the status of a "Once-Industrialized Country" (in the words of the London *Sunday Times*) since the election of Prime Minister Margaret Thatcher in April 1979.

According to First National Bank of Boston Chairman Richard Hill and other top banking officials (see interviews), the blackmail began with a private dinner in New York City Dec. 8 at which Volcker received his marching orders from the board chairmen of the top eight New York clearing banks. Volcher was told—and told the President—that any perceived "weakness" in the Fed's tight money stance, or any attempt on the part of the new administration to make Volcker abandon the tight money policy, would lead to immediate attacks on the credit markets. The big institutions would start "moving money around," shorting the market in long-term Treasury securities, undermining the record $35 billion net new financing program of the Treasury, and leading to higher interest rates.

Although Treasury Secretary Regan is not an ideological monetarist—he was chosen for the job precisely for that reason—he wears Wall Street blinders, fearing that a loss to the Fed's "credibility" would produce an unmanageable crisis.

On the contrary: the Fed's policy will rapidly lead to a generalized credit crisis, as Alan Greenspan warned Congress two weeks ago, including a crisis on the vulnerable Eurodollar markets. Under the Credit Control Act of 1969, the President has adequate powers to impose a *two-tier credit system,* making available producers' credit while drying out speculative markets. Something of this sort is proposed in a sense-of-the Senate resolution introduced in early January by Senator Sasser (D-Tenn.).

The triumvirate

However, President Reagan is besieged not only by external threats, but by the wrong kind of advice from friends. Through certain leading figures in the "California mafia," the immediate circle of old Reagan political backers, Milton Friedman and Hoover Institution Director Glenn Campbell have secured key appointments inside the new Treasury and OMB.

These include Friedman protégé Beryl Sprinkel, formerly chief economist at Harris Trust in Chicago, and Bear, Stearns and Company economist Lawrence Kudlow. Sprinkel has the undersecretary of treasury for monetary affairs job, and Kudlow was named Feb. 4 assistant director of OMB for economic policy. Kudlow told his Bear, Stearns colleagues before heading for Washington that the triumvirate of Stockman, Sprinkel, and Kudlow would ensure that "the Fed chairman has more freedom to pursue monetary objectives than in any of the preceding administrations."

Meanwhile, the Federal Reserve has tightened monetary policy steadily since the Dec. 8 meeting in New York. Volcker adopted without publicity the old Morgan Stanley proposal to restrict the growth of banking reserves without concern for money-supply growth as such, endorsed in the famous Jack Kemp-David Stockman "Dunkirk memorandum." Banking reserves have, in consequence, fallen by $1.5 billion in the past seven reporting weeks, and bank lending dropped precipitously in December and January. Bank credit is so tight that even large corporations are hard put to find routine trade credits.

The result of Volcker's post-Dec. 8 action is to put the issuance of credit and the intermediation of savings into the hands of a tiny handful of money-center institutions—the same institutions committed to the blackmailing of the White House.

Unable to obtain credit from domestic sources, those corporations who can are seeking Eurodollar loans, through the small number of American institutions with the international clout to raise funds on the offshore market. These include the commercial banks represented at the Dec. 8 New York meeting. Corresponding to the drop in money-center banks' domestic loans is a rise in Eurodollar borrowings from foreign branches, indicating the size of the inflow. The actual flow is greater, since corporations raise funds through foreign subsidiaries to ship home for working-capital purposes.

In effect, American industry has to go begging to the holders of America's foreign liabilities.

Even more significant is the sudden increment of power to the life insurance companies. With a savings rate in the range of 4 percent, the thrift institutions are unable to staunch a net outflow of deposits that totaled about $20 billion during 1980. Families will withdraw savings deposits, but continue to pay life insurance premiums and pension fund contributions.

The life companies and the pension funds (managed by life companies, investment banks, and bank trust departments) are now the only source of mortgage money available. The principal activity of the savings and loans has become the resale of mortgage portfolios (in the form of pass-through bonds) to life insurance companies and pension funds, picking up scraps from the life companies' table. According to S&L specialists, the volume of such bond purchases is insufficient to prevent a wave of failures throughout the thrift industry during the first half of 1981 if the current interest-rate environment continues.

