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Which way will Washington panic?

by David Goldman

Washington's supposed policy-debate over whether to support the dollar by crashing the U.S. economy, or crashing the dollar by supporting the U.S. economy, fell to pieces on April 29, when the nation's largest securities firm, Merrill Lynch, put more pressing issues on the agenda: it announced a $250 million loss for the preceding trading week, due to crashing mortgage-bond prices. Bond prices responded by crashing more than 2%, wiping out gains registered earlier in the week, when traders covered short positions in the off-chance that visiting Prime Minister Yasuhiro Nakasone of Japan and President Reagan might come up with some accord.

Mortgage-backed bonds, a trillion-dollar market, have lose to 12 to 15% of their total value since late March, and stand to plunge much more, wiping out the entire thrift industry, as well as their market-makers.

Since the entire U.S. financial system has lived off borrowing cheap short-term money and buying long-term bonds for the past three years, it doesn't matter which alternative Washington chooses. If the Federal Reserve continues to raise short-term interest rates, the cost of shor-term money will blow out the thrift system, dumping a $100 billion charge in the lap of the bankrupt Federal Savings and Loan Insurance Corporation. If the Federal Reserve keeps short-term money cheap, which it can do in the short term, the dollar will continue to crash, and the foreign-financed long-term bond market with it. The value of thrifts' portfolios and security dealers' inventories will crash.

A smoking crater now gapes, where Washington's financial policy once stood. Those who argued that some slight degree of monetary manipulation would stave off the crisis, at least for some weeks, may complain that the passage of the Gephardt amendment to the House trade bill April 29 ruined the impact of the Fed's slight tightening. Gephardt's amendment mandates automatic reductions in the trade deficit through punitive tariffs. It was accompanied by a further proposal by Rep. Don Riegel (D-Mich.) to ban Japanese securities firms from primary dealerships in U.S. government securities. That did not inspire U.S. bondholders, who count on Japanese purchases of $100 billion per year to maintain the present level of securities prices.

Since the U.S. government currently has *no* policy for the reduction of a trade deficit now barreling along at a $170 billion per year, it has no moral authority to attack the stupidity and destructiveness of the Democrats' trade-war program. The prospect of financial collapse, perhaps triggered by Japan's refusal to continue financing the American budget deficit, has persuaded the U.S. government to back off from the trade-war stance embodied in the mid-April imposition of punitive tariffs on Japanese electronics goods. Special Trade Representative Clayton Yeutter's leash has been tightened, and he has suddenly discovered that the Japanese have begun to comply with the terms of the disputed Japanese-American semiconductor agreement.

It will be recalled that the trade-war policy represented an act of desperation, following the collapse of the Administration's effort to correct the trade deficit by devaluing the U.S. dollar. Now that Treasury Secretary James Baker III has admitted that crashing the dollar will not reverse the deficit—it only raises the dollar price of a diminished volume of imports—the Administration has nothing to say on the subject at all. The Treasury's alter ego, the editorial page of the *Wall Street Journal*, was reduced April 30 to demanding that the Japanese open their markets in order to stimulate American exports, forgetting to enquire whether the U.S. can still produce anything that the Japanese might want to purchase. In effect, the Wall Street viewpoint boils down to

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agreement in principle with the liberal Democrats, despite the apparent disagreement about means.

Another Columbus Day Massacre?

A Western statesman once commented that that Communist parties are capable of only two kinds of actions: a right turn, and a left turn. The Federal Reserve has an analogous problem. It knows how to loosen, and to tighten. For the past three years it has loosened, bringing interest rates down to the 6% range for Federal funds. Now it is tightening. Federal Reserve Chairman Paul Volcker admitted April 30 that the Fed has conducted "some slight snugging" of interest rates to support the dollar. He told the House Banking Oversight and Investigations Subcommittee, "In recent days, we have been a bit more cautious in the Federal Reserve in providing reserves the market. . .Perhaps we could be dscribed as having a somewhat less accomodating policy, reflecting in part the weakness of the dollar—a slight snugging approach, in the some of the market jargon."

