The implications of a U.S. business collapse

by David Goldman, Economics Editor

Off the record, administration economists now believe the present industrial collapse will be substantially worse than that of 1974-75, i.e. the worst since the 1930-31 breakdown—a particularly striking conclusion, since the economy only functioned at the best levels of 1978 during the peak of the false recovery earlier this year. With auto production levels the worst in 20 years, housing starts the worst in 15 years, and unemployment certain to exceed the post-war record of 9 percent during the month of November, it is clearly time to say that the American economy is now in a depression.

The global consequences of this fact, and the reverberations of the global effects back into the United States, are the subject of frantic discussion at the Federal Reserve, the Bank of England, and the "mother" of the industrial nations' central banks, the Basel-based Bank for International Settlements. Morgan Guaranty Trust chief economist Rimmer de Vries, the dean of Wall Street international economists, had already warned in a Nov. 16 discussion with *New York Times* columnist Leonard Silk that a sharp and prolonged industrial downturn in the West could lead to a "world depression"; such a conclusion first appeared from such sources in the text of the Bank for International Settlements' 1981 Annual Report released this June, in which the bank's chairman, Jelle Zijlstra, warned that national governments' failure to reduce their budget deficits meant an economic decline "like that of the inter-war years" 1929-39. Since the budget deficits were the direct or indirect results of the Federal Reserve monetary tack approved by the Bank for International Settlements, the predictive quality of the June statement is striking.

At their last meeting at the beginning of November, the central bankers who attend BIS monthly conclaves told the press that—contrary to the enthusiasm of the bond market during the past month—the present drop in U.S. interests rates was illusory, and that rates would go up again. Whether the bond market's Nov. 17-18 stall, following a single day's sale of $1 billion in corporate bonds and the announcement of $2.25 billion of new issues reflects the end of a rally that brought long-term bond prices up over 13 points is not so much the question; the point is that the debt-refinancing requirements of households, corporations, state and local governments, the federal government, and large international borrowers represent an extraordinary continuing source of credit demand. Until major corporate bankruptcies, and a few major international bankruptcies, work their way through the system, there is no real prospect for a sustained drop in interest rates—short of a dramatic policy turn at the White House.

'We'll call a five-minute recess'

According to a senior economic adviser to the IMF, "The real fear isn't that the developing countries can't go on borrowing," which the U.S. Treasury had made a public spectacle about at the IMF affair. "The fear is—and this is what [Morgan bank's] Rimmer de Vries is talking about—is that if there is a replay of 1974-75, or, more accurately, 1928 to 1929—these countries' deficits will open right up, and the system will be unfinanceable. The question is, what type of threat is there to the system: if it were a matter of an error at one or two banks, or a problem of one or two countries, then the central banks could handle it through regulatory policy," that is, by cutting back lending, or rescheduling debts, or bailing out banks. "There are already some effects of tighter regulation, such as more prudent lending to banks from countries where the regulatory regime is thought not to be good. But that doesn't deal with a major recession on the 1928 or 1929 scale. In this situation both the terms of trade and the ratio of these countries' exports to debt service deteriorates like mad.

"There is perhaps more thinking at the staff level of the Bank of England and the Bank for International Settlements on the 'lender of last resort' function than most people think," the IMF adviser said, "but not nearly as much thinking as needs to be done. In this sort of situation it is impossible to anticipate every crisis. You have to wait until it strikes, and then ask for a five-minute recess. I repeat, you cannot anticipate a crisis. It is a very distressing situation."

In economic terms, the problem is no different from what we have discussed for some months (see *EIR*, Aug. 12, 1981): with a debt-service bill in excess of $100 billion at current interest rates and total debt of over $600 billion, the developing nations face a current-account deficit in the range of $100 billion (trade deficit plus interest on debt plus services deficit). To manage their debt-service requirements, most of the major debtors, Brazil, Korea, Argentina, Turkey, the Philippines, and so forth, have drastically increased their exports. To shovel out these exports they have had also to increase their imports of raw materials, fuel, and so on. A collapse of their markets (the United States, as President Reagan told the IMF audience, imports 40 percent of the developing nations' total non-oil exports) means a collapse of exports both in price terms (because much of their exports are price-volatile raw materials) and in volume, and hence a collapse of their ability to service their debts. The banks will be in real trouble.

This coincides with a situation in which the Chryslers, International Harvesters, and Pan Ams are not expected to make it through the winter, and where American Airlines and Eastern Airlines are respectively demanding of their employees a pay reduction and a pay freeze. That the corporate liquidity situation is worse than that of 1931 we emphasized in the last issue. More significant in the present case is that the Fed supported by such congressional allies as Joint Economic Committee co-chairman Henry Reuss, is determined to have a bitter enough depression to destroy the American labor movement. In other words, the Federal Reserve, which "knew we were engineering a recession when we adopted the present monetary policy," as a staff economist put it, wants to use the threat of bankruptcy hanging over the early 1982 round of wage negotiations to ensure that the reduction in real incomes is steeper than the 1.6 percent drop of 1980 and the 4.5 percent drop for 1981 (for a family of four) over the coming several years. Reuss's advisers believe that the crushing impact of the next several months' industrial downturn will obviate any need for controls over wages, prices or credit, because the threat of unemployment will be sufficient to bring down wage demands.

"If we perceive that the present policy is leading toward a depression like that of the 1930s," said a Fed economist Nov. 18, "we will raise the aggregates target for money supply growth. The President won't have any problem persuading us of that." There is no need to take such statements seriously; the notion that in the midst of a collapse of debtor-creditor confidence the Federal Reserve might regenerate additional lending to the real economy through simple open-market operations derives from Milton Friedman's fraudulent argument that the Federal Reserve caused the 1931 collapse by withdrawing money from the banking system. In fact, no central bank is capable of reversing a panic of this sort through conventional methods.

The current thinking of the White House—according to sources in close touch with the President—centers on how to get rid of Fed Chairman Volcker. A few White House leaks toward this point have come out in the last week, e.g. a Nov. 17 *New York Post* story accusing Volcker and his associates of being "Carter plants" out to "ruin the President" through recession. (One senior Fed staffer responded, in all seriousness, "If the truth were told, we were responsible for the election defeat of Jimmy Carter. The Fed is evenhandedly destructive of the political careers of American Presidents.")

For the first time, a proposal for a pro-industry, directed-credit, two-tier solution to the interest-rate holocaust is getting at least serious study from the White House, sparked by receipt of a plan by the National Association of Homebuilders to issue direct cheap credit to homebuilding and other basic industry. But Federal Reserve officials scoff at the idea that the President could stop his ears to the noise of "20 chief economic advisers and no economic policy," and take on the central bank, now the most powerful institution in the United States. One says. "By the 1982 congressional elections, Paul Volcker will be the only point of stability in this administration."

Whether Mr. Reagan can maneuver through the present crisis is a matter of the capacity of a man with limited understanding of the nature of the crisis to learn on the job very, very quickly. His effort to examine the gold issue seriously represented a good instinct, but will likely founder on the recalcitrance and sabotage of his Gold Commission. The one thing that is certain is that the January timetable the President has set for economic policy re-examination represents the last chance this generation has to avoid the Great Depression their parents endured.

Reuss aide predicts a 'donnybrook' in the federal budgetary process

Joint Economic Committee Chairman Henry Reuss (D-Wis.) expects a confrontation with the White House and blowup of the budget process Nov. 20 over the budget-appropriations continuing resolution, JEC staff chief Jamie Galbraith told financial sources Nov. 16 who provided the following interview to EIR.

Q: Reuss expects a blowout of the Reagan economic program to lead to a victory for Fed Chairman Paul Volcker's strategy of busting the American labor movement. Do you think that such a blowout might force the President to impose Nixon-style "Phase II" controls? That's what Herb Stein predicted in yesterday's *Baltimore Sun.*

A: Wage-price controls will not be necessary. The recession will be deep enough and long enough for the administration to get what they want out of all the myriad wage negotiations coming up next year. These unions, starting with the Teamsters and the UAW, are going to be coming into negotiations with 9½ or 10 percent unemployment, and their wage demands are going to be correspondingly mild—particularly with the financial conditions most of their industries are in. Do you think the Teamsters want to bankrupt 20 percent of their employers? Does the UAW want the Chrysler loan guarantee withdrawn, or the banks' loans to Ford?

This kind of recession is the deliberate strategy of the administration, a strategy to carry out Volcker's prescription of reducing the costs of wage inflation. The administration, led by Donald Regan, is carrying this out.

Q: What is Reuss's long-term scenario for the economy?

A: Look, forget long-term, you should be really worried about the short term. We're about to have a donnybrook over the continuing resolution which could shut down the government. If you have any elderly relatives living on government paychecks, you better figure out how to feed them next month.

Ronald Reagan is taking the nuclear-cowboy approach to the budget resolution. Apparently, under the advice of Donald Regan, he met with the Republican congressional leadership last Thursday [Nov. 12], just before taking Stockman to the woodshed for lunch, and the Republican Congressmen told the President they just can't get one more cent of budget cuts through. No matter what they do, they told him, the Senate and House Appropriations Committees will act by Nov. 20 to pass a continuing resolution on the budget which will continue the fiscal 1981 levels through at least March 30, 1982, and likely through Sept. 30. That is, Congress wants no more budget cuts for fiscal '82 over '81.

Reagan now intends to veto such a continuing resolution, which means the lights go off on Capitol Hill after Nov. 20. We expect a donnybrook. The President was totally unsympathetic to the Republican leadership, and we think he's going for a blowup. If he vetoes the resolution, his agents in Congress led by Phil Gramm [D-Tex.] will then propose an alternate resolution cutting the budget 6 percent or 12 percent across the board. But that would amount to administration fiat, to a stifling of the budget-appropriation process. The Appropriations Committees will never agree to this, they'll say it destroys the appropriations process. Then the lights go out.

Q: But, why—just when he has the Haig, and Allen, and Stockman affairs—why would Reagan seek a blowout now with Congress?

A: It's called the "Masada complex." Some of his advisers think he can get away with it—mainly Donald Regan.

This administration is going into the Thatcher syndrome. They're just going to force major slashing of the budget, just set their jaws and cut more and more, and either they will have to raise taxes, or the states and cities will have to raise revenue to make up the difference.

Q: What will happen, then?

A: Well, Congress can't override Reagan's veto, they're just trying to fake him out. Congress is not in the driver's seat. Reagan has gone back on all the deals he made with the Midwest Republicans in August, and is now asking for additional 12 percent cuts in the programs he promised them he would not touch. He's committed to confrontation.

The impact of the Stockman affair is it undermines Reagan's credibility, and forces him to confront the

Congress and vindicate his program. This confrontation is designed to force through policies that would not otherwise go through—including the Federal Reserve's tight-money policy.

Money will be kept tight, and there will be a huge recession—a deep depression, you could call it. Sure, there will still be a huge budget deficit, because the kinds of things they are going to cut will not help balance the budget, but only create more spending in other areas. So the deficit will have to be financed, and that means that the government will take up the credit in the markets.

Interest rates will be kept under control under these conditions simply by the fact that the recession will simply cut out a corresponding amount of credit demand from the private sector. I'd advise you to get a job in the public sector. The private sector will be out of work. Chrysler will go under, because they have to show they're viable to get the rest of the loan guarantee, and can they? Even if they do, there's only $300 million left in the kitty, and do you know how fast Chrysler can eat that up? International Harvester is going under, there will be other corporations. Then the cities will start to go under—that could be interesting. It's going to be a long, hard recession.

IMF: Reagan is too soft on budget cuts

The following interview with Brian Stuart, Deputy Director, North American Division of the International Monetary Fund, was provided to EIR *by a journalist.*

Q: Would you endorse David Stockman's criticism of the failure to get U.S. budget deficit under control?
A: Yes, to the extent people sit down and read Mr. Stockman's *Atlantic Monthly* article, that will be educational for the President.

Q: The President? But I thought the President wants to cut the budget, and the problem is Congress won't do it.
A: No, I would say the President has needed an added incentive to cut the budget. Reagan has been complaining that Congress is balking on cuts, but in fact he has not submitted serious enough cut proposals himself. He has submitted none of the specifics on his Sept. 24 proposals, and Congress is still waiting for direction. He's sat back.

Reagan is only demanding an $8.4 billion cut for fiscal 1982. When he says he now wants a 12 percent cut over the August authorizations, that means a 12 percent cut in discretionary spending, which comes out to $8.4 billion. But he also proposed an additional $2 billion on defense, $2.6 billion on entitlements, and a $3 billion tax increase—that is, another $7.6 billion. None of these have ever been clarified, and as far as we can see, most of them, especially the tax increase, have been dropped until January. Calling for 12 percent cuts in a copout. We agree with the Wharton econometric model's estimate of a 1982 deficit of over $90 billion. Cutting $8.4 billion is significant, but it still leaves an $82 billion hole.

Reagan will, of course, veto the congressional resolutions, and then they will have to give him his 12 percent cuts for the government to say open. But that is simply not enough. Just because the President gets one veto, that doesn't mean he's won the battle. He still has to go back in January and demand more appropriation cuts for the '82 budget when they present the '83 budget. They should try for at least $20 billion.

Q: But with these budget deficits, don't you expect a financial-market panic?
A: That depends on how much the economy weakens. We can have as big a deficit as Reagan likes, if the economy weakens enough. If there is little private-sector corporate borrowing, if the deficit is only rising because the economy is weakening, then it just means that the government borrows what the private sector will not, and interest rates stay the same.

Q: You mean you would allow for what Nixon's OMB Director George Shultz called a "full-employment deficit"?
A: Why not, as long as we have a long, deep recession?
Q: Just how weak will the economy be?
A: Well, it's dropping pretty rapidly, that is ensured by the Federal Reserve's tight monetary policy. This takes the pressure off the Federal Reserve, which must continue with tight money as long as there are major budget deficits.

Our forecasts have been the most accurate, because they are based on [Fed] monetary targets—and our forecasts show the economy dropping pretty rapidly. We knew those targets were not going to change and, indeed, they haven't changed. The Federal Reserve has enforced a very low rate of growth, I'd say negative 4 percent in real terms for the fourth quarter of 1981. And if you assume 1981 is very bad, then our projections hold for 1982. We projected a 1 percent or negligible rise in real GNP for the fourth-quarter 1982 versus fourth-quarter 1981. If the latter is negative 4, then 1982 as a whole is going to be negative. Wharton is still saying 1982 will be plus 0.5 percent, but we think they'll have to revise that.