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# Carter's inflationary economics–out of control

by David Goldman

The White House and its economic advisors do not have the faintest notion of what inflation *is* and that fact makes the current panic of the Carter administration over the inflation issue especially dangerous. The budget cuts, credit controls and other plans the White House has put forward in a sudden effort to reverse three years of slide into inflation are, in fact, inflationary plans. In the case of the present reworking of the federal budget for fiscal year 1981, due to be released March 17, the result is very likely to be a *hyperinflationary* plunge beyond easy retrieval.

The one thing that the White House, Treasury, and Federal Reserve are correct about is that the current situation is an emergency, as the approximate 40 percent decline in the value of long-term, fixed-interest dollar securities has made plain since Oct. 6, when Volcker first tightened interest rates in the name of "fighting inflation." The world economy is now, broadly speaking, divided into two major groups of industrial countries: America and Britain, with inflation levels of about 20 percent, and the European Monetary System sector and Japan, with inflation at half that level or less. What the West Germans and French describe as an "interest rate war declared by the United States" will either end in the breakup of the present trillion-dollar international market or a reversal of administration policies through internal and external pressure. The coincidence of West German Chancellor Helmut Schmidt's visit to Washington this week and the shambles in the presidential primaries set in relief what an intense political crisis the inflation problem has caused.

The situation, as reflected in the debate over the federal budget deficit for fiscal years 1980 and 1981, is manifestly out of the administration's or the Federal Reserve's control. At this writing, the budget deficit could easily overreach the **$100 billion mark,** as any simple inspection of budget arithmetic demonstrates, while the White House is frantically trying to show a "balanced budget" for the 1981 fiscal year. What the Mad Hatter's Tea Party at the Office of Management and Budget and the Council of Economic Advisors will yield on March 17 is anyone's guess. The facts are as follows:

Carter has projected a **$40 billion and over** budget deficit for FY 1980 ending October, and a **$16 billion deficit** for FY 1981. Wall Street, with virtual unanimity, has declared that these deficit levels are inflationary and responded by putting the federal long-term borrowing rate at **13 percent,** the federal short-term borrowing rate at **15 percent,** the prime lending rate of commercial banks at **17.25 percent**, and the critical London Interbank Offered Rate for Eurodollars at **17.5 percent**, all record-breaking levels and all still rising.

The actual annual rate of the federal deficit is higher than Carter's "pessimistic" projections by the following amounts:

**$50 billion per year** in so-called off-budget borrowing, including federally guaranteed and federally sponsored borrowing, which is identical in its impact on the markets to ordinary Treasury borrowing. The placement of federal programs on the "off-budget" accounts is simple accounting fraud.

**At least $24 billion per year** in additional interest payments. The presest FY 1981 budget "assumes" a Treasury bill rate of about 9 percent. The Treasury bill rate is now 15 percent with no likelihood of reduction, but a great likelihood of increase. For every 1 percent rise in the Treasury bill rates, given the maturity schedule on the more than $800 billion of federal debt outstanding, interest payments rise about $4 billion. Instead of the $78 billion in debt service expected the federal government will pay over $100 billion.



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**At least $25 billion** to maintain the real level of defense expenditures at the 3 percent per annum rate of increase demanded by the administration. In congressional testimony Feb. 28, Defense Secretary Harold Brown stated that the Treasury would spend whatever was necessary to maintain defense expenditures.

The actual rate of federal borrowing will be, without Carter's projected cuts, **$115 billion per annum**—but only assuming that the administration's "moderate recession" scenario holds. Manufacturers Hanover Trust economists expect an additional **$20 billion** to be added to the budget deficit in 1980 due to loss in tax revenues. In the case of a sharp downturn in nominal economic activity, the loss in tax revenues and the increase in federal transfer payments due to a rise in the unemploymennt rate could easily bring the additional deficit up by **$50 billion.** The question of the economy's performance in terms of the misleading Gross National Product measure will be dealt with below. However, only administration employees are unwilling, at this point, to admit that the deficit is so out of control that the proposed cuts are a pathetic joke.

The monetary process, no longer the "lubricant" of real economic activity, has taken on a life of its own and become apparently uncontrollable. There is no clearer illustration of this than the relationship of the American interest rate spiral to the foreign markets during the weeks of Feb. 25 and March 4.

