Who will determine Reagan's Phase Two?

by Kathy Burdman

The autumn political collapse of President Reagan's economic program, informed observers believe, could force the administration into attempting credit controls of the deflationary magnitude imposed by Jimmy Carter in March 1980. Wall Street analysts are warning that the Dow Jones Industrial Average is set to plunge beneath the strategic 840 mark, forcing a call-in of margin loans that could bring the house down.

At the same time, Congress, just back from nose-to-nose sessions with enraged constituencies during the summer recess, is balking at the next round of the Reagan program, specifically, the demand for an additional $30 billion in budget cuts for fiscal 1982, beginning Oct. 1. Congress, our best sources say, is in no mood to further estrange the voters. Even those closest to Federal Reserve Chairman Paul Volcker, who with the Swiss-based Bank for International Settlements have most loudly demanded a new round of U.S. budget-gouging, are fearful that that particular game is up.

"Reagan may simply not be able to get the level of cuts that Volcker wants," one Fed official told *EIR*. "If you think the financial markets are voting against Reagan with their feet now, wait until it becomes clear that Congress won't act to prevent the budget deficit from ballooning out of control." Congress, the Fed official told *EIR*, may be getting ready to "throw the blame directly on the Federal Reserve."

Already, addressing the Senate Budget Committee, Senate Majority Leader Howard Baker announced Sept. 9 that Volcker's high interest-rate policy, and not the budget, is the nation's number-one problem, and could cost the Republicans the chance to win control of the House in the 1982 congressional elections. "I'm saying those rates have to come down now," Baker stated, "I'm saying they're doing drastic damage to the economy of the nation, to individual citizens, and to the *government of the United States*" (see National).

Blame, however, does not make a policy, and there has been none enunciated by either the Congress or the White House which could solve this impasse. Rather, it is the hated March 1980 Jimmy Carter policy of credit controls which has surfaced the second week in September for public discussion.

Speaking to reporters after his Sept. 9 denunciation of interest rates, Howard Baker went so far as to threaten Wall Street with the imposition of credit controls and a tax on interest-rate profits, the first such statement made by a leading Republican figure since the Nixon administration. The Majority Leader was seconded by House Republican Minority Leader Robert H. Michel. Reached for comment, Baker's and Michel's aides hastened to add that the Republicans are not pushing for controls, but are desperate that something be done to lower interest rates. "We don't have any concrete policy for controls," Senator Baker's office told *EIR*. "We're just trying to point out that something must be done. We don't know what."

That is precisely the problem. The nation now has no coherent budget policy, not even a bad one, and the White House continues to ignore the rising demand in Congress for a halt to the Volcker interest-rate policy. Indeed, the official White House line is still full support for Volcker's credit squeeze and for the unconstitutional "independence of the Federal Reserve."

In this vacuum, the Volcker Fed has announced that it will continue to lean as hard as possible on credit to the economy. If Congress won't make the cuts, "then we follow through on Volcker's public promise to tighten further," one Fed official said, in an interview printed below. Baker's call for credit controls is "not serious," he said, but simply reflects congressional panic about interest rates. "These guys are desperate," he said, "they've just been beaten up by their constituents."

Congress, he added, can be safely "ignored," however, unless it is ready to move for actual legislation restraining the Fed's hand—something the Fed is betting they still lack the nerve to do.

Given this free hand, Fed officials said, Volcker intends on the one hand to continue running the productive economy into the ground with higher rates, and to "print money" to bail out failing savings and loans and whatever other financial institutions go under water "in order to prevent a financial collapse."

This is a recipe for rapid inflation and dollar crises of precisely the sort which will force the Reagan administration toward credit controls whether they like it or not. Although the Fed is loudly protesting that it opposes controls, *EIR* believes that Volcker will be perfectly willing to go that route a second time if he can do it over Ronald Reagan's dead political body.

That is also the analysis of Dr. James J. O'Leary, chief economist of the elite New York-based U.S. Trust Company and leading member of the Ditchley Foundation, the Anglo-American brain trust whose board features former Carter Secretary of State Cyrus Vance and Paul Volcker himself. Dr. O'Leary told *EIR*'s Richard Freeman Sept. 10 that the administration is being forced to "question its fundamental strategy" by the reality principle in the credit markets, where corporations face a "lack of availability of money," plain and simple. "Reagan is in the same situation that Carter was in in March 1980," Dr. O'Leary correctly noted. The Republicans face a fall 1982 election, he said, and Reagan "has to do something to get the economy under control."

Controls, as our Fed sources were quick to point out, will work no better than they did for Richard Nixon, however, and will only result in an eventual replay of the 1971 debacle for the U.S. dollar. But so far the administration has come up with nothing better.

Alternate routes to deflation

A move to credit controls, as Monte Gordon, director of research for the Dreyfus Corporation, told *EIR* this week, "would collapse the U.S. GNP by 10 percent" within weeks, as it did last year. Meanwhile, several spokesmen for the European oligarchical families who back the Bank for International Settlements and the Volcker Fed also began to put out the word this week that the United States is in for a major deflation.