In October 1979, the last time the dollar faced an uncontrollable crash, the same Paul Volcker flew back suddenly from the ongoing annual meeting of the International Monetary Fund in Belgrade, Yugoslavia, to announce what became fabled as the "Columbus Day Massacre," putting interest rates on a track to the 20% range by December of the same year. The nudging-up of U.S. interest rates in the last week of April, complemented by another nudging-downward of Japanese interest rates, will impress no one. Having failed once, Volcker is most likely to repeat the exercise. Alan Reynolds of Polyconomics, a consulting firm with strong ties to the Jack Kemp camp in the Republican party, now predicts that the Federal Reserve will make an additional such gesture, by raising the discount rate.

Reportedly, Volcker is terrified of the consequences of higher interest rates; perhaps Federal Home Loan Bank Board Chairman Edwin Gray has told him what 8% Federal funds would do to the savings system. It cannot be ruled out that Volcker will "fly forward" into the guns, and repeat his 1979 performance.

The creditors' demands

Now, America's creditors are demanding that America adopt a "crisis-management" approach, i.e. a drastic austerity program, involving huge budget cuts, and reductions in consumption: in short, the Brazilianization of the United States. That was the message delivered to the U.S. government by the Organization for Economic Cooperation and Development, whose stark warning about the expansion of the U.S. budget deficit April 22 marked the beginning of the end of Treasury Secretary James Baker III's political career.

Baker's roasting on the front page of the *New York Times* April 29, the day of the Merrill Lynch debacle, has nothing to do with the former Dallas real estate lawyer's performance as such; it marks a decision on the part of America's foreign creditors that the day of the credit-financed consumer bubble, and the phony "Reagan recovery," are over, and that the U.S. must enter a drastic period of austerity. Since Baker was associated with this policy, Baker must go, the creditors demand.

The notion that monetary and fiscal austerity can lower the budget deficit deserves nothing but contempt, for one reason that should be obvious enough: the U.S. government has pledged its "full faith and credit" behind a trillion dollars of repackaged home mortgages, another trillion dollars worth of savings deposits, and numerous other "off-budget" guarantee categories. Pull the plug on the U.S. economy, and the guarantees will be activated.

According to an analysis to be presented in *EIR's Quarterly Economic Report* for spring 1987, the direct effects of higher interest rates, plus their indirect effects, i.e. the triggering of such guarantees through the collapse of the savings system will bring the budget deficit up to the $328-$398 billion level. On the basis of conventional budget calculations, the deficit cannot be reduced below the present projected annual rate of $185 to $190 billion, i.e. $80 billion above the President's target. However, this and previous Administration's policy of pumping air into the consumer sector, through off-budget financing, is coming back to haunt it, through the massive funding requirements of the Federal Savings and Loan Insurance Corporation (FSLIC), the Federal Deposit Insurance Corporation (FDIC), the Farm Credit System (FCS), and the various mortgage-guarantee agencies operating under the Federal Home Administration, including the Government National Mortgage Association (GNMA) and the Federal National Mortgage Association (FNMA).

The present state of the budget

Virtually all of the reduction of the deficit from last fiscal year's $230 billion level is due to tax reform, the supposedly "revenue-neutral" program adopted by the Administration last year; all the increases were front-loaded into the earlier years of the program, and all of the decreases left for later years, where they will not be noticed in any event. That swindle has brought in new revenues at an annual rate close to $20 billion. The largest part of the "revenue dividend" associated with tax reform was concentrated over the December-April period, as corporations completed repayment of now-forbidden investment tax credits claimed in 1986, and individuals pay taxes on the rash of capital gains taken late last year. That is to say, most of the payments came direct out of corporate capital formation, to which many analysts attribute the miserable performance of capital investment during the past six months.

So much for the reduction of the deficit thus far. For the past three years, the International Monetary and the Bank for International Settlements have proposed, in effect, that the U.S. undertake not merely a politically-impossible domestic austerity program, but unilateral disarmament. As matters stand, their prescription includes the side-effect of uncontrollable fiscal chaos.