Dollar certificates of deposit, yielding over 17 percent, attracted a large short-term flow of funds out of mainly the Japanese yen and, to a lesser extent, the West German mark and Swiss franc. To stabilize the parity of these currencies, foreign central banks either drew on swap lines with the Federal Reserve or liquidated Treasury securities to obtain dollars with which to intervene on the foreign exchange markets.

The sudden 1 percent rise of the Treasury bill rate to 15 percent on March 5 was the result of a $1 billion sale for the account of the Bank of Japan, which coincided with a major Treasury refunding of bills. However, according to Wall Street analysts who note that foreign intervention has exceeded $2 billion in the past week, the Treasury has merely monetized the lost holdings of its paper ("printed money") out of fear of putting more of it on the markets.

Contrary to the usual logic, an inflow of funds due to higher interest rates is forcing interest rates upward, in a never-ceasing spiral. The Federal Reserve is helpless.

### What inflation is

If inflation were merely a uniform rise in the general price level, it would not present a problem of any sort and, in any event, could be eliminated through indexation. If it were a differential rise in the levels of different

## Friedmanism blew up Great Britain's economy

Schachtian economist Milton Friedman, currently in London to promote a new television series on the virtues of his economic theories, caused more damage to the British economy in the past year than Napoleon ever managed.

Under the guidance of Sir Keith Joseph, Britain's Industry Minister, Prime Minister Margaret Thatcher led the Tory government that assumed power 10 months ago in a binge of budget-cutting and credit stoppage, in an almost precise replica of the Carter administration's current proposals. Sir Keith identified the policies as the first full-scale application of Milton Friedman's economics to an industrial country.

However, rather than falling, Britain's inflation rate *tripled* from 6.6 percent per year during the last quarter of 1978 to roughly 20 percent now. With bank lending rates at 18 percent, only slightly higher than American rates, British companies are still borrowing every pound available, frustrating the British monetary authorities' attempt to continue the crunch. As a result of the high interest rates brought on by the monetary squeeze, Britain's most-used money supply measure rose at a 12 percent annual rate during the last half of 1979, against a 7 percent target rate. The Bank of England has been forced to inject more than $2 billion into the markets during the past four weeks to prevent a shutdown due to lack of liquidity.

Friedman, however, is nonplussed. Monetarism "causes some dislocation in the short run," he wrote in the London *Times* March 1.

types of prices, the federal government could correct the differential through a variety of means, the simplest of which would be price controls. Wall Street commentators speak a great deal about the consequences of "inflationary psychology," especially considering the population's unwillingness to save—as if the state of the economy and declining personal income left the population with spare funds to save.

The most brutal idiocy advanced by the economics profession—the monetarist argument that fiscal and monetary lassitude create excess money and, through the "quantity theory of money," raise price levels—has become the fallback explanation both on Wall Street and Pennsylvania Avenue. As we will show below, cutting the federal budget the way Carter proposes will breed more inflation. The White House has nonetheless adopted the assumptions of Milton Friedman. Fed Chairman Volcker dutifully brought the level of what used to be $M_1$, or currency plus demand deposits, down to a 3.1 percent annual growth rate during the last four months of 1979, and $M_2$ to a 6.8 percent per annum growth rate during the same period. In the same period, the inflation rate doubled from about 11 percent to almost 20 percent per annum.

Britain's Thatcher government obtained even worse results during its nine months in office, succeeding in tripling inflation while reducing money supply growth (see box on page 15).

Washington's current disorientation may be characterized by its obsession with those economic theories which are most obviously disproven by readily available facts. Any simple comparison of numbers (with or without time lags) shows that there is no *direct* relationship between inflation and the money supply.

The place to look for the cause of inflation is not at the money level, but at the level of the tangible economy. Even Milton Friedman's cited forebears, like Sir William Petty and Adam Smith, knew that, for tax purposes, the most rapacious government had to know what *tangible product* could be disposed of. Any policy which shifts economic activity away from tangible goods production toward nonproductive activity, like military spending, is inflationary. Carter's policy, which proposes to collapse the productive sectors of the economy in favor of Schachtian military and energy schemes, is *hyperinflationary* in the precise meaning of the word. Carter's policies create self-feeding, accelerating deterioration of the productive sectors of the economy while otherwise increasing nonproductive incomes, resulting in a continuously accelerating rate of inflation.

Net of inventory changes and lags in financial intermediation, the price of all goods produced in a given period is at least equal to all incomes earned in that period. Credit expansion in excess of saving may also create temporary price increases in goods in short supply, like oil or basic metals. Any increase in the proportion of total employees engaged in producing tangible goods, or a rise in the productivity of labor, will lower prices. A fall in the proportion of employees producing tangible product or a drop in productivity raises prices.

Since 1971, when Treasury Secretary John Connally and Undersecretary Paul Volcker eliminated the dollar's link to gold, inflation has become self-feeding. The now-trillion-dollar Eurodollar market enabled the petroleum companies and similar groups to rig the price of basic raw materials, raising the cost of investment in tangible production as opposed to investment in, say, McDonald's franchises or gambling casinos. Reductions in the level of tangible-product investment, and the consequent reduction in the rate of growth in productivity of labor, raised the American economy's underlying level of *structural inflation*. In turn, structural inflation eroded sources of long-term financing for productive investment at home and abroad, and channeled profits into inflation-producing forms of nonproductive investment and speculation.

Part II of this survey will analyze structural inflation in depth. The above summary will suffice as a guide to examine the administration's and various private proposals for dealing with inflation.

## What won't work

**Cutting the federal budget.** The criterion for deciding whether a change in the federal budget will help or worsen the inflation problem is how it will change the tangible product of the economy relative to total incomes. The pesent budget, as *EIR* has documented, contains a staggering inflationary bias, especially when so-called off-budget spending is taken into account. Carter proposes to spend an additional **$15 billion** (actually **$40 billion**, as noted above) for defense and at least **$10 billion** per annum for "energy security," which does not add a barrel of oil to the nation's energy supply. The budget implies a **$50 billion** increase in nonproductive spending.

Much worse, the budget contains a much larger reduction of productive activity otherwise supported by the government, including a **$40 billion** increase in taxes per annum and a **$10 billion** reduction in off-budget support for the prostrate housing market. In these major categories alone, the budget, as it currently stands, contains a **$100 billion** net swing from productive to nonproductive activity. Certain nonfiscal features of federal policy, including the halt in construction of 14 nuclear plants around the country, proposed trucking deregulation, the dismantling of the Midwestern rail network, and related policies, will have further deleterious effects

on the productive sector. (Trucking deregulation, if it is approved, will cost about $20 billion per year, according to an *EIR Special Report*). Worst of all, the explosion of interest rates in response to the real deficit levels will choke off all economic activity requiring long-term investment (except that demanded by the Department of Defense and the Department of Energy).

That is how matters now stand. As noted above, cutting $15 or $20 billion from the budget is aleady a joke, since the federal government will pay more than that in excess interest changes in any event. Reportedly, Fed Chairman Volcker has demanded a 10 percent real-dollar cut in the FY 1981 budget, or about **$70 billion**, as the condition for monetary stability. If Carter decided to remove his pet energy and military projects from the budget, the rough equivalent of resigning his office, Volcker's proposals might be ameliorative in a significant way.

However, the proposed mammoth cut in the budget would probably follow the direction of Carter's current proposed reductions, hitting the consumer sector of the economy most directly. Presumably, the reduction in incomes due to a drop in federal transfer payments would be mached one-for-one by a drop in expenditures, because the savings rate is now around zero, and there are no sources of consumer credit open to low-income individuals. Tangible goods production in the consumer sector would therefore contract sharply, with a much sharper reduction than the 10 percent drop in consumer durables' output during 1979 spreading also to nondurables, which held fairly steady during that year.

At very best, the inflation effect would be neutral, eliminating both incomes and output. However, the likelihood in the real world is that the fungus-like growth of the military, "energy security" and similar sections of the budget would continue to overrun their spending targets by several tens of billions of dollars, pushing the budget mix even further over to the inflation side.

*Milton Friedman*

## New book to expose Nazi doctrines of Friedman

Democratic presidential candidate Lyndon LaRouche announced Feb. 29 that he and financial analyst David Goldman, *EIR*'s Economics Editor, are currently producing a book which will expose Nobel prizewinner Milton Friedman as a self-confessed Nazi economist.