Echoing predictions first made by *EIR* a full year ago, the prestigious Canadian journal *International Bank Credit Analyst* in its September issue predicts that a blowout in the U.S. budget deficit and continued tightening by the Fed will lead to a world currency collapse and an incipient international banking crisis. In "The Possibility of a Fall Currency Crisis," author Richard Coghlan argues that continued Fed tightening will lead to a sharp rise in the dollar over the short term which "would create intolerable pressures on the other major currencies and precipitate a crisis of confidence."

Mr. Coghlan told *EIR* that such a crisis could cause crashing defaults in Third World debt and bankruptcies among major European and U.S. commercial banks. If this occurs, he predicts, the International Monetary Fund will step into Third World countries and demand major cutbacks in world trade, throwing the United States into an export collapse and deep depression.

Others predict that the Reagan administration will be forced to move to a highly deflationary gold reserve standard to avoid the credit-controls route, which would have the same effect on the economy. Meeting in Italy, the elite Siena Group of gold-oriented economists dominated by the central bank of Italy predicted that continuation of the Volcker policy will eventually lead, as Fed officials predicted, to a vast overprinting of dollars relative to tangible-goods production in the United States, which would force Reagan to move to gold to save his political neck (see Gold). They called strongly for Reagan to phase out the "paper dollar" standard altogether and move to a harsh 19th-century-style gold-coin standard.

Strictly speaking, there is no contradiction between the *Bank Credit Analyst*'s predictions and those at Siena. In the course of trying to print money to handle the Canadian scenario, the Reagan administration could easily be forced into the Italian one.

A voice of reason

The bathetic quality of American policy-making was not lost on West German Chancellor Helmut Schmidt, who delivered a major denunciation of the Reagan and Volcker policy in a public statement this week.

Describing the Reagan combination of high interest rates and austerity against social programs and industry as "ruinous," Schmidt told the *Rhein-Neckar Zeitung* Sept. 8 that "not in a dream would I think of trying such a policy here. . . . If this high American interest-rate floor continues, then no economy can endure it." Schmidt predicted that the Reagan administration and Volcker will drag America's European allies into economic collapse and political chaos unless they change course.

Schmidt stated that he will not repeat policies such as those of German Chancellor Heinrich Brüning, who paved the way for Adolf Hitler. It was the first time since the war that a German leader had warned of fascism flowing from incompetent economic policy.

Interviews

The Fed and U.S. Trust outline some possibilities

From a Sept. 10 interview by EIR*'s Richard Freeman with Dr. James O'Leary, chief economist of United States Trust Bank in New York:*

Freeman: Dr. O'Leary, what are the chances of credit controls being applied?

O'Leary: I do not find it surprising that Senate Majority Leader Baker is talking about credit controls. The administration has to be questioning its fundamental strategy. If it finds that its strategy is not working, I think that we will soon—within a month or two—see a move toward credit controls or gold.

Freeman: Why is this?

O'Leary: There is a lack of availability of money to business in the long term. Corporations lack the availability of bond issuance. Between March and August, bank commerce and industry loans have grown by 23 percent. Corporations are going to banks to keep themselves with some funds; but they have to be able to fund these debts longterm—and they can't.

Freeman: So there is a liquidity problem?

O'Leary: Yes, and the budget deficit is too large. Stockman is right; we have to make very large cuts in the budget.

Freeman: You say credit controls may be needed, but after they were applied in March 1980, they collapsed production, and then, soon after, interest rates started going right back up to the 20 percent range.

O'Leary: Yes, that's quite true. So the solution is that instead of what happened in March 1980, when controls were held for only a month, controls would have to be applied longer, limiting new loans to business to an increase of 5 percent over a base rate, and then after a while increasing that level of new loans, but keep the controls on.

Freeman: Will Reagan go in this direction?

O'Leary: Reagan is in the same situation that Carter was in March 1980, Carter had a fall election coming up and had to do something about the economy; Reagan faces a situation in which Republicans are going to have to be campaigning in June for the fall, and has to do something to get the economy under control, especially if his program is not working.

EIR *interviewed a senior Federal Reserve official on Sept. 10 who preferred not to be identified:*

EIR: How do you feel about the Republican call for credit controls?

A: It's fantastic, I can't believe this administration would want anything to do with credit controls. I assume that the administration is talking through Congress, through the Republican leadership, and that this is not a serious call for credit controls, but an attempt to talk down interest rates. Congress has just been back to the districts, and they're getting really worried.

The problem for them is that neither the administration nor the Congress has much credibility left. Credibility is the heart of it, and if the administration reverses itself from its extreme free market stance and moves to controls, which it said it would never do, then they're dead on credibility level, just simply dead. Their credibility at that point drops as low as Jimmy Carter's ever was.

EIR: But wouldn't you really like to have controls?