Simultaneously, the insurance companies are now the only available source of mortgage finance for housing. The political clout they wield from this position is considerable. At last week's convention of the National Association of Homebuilders, outgoing President Merrill Butler deliberately muted attacks on Fed Chairman Paul Volcker—even though the man responsible for the bankruptcy of one-third of the association's members during 1980 was hanged in effigy in front of the convention hall. The homebuilders were under pressure not to alienate their principal source of funding, the life companies. Their industry, in consequence, has fallen into two categories: the smaller single-family homebuilders, whose ranks are thinning out rapidly, and larger corporate homebuilders who can obtain life insurance funding for larger projects.

Controlled environment

Meanwhile, the life companies are warning the administration that it dare not touch the power of the Federal Reserve. "Volcker's strength arises from his constitutional invulnerability," says Kenneth Wright, chief economist of the American Council on Life Insurance. "He can't be asked to step down. They can't touch him. They have no legal right. . . . If he's criticized, or chastised, or asked to step down, the international financial community would see this as a real blow to the credibility of the U.S.'s ability to control inflation. This would cost the dollar tremendous prestige. It would cause a run on our currency."

The large money-center financial institutions have woven a controlled environment around the White House. Through direct pressure, they have been able to choke off the protests of important constituency organizations who have suffered the worst effects of the Federal Reserve's actions.

Beholden to the life insurance companies, organizations like the National Association of Homebuilders and the U.S. League of Savings and Loan Associations are reluctant to play rough politics with the Fed. Because Paul Volcker has restricted the money markets to what these institutions directly control, the institutions are free to punish or reward the administration for actions according to their own criteria. What President Reagan sees from the White House is not the play of "inflationary expectations" in a "free market," but the guiding nudges of a market rigged by the Federal Reserve.

Although it is difficult to gauge in advance the nature of the budget cuts that will ultimately appear after Congress has been through the administration's proposals, a few test cases indicate that the administration has started to break down in the face of financial community demands. *EIR* has confirmed that the Eximbank of the United States will not receive the generous support envisioned earlier by Sen. Jake Garn, the chairman of the Senate Banking Committee.

According to sources close to Garn and to Eximbank officials, the administration intends to force a 25 percent across-the-board cut in Exim funding from the Carter 1982 budget proposals, already tiny compared to the export funding programs of America's European allies. OMB Director Stockman is justifying the proposed cut with the argument that Eximbank funding aids only large corporations—although Exim officials point out that every $1 billion in exports generates 40,000 jobs.

The Eximbank issue—which is central to America's position as world industrial power—is one of the budget items that tests the administration's ability to pursue an economic growth policy. America's allies "will laugh at us when we propose cutting back our subsidies like this," says a Senate aide lobbying for additional Eximbank appropriations. "We might be able to get somewhere if we bargain from a position of strength, but with this stuff in the air, there is no possibility of an agreement" on containing export subsidies. "No one will feel pressed to agree to control subsidies if we are cutting back Exim unilaterally."

The Senate aide continued, "What I really do not understand is where Reagan's California friends are in this. They are all people who built their companies through Exim—just look at Bechtel, and at Fluor, and so forth. . . . But these guys do not seem to be doing anything to influence this fight. It does not tie together this 'supply-side' stuff, either. What will happen is that all the feeder industries to the high-tech companies will go under—lots of machine tool workers and so forth."

In effect, Fed Chairman Volcker is demanding that the Treasury pay the cost of an additional $20 billion in interest charges on the federal debt—charges arising from Volcker's high interest rates—by chopping away the programs most conducive to improved American productivity!

EIR has argued (see Economic Survey, Dec. 10) that the content of the Volcker policy is not to cool inflation, which it has not and cannot, but to force the transformation of the American economy away from "smokestack industries" and toward an "information society." This is the content of the Carter administration's "Agenda '80s" report, produced by a panel chaired by Carter adviser Hedley Donovan. The institutions who have obtained virtual monopoly power over credit flows as a result of the Volcker monetary program, are using this power to enforce such a shift (see Corporate Strategy).

In the appended interview, First of Boston Chairman Hill sets forth a chilling program to reverse "the old Eisenhower program to pave the U.S. with highways, and have everyone build his own home and backyard." If the blackmail against the President succeeds, the Reagan administration will preside over not only a depression, but the dismantling of the institutions and programs that have made America a great and prosperous industrial power.

Threatening Reagan with catastrophe

An aide to Congressional Joint Economic Committee Chairman Henry Reuss (D-Wisc.) described how Reagan is being threatened with a financial crisis.

Q: Why has Volcker been able to say publicly that he will "lean against" the administration if they cut taxes?
A: If Reagan cuts taxes, it will gun the money supply and cause inflation. Then Volcker will jack up interest rates again. If this happens, we're in for a severe slump, and real trouble for the financial institutions.

But the administration can't pressure Volcker. If they do, he has put out word all over Capitol Hill that he's going to resign. Volcker will have no other choice. And if he resigns, this will crash the dollar, no doubt about it.

Richard Hill, chairman of the First National Bank of Boston, said the leading banks agree with Volcker.

Q: How do the major banks view the President's desire to have a tax cut and also lower interest rates?
A: Obviously, the desire of a politician like Reagan is to see rates drop, but Reagan can't take the risk. It's too inflationary. The tax cut will have to wait. Reagan should concentrate on cutting the budget.

Q: Have the banks and insurance companies made it clear to the President that any pressure on Volcker to ease ratos will hurt the markets?
A: Obviously, if we think inflation is going to continue, we'll continue to move our funds around, to move money out of the long-term bond markets and other long-term investments. Why should we lock up our money?

Q: I understand [Citibank chairman] Walter Wriston and the other top New York bankers met with Volcker and [New York Fed Chairman Anthony] Solomon to

work out voluntary lending restrictions.
A: Look, I just talked to Donald Platten [Chairman, Chemical Bank] Walter Wriston, and John McGillicuddy [chairman, Manufacturers Hanover] yesterday. The Fed would never tell them to cut back lending. We tell the Fed what we'd like to see. Inflation must fall.

Q: Have you told Volcker this? Or the President?
A: Volker knows this. He doesn't need to be told. And he has told it directly to the President himself, at the lunch they had last week. Furthermore, Treasury Secretary Donald Regan is no fool, he knows it. He's an investment banker, he knows how the money markets work. The fact that he's brought Beryl Sprinkel, an arch-monetarist, into the Treasury means he is prepared to see Volcker tighten further if need be.

Lacey Hunt, chief economist of Philadelphia's Fidelity Bank, emphasized the imminence of a dollar crisis if President Reagan insists on tax cuts.

Q: What are Reagan's options vis-à-vis Volcker?
A: Volcker is not a popular guy.... Reagan has no option with Volcker. There's a constitutional issue around the independence of the Fed.... Reagan can't afford to dissipate his energies in a constitutional crisis.

Q: What are Reagan's priorities, then?
A: You're not going to see any major foreign-policy initatives. The mandate for the administration is to bring down inflation, and reduce the budget deficit....

Q: But Reagan said that he wants to have tax cuts, not necessarily coupled with budget cuts.
A: If Reagan in his TV speech on the economy on the fifth [of February] tries to decouple tax cuts from the equally necessary budget cuts, it will be seen as highly inflationary. The dollar will start to fall the next morning.

Dr. Kenneth Wright, chief economist of the American Council on Life Insurance, noted that "international bankers" are also threatening a dollar crisis:

Q: Will Volcker have his way on tightening credit?
A: Our concern is the need to control inflation. Mr. Reagan must realize this. The administration can talk all it wants about tax cuts, and it will get bogged down in Congress for six months trying to get tax and budget cuts through. Meanwhile, Volcker will go his merry way and never swerve. He will lean on the money supply, and that's how policy will be.

Q: What power does Volcker have to do this?
A: Volcker's strength arises from his *constitutional invulnerability*. He can't be asked to step down. They can't touch him. They have no legal right.

Q: The law can be changed by Congress....
A: They'd never get a bill through Congress. And besides, Mr. Volcker's main political bulwark is, he's the man in the administration with the credibility with the international financial community. If he's criticized or chastised or asked to step down, the international financial community would see this as a real blow to the credibility of the U.S.'s ability to control inflation. This would cost the dollar tremendous prestige. It would cause a run against our currency.

Robert Synch, economist of Bear Stearns investment bank, described "linkage":

Q: During the campaign, President Reagan often attacked high interest rates. Who is encouraging Reagan now to support Volcker?
A: Well, you know that Lawrence Kudlow [Bear Stearns chief economist] has been appointed as OMB Director Stockman's top aide this morning. I think that Stockman, especially with Larry as his assistant and Beryl Sprinkel as the undersecretary of the treasury, are organizing support for Volcker. I think you will see more support for Volcker inside the Reagan administration than at any time within the last twenty years for a Fed chairman.

Q: Who outside the administration is responsible for Reagan going in this direction?
A: Sprinkel is a confirmed monetarist who used to be a member of the Shadow Open Market Committee. Milton Friedman got him his job.

Q: How did Friedman do this? He's not on very close personal terms with Reagan.
A: People who support Friedman around Reagan got Reagan to consult with Friedman. The appointment was then worked out. Donald Regan definitely did not make this appointment or have much say in the matter, although he was consulted.

Q: I understand Stockman had a meeting this weekend.
A: Yes, Larry briefed Bear Stearns about it this morning. At the meeting it was agreed that Volcker has to control the monetary aggregates. They worked out a strategy that tax cuts would be presented as part of a unified plan. You cannot have tax cuts without budget cuts, and you cannot have budget cuts without monetary control, so it was agreed that there will be no tax cuts unless there is support for tight monetary control.

Q: Do you foresee the economy turning down?
A: Not yet. Volcker is going to be put under a test.

During the first six weeks of the quarter, he had it relatively easy. Borrowing eased off, and the Treasury floated $14 billion in new cash issues. In the second six weeks of the first quarter, Volcker is going to have to be tough. There will be $21 billion in new Treasury cash issues in those six weeks. Volcker has to show that he will not ease off like he did last summer. If he holds firm, then the economy will turn down.

Q: It appears that over the last seven weeks, Volcker has followed a policy of managing reserves.
A: Yes, he has. Now he has to show he will stick to it.

Richard D. Hill, chairman of the First National Bank of Boston, has organized a conference in that city Feb. 9 to publicize the Heritage Foundation's urban free enterprise zones. Mr. Hill, in an interview provided by journalistic sources, explains that he seeks to "shift the urban economy" from heavy industry to light manufacturing using the zones as a catalyst. Central, he says, will be use of the zones to remove the minimum wage, Davis-Bacon regulations, and large sections of social security, unemployment, and other transfer payments which he claims to be the "root cause of American inflation."

Q: Do you see enterprise zones as helping to shift and renovate the urban economy?
A: Yes, the American economy is out of whack, largely because of the way our cities have put it out of whack. The cause of the cities' problems is the old Eisenhower program to pave the U.S. with highways, and have every man build his own home and backyard, which created the suburbs and urban sprawl. This was aggravated by deliberate government policy, policy to build the highways, policy to have the Federal Housing Authority give cheap mortgages. This created the homebuilding industry, created the auto industry—which created the steel industry. This sprawl was a misallocation of resources.

Added to this were other government policies which built inflation into the industrial system, just as this urban sprawl built inflation into the system. We allowed wages to rise, we sanctioned unlimited cost of living adjustments in labor contracts, we built a huge federal transfer-payments system guaranteeing social security, unemployment insurance, minimum wages, all of which kept people where they were. It also inflated us right out of the ability to even make automobiles or steel and compete internationally, added to the cost. We have got to reduce this social cost.

The only way to reverse this trend is free enterprise, we must remove these government interferences. This is the purpose of the free enterprise zones, to do this to encourage manufactures to locate in the cities again. This means we have to do away with harmful manufacturing taxes, kill the Davis-Bacon Act, remove the minimum wage as much as possible, reduce unemployment compensation and social security, and unemployment and social security payments by business. Of course this is politically very unpopular. The idea of the enterprise zone is that you can do it in the six experimentally designated cities, and experiment with the nation's labor laws, without changing the law of the land. Then people will see this is the only way to rebuild the cities.

Q: Would you put money into the same traditional heavy industry in these zones?
A: No, those industries are overinflated. They will still exist, but they must be greatly scaled back. We need to set the example for them in the enterprise zones. These industries need a lot more discipline in wages and federal social payments. The cost of living adjustments must go, they are the worst thing that ever happened to the U.S., a disaster. And those heavy industrial companies who are surviving know that they have to scale back. U.S. Steel is becoming profitable again, by closing off all its unproductive facilities. Auto must do the same, trim the fat. GM, Ford, they will retool, and bring in highly mechanized robot assembly. They will shrink, and have a much smaller work force.

We want to reverse the flow out of the cities, of people working in such industries, and back into the cities, by setting up those industries appropriate to the inner city, primarily light manufacturing, and especially light assembly. For example, Wang Laboratories is moving right into the "combat zone," the red light district, here in downtown Boston on lower Washington Street. They'll be doing primarily light assembly of computer components, which won't require a force. They'll open a training school and train local residents, the Chinese, the blacks who live in the area. We're working with Wang on this, and also Digital, and Teladyne, whose chairman I saw last night. IBM is interested. We're also having small businessmen up here tomorrow to encourage them.

Q: So the size of the cities will have to shrink?
A: We've moved all the economically viable people out, and populated cities with the economically unviable. We need a shift in resources to allow us to employ those here.

Q: Do you believe there is a population problem, and what should we do about it?
A: The economically viable are already in zero population growth. The population problem is with the economically unviable, that population must stop growing.

Q: Do you agree with the McGill Commission, the President's Commission on the 1980s, there?
A: Yes, although people misunderstand it. The McGill

report doesn't say "move people out, down South." It says, just don't keep them anywhere artificially with government encouragement. We have to stop these government incentives to stay in unviable places. We must not do anything to stop unemployment in these industries. Just stop the cost of living allowances, stop the OSHA rules, stop the unemployment costs, stop Davis-Bacon, stop the minimum wage. Experiment. See if by removing barriers, you get people out of those industries and areas and into new areas. People will have to move. This is how to deal with the population problem among the economically unviable. Cities will be greatly scaled back, there will be fewer people.

Q: What is the role of the institutional investors, banks and insurance companies?
A: We will play our traditional role. We will finance the property development. We'll make the real estate loans, just as we used to do in the suburbs. Take that Wang factory. They've bought a rundown inner-city building which must be completely rehabilitated. We helped put together a consortium of local community real-estate developers, and we gave the consortium a first-construction mortgage on the building, backed by the Massachusetts [State] Land Bank, and by the federal Economic Development Administration [Commerce]. Wang will lease the building from the consortium, and we'll have the mortgage, and since the project will be economically viable, we'll be able to buy their industrial revenue bonds, too. Then it becomes a viable commercial property.

Q: Will this help raise real-estate values in the area?
A: That's the idea. It will encourage real-estate values to rise. Then we can get the present tenants to move out, and business will come in, restaurants will start up. New England Medical Center has plans to build there, Tufts Medical Center may build. Values in the area will rise.

Q: How do the AFL-CIO and other unions react?
A: Publicly, of course, they are very much against it.

Q: Don't they know they need these jobs?
A: Yes, they know very well they do, and I've met with these union leaders in Washington and they understand it, and they are behind the concept, privately. But it's a very sensitive issue.

Q: You've met with Lane Kirkland on this?
A: Well, I can't be specific as to names. But I've met, as I say, with union leaders. Especially those in New York, they understand the situation well.

Q: You're referring to Victor Gotbaum of AFSCME?
A: Well, as I said, I can't give specific names.

Institutional investors force industrial shift

by Kathy Burdman

"Prudential, Equitable, and other insurance companies seek to redirect the major capital flows in the economy, and change the whole organization of production over the next decade," Stanley Karson, director of the Clearinghouse on Corporate Social Responsibility, told a journalist. The Clearinghouse is the "political arm" of the American Council on Life Insurance. The chief executives of the insurance industry who make up the Clearinghouse board believe that "dying industries like auto and steel" are no longer a "good investment" for the large institutional investor, Karson stated.

"The major institutional investors, led by insurance, are engaged in a tremendous reallocation of resources away from the smokestack industries," George Needham of the First Boston Corporation corporate finance group told *EIR*. "The U.S. no longer has a competitive advantage in steel, paying $20 an hour for labor. The 25-year steel and auto bonds bought by an insurance company ten years ago for 6 percent interest today are worth 60 cents on the dollar. "Where future money will be made, where tremendous profits are growing, is in the computer, microchip, electronic, and related service industries," Needham said.

The institutional investors have a "short- and long-term strategy" of moving some $150 billion in financial assets out of "smokestack" industry bonds and stocks and into the new industries, Mr. Karson stated.

"If you polled our board members," such as Robert Bates, Prudential chairman, Kenneth Austin, Equitable chairman, and John Filer, Aetna chairman, "you will find them in near unanimous agreement on moving America into the 'postindustrial society,' " Karson said.

Manufacturing is out

This is the context for the mass reorganizations of the "information-age" companies, led by the mysterious shakeup this week at RCA. RCA Chairman Edgar Griffiths, after having dramatically improved the company's profit picture since taking over in 1979, was summarily dumped by three RCA directors, Donald Smiley, ex-chief of R. H. Macy; Peter Peterson, chair-