The decision to produce the book was triggered by Friedman's public declaration of his admiration for Nazi Finance Minister Hjalmar Schacht on a radio talk-show during this past year. Friedman's public confession of his Nazi sympathies showed that the resemblance of Friedman's "fiscal austerity" doctrines to those of Hitler's Nazis is not a coincidence. Friedman has publicly acknowledged the connection.

The book will show that the presently adopted economic policies of many Republican presidential campaigns are based on the Nazi-imitating doctrines of Friedman and F. von Hayek. The current "energy" and "austerity" policies of the Carter administration are also Nazi-modeled. The included object of the book, says LaRouche, is to shame honest Republicans and Democrats into second thoughts concerning the Nazi-like evil they are condoning under the mislabeling of "fiscal conservatism."

The book is presently scheduled to be off the presses early this spring, well in advance of the June 1980 final round of primary campaigning.

In making the announcement, LaRouche referenced an hour-long conversation he had with France's Jacques Rueff on the subject of Nazi economics. They compared Rueff's published treatment of Schachtian "fiscal conservatism" as "inflation turned inward" with LaRouche's different approach, leading to the same conclusion.

They also discussed LaRouche's approach to creating a new, gold-based monetary system, a basic monetary reform which both LaRouche and Rueff saw as the only alternative to an imminent revival of Nazi-like economic and monetary policies among the OECD nations.

The new book, said LaRouche, will honor the late Jacques Rueff's own published analysis of Hjalmar Schacht's methods, demonstrating that the economic and monetary doctrines of Friedman and von Hayek are identical with those of the Nazi regime.

In any event, the political likelihood of a $70 billion budget cut is in the order of a Harold Stassen victory at the Republican convention this summer.

**Credit controls.** The strongest argument against the credit controls proposed by Henry Kaufman of Salomon Brothers and other economists came from Paul Volcker himself. Volcker informed the White House, which considered that measure over the past week, that the Fed could not impose such controls on private credit extension while the federal government continued to borrow **$100 billion** a year. The issue appears shelved.

The deeper point is that structural inflation is now so advanced and will be so exacerbated by the Carter budgetary program that credit controls are out of the question. The economy is so short of basic capital goods capacity that the military spending program about to come on line implies rates of inflation this country has never seen. Currently, the **$60 billion**, five-year auto industry retooling program has absorbed enough machine tool capacity to put a three-year wait on completion of all new machine-tool orders, *before* the military push really comes onstream. The demands for steel shapes and special metals of the **$20 billion** synthetic fuels program, which proposes to build gigantic piles of plumbing next to coal mines, will impose a shortage on basic steel capacity in the United States (which the steel companies, engaged in reducing capacity, have been counting on).

The 54 percent per annum rate of increase of durable goods orders during the November-January period has convinced some economists that the economy is not going into recession, and will therefore experience ordinary "boom" inflationary pressures. As Part II of our survey will document, the bulk of this spending is either related to "energy-saving" or "military production" and will not add to available useful tangible output. This is a boom, fostered by the Carter administration, in the nonproductive sector; since the government is demanding it, it must be financed and credit controls are out of the question.

**Reducing dependency on imported oil.** Strictly speaking this has nothing to do with inflation, but the Carter administration insists it does. They propose to deal with the problem of high-priced imported oil by

- politically undermining any agreement with the OPEC producers of the type French President Giscard has tried to initiate;
- eliminate nuclear power construction;
- eliminate price controls on the domestic price of oil; and
- build "synthetic fuel" plants which require (in constant 1979 dollars) a $40 per barrel oil price to turn a profit.

There is, of course, some truth to Carter's claim that inflation is in part due to high oil prices. However, West Germany, which must import all its oil, has consistently sustained an inflation rate at about half the American level. This is due to West Germany's proindustiral and pronuclear policy, through which that country has compensated in part for the higher oil price through increases in the productivity of labor. The issue of imports versus domestically produced oil is entirely irrelevant to inflation. Britain, which has become an oil exporter, is America's only competitor in a race to reach the 20 percent per annum inflation level.

**Supply-side economics.** The Joint Economic Committee of Congress, presidential candidate Ronald Reagan, and various other groups have adopted the tax-cut theory best associated with University of California's Arthur Laffer, economic journalist Jude Wanniski, and Congressman Jack Kemp (R-N.Y.). With a new computer model prepared by the formerly Keynesian Data Resources, Inc., the Joint Economic Committee issued a report calling for a **$25 billion** tax cut, about equally divided between consumers and corporations. The JEC claimed that this would reduce the inflation rate by 4 percentage points by the late 1980s.

"Supply-side economics" has become a fad, now involving the JEC, the Harvard Business School, the major computer econometrics firms like DRI and former Chase Econometrics chief Michael Evans, as well as the old Laffer-Wanniski-Kemp boosters. Any number of variants of the proposition have emerged, but it can be summarized very simply. The thesis is that tax cuts properly applied will generate sufficient economic activity to make up or more than make up the lost tax revenue, by giving producers incentives to produce more and expanding the tax base.

There is both obvious truth and obvious fallacy to this proposal. In an economic environment where energy, credit, and other policy considerations place intolerable burdens on long-term, capital-intensive investment required to expand tangible output, the proposed tax cut would be pure inflation. True, it would increase the rate of savings, but these savings would be applied to those ventures already defined as "profitable" in the context of aggravated structural inflation. However, Japanese-style tax breaks on depreciation of new capital investments, would be an essential feature of breaking structural inflation.

None of the supply-siders seem to understand this. Congressman Kemp, in his recent book *An American Renaissance*, seems to think that investment in professional sports teams is no different than investment in steel mills.

# Rohatyn recommends a national 'Big MAC'

*Attendees at the Feb. 28, 1980 Financial Conference of New York City's well-known corporativist think tank, the Conference Board, heard their featured speaker warn that the United States is "headed for national bankruptcy."*

*The speaker? Felix Rohatyn, partner of the Lazard Freres investment banking house and head of the infamous Municipal Assistance Corporation (Big MAC) that has overseen the looting of New York City's municipal services since 1975. His answer to the impending crisis? The creation of a national Big MAC, which would supersede the authority of the U.S. Congress to impose fascist controls on the economy.*

*The following are brief selections from Rohatyn's anti-inflation prescriptions for the national economy—prescriptions no better than the ones recommended by the administration.*

It has been apparent for some time that our economy was out of control, our currency in danger and that the ability of our government to react was inadequate. Inflation is accelerating....What is happening to the U.S. in 1980 is similar to what happened to New York City in 1975, namely a slide towards bankruptcy. This led me to conclude last year that an approach at the national level similar to the one we took at the city/state level was needed. This approach includes:

1) A temporary 12-month wage/price freeze, together with extreme budgetary restraint. This should include a cut of at least $20 billion in current outlays to break inflationary expectations and provide a solid base from which to adopt an integrated, multi-year economic strategy.

2) A significant gasoline tax (at least $.50 per gallon) to reduce consumption, strengthen the dollar and provide the basis for a dialogue with OPEC concerning pricing, long-term supply and alternative payment methods for oil. The only alternative to a gas tax is rationing, which, in my judgment is a poor second best.

3) The creation of a bipartisan commission modeled after FDR's Temporary National Economic Commission of 1938 to recommend an integrated economic strategy, both domestic and international, for the next two decades. Domestic and international policies are, after all, sides of the same coin....

The Temporary National Economic Commission would... recommend an economic strategy for the U.S. for the next two decades. It must do so for two basic reasons: first, because nowhere in government today does strategic economic planning take place; second, because difficult, controversial policies must originate from nonpolitical, credible bodies, created in an atmosphere of emergency, to generate the political support enabling the President and Congress to act....

The TNEC should consider recommending a change in the role and makeup of the Council of Economic Advisors to perform a similar function to the Joint Chiefs. The CEA could become a permanent, independent body of "wise men" outside of the executive and legislative branches to review the budget on particular and economic policy in general and report to the President, the Congress and the public....

We are at a turning point in our economic, social and political life. It has been coming for a long time and it will take a long time to adjust to the new realities. If the impetus for reexamination does not come from the political leadership seeking solutions, it will come from the markets demanding them.... There is a clear danger that continued deadlock over may of these issues or continued application of bandaids will ultimately create social and political upheavals of unforeseeable dimensions. What we are facing is not only a sudden economic emergency caused by a few unpredictable shocks. We are facing a political and social crisis of major dimensions....The social fabric...is taut as a bowstring, tight as a drum. If pushed hard, it will not give but will come apart. It is not a risk worth taking....