A: No, they certainly didn't work last time. They only repressed inflation, they didn't wipe it out. That's what I meant about Carter, he forced us into it screaming.

EIR: You mean you wouldn't support the administration on controls?

A: Only if forced, but the markets will never support it. No one believes you can really get credit demand down with controls. Sure, you can have a short-term drop in credit demand and activity, and short-term instruments might look good, but anyone sitting there holding long-term government and industrial bonds will know that the thing is doomed to fail and fall apart within months. People will dump long-term instruments dramatically. The administration's credibility in the financial markets will be dramatically reduced, and it's crappy now.

EIR: So you don't take the Republicans seriously?

A: No. The only thing I can see them trying to do is to talk, to bludgeon Wall Street into buying some Treasury bills a little cheaper than they've been willing to do.

From a Sept. 10 discussion with the Federal Reserve's Congressional Liaison Office in Washington, provided to EIR:

Q: What's your reaction to Congressional calls for credit controls?

A: All this reflects is the rising concern on the Hill about interest rates; these guys have caught hell from their voters during recess, and they're looking for a scapegoat. We're it. We've seen all sorts of crazy-ass legislation in an attempt to force interest rates down artificially. We're throwing all the cold water we can on any talk of credit controls. We don't take them seriously on that. Anyway, we've never heard anything from the White House on credit controls, and I can't believe that Baker would move against Reagan.

Q: But this is the Senate Majority Leader. . . .
A: I still don't take him seriously. These guys are desperate, they pop off, they make any statement to get press; they've just been beaten up by their constituents . . . and they're desperate to look like they're doing something. But there is no evidence they're sincere—no legislation.

Q: What about the Melcher resolution on interest rates?
A: Same thing—it's just a resolution, no force of law. It can be ignored. It means nothing, and will be ignored.

Q: So far Congress has had to swallow your interest rates. But does this mean they won't take the budget cuts?
A: Look, we've said that the only way we will put rates down is if they take those budget cuts. And the Congress doesn't like it. Right now, the only way the administration can get any cuts out of this Congress will be if they take half the cuts out of the defense budget. If Reagan wants to cut $30 billion in fiscal 1982, and he has to, then he will have to look to defense for half of that, $15 billion, or a third minimum, at least $10 billion. He can't go back to the social programs and bleed them, he'd loose even the Republicans. His program is rotting.

Right now I hope that Stockman has won cuts in the military budget, which will allow cuts to go through. It will upset the national security lobby, but I think Reagan is popular enough to pull it off.

Q: But if Congress won't take the cuts? Then what?
A: Then we follow through on Volcker's promise to tighten.

Q: Are you ready to bail out all the bankrupt S&Ls? You are going to have quite a bit of inflation then.
A: The Fed is the lender of the last resort. The last thing we want is for the S&Ls to go belly up. If the time comes, the money will be found, and you know as well as I that there is not enough in the Federal Savings Deposit Insurance funds. Whatever money that would be necessary to stop a financial collapse would be found.

Q: Found?
A: I think more money than the insurance funds would be found.

Q: Found?
A: Printed, found, spent as a deficit, whatever necessary.

Interview

Why Schmidt rejects U.S. economic policy

On the eve of U.S. Secretary of State Alexander Haig's arrival in West Germany, Chancellor Helmut Schmidt has delivered a sharp attack against the "ruinous" economic policies of the Reagan administration. "Not even in a dream would I think of trying such a policy here," he said, in an interview with the Rhein-Neckar Zeitung *(RNZ) published Sept. 8. Schmidt reiterated his often-repeated warning of recent months against an austerity policy like that of Heinrich Brüning, the German chancellor of the early 1930s who paved the way for Adolf Hitler.*

Asked about the likely outcome of the current controversy in West Germany over the federal budget for 1982, Schmidt responded:

Schmidt: I will have to place this question in a broader context: how the economic situation of our country develops over the next 6 or 12 months is to a much greater extent dependent on how the world economy and the European economy develop. When the discount rate in America remains over 20 percent, and when the American finance minister himself has to take out 10-year loans at a fixed 15 percent interest rate, when this gigantic American economy—225 million people—continues to make the mistake of creating and maintaining economic conditions in which the interest rates of the whole world for normal credit customers are raised to over 20 percent—then less strong economies are forced to keep their own interest rates even higher in order to get their share of the pie of international liquidity. In other words: if someone sitting in an OPEC country with a financial surplus to manage can get over 20 percent in New York, then Paris has to offer him more, and Rome or Milan even more. Therefore the interest-rate floor in France or Italy is over 20 percent. The fact that our businesses are still attracting investors at interest rates of 15-16 percent is a sign of how great the trust of the international credit markets in the German economy is.

We still receive money from abroad—for example from Saudi Arabia—otherwise we would not be able to finance our balance-of-payments deficit. They invest a large portion of their money as credit to us although our interest rates are under 20 percent. But if this high