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Carter sacrifices economy in war on Europe

by David Goldman

The flood of criticisms directed at the Carter-Volcker "anti-inflation" package of March 14 has established beyond doubt in the minds of the public and legislators that the effort will not be successful in containing inflation. However, as banking community sources in the best position to evaluate the content of Fed chairman Paul Volcker's actions state, the credit control measures are not designed to reduce inflation.

They are designed for a domestic purpose, but also a foreign purpose. On the one hand, the measures will prepare the stage for full-scale use of the Credit Control Act of 1969, the most totalitarian piece of legislation currently on the books, along with other wartime-level controls. But equally important, as the British financial press has emphasized, the Volcker package is intended to impose a deflationary regime on Western Europe, and freeze current European plans to advance the proposed European Monetary Fund.

The effects on the continent

"The most immediate effects will be on the international markets, where they will make a significant contribution to slowing down inflation," writes the London *Times*. "The measures will reduce... speculative pressure... Although no conscious decision has been taken by the other nations of the West, they have all been forced into adopting the anti-inflation monetary policy in line with the U.S. example."

While the content of the *Times's* statement is false, the *Times* is not lying about Volcker's intent. The actual impact of so-callld anti-inflation measures in the U.S. on Europe has been to touch off an interest-rate war which, over the past year, has nearly doubled the interest rates, and consequently the rate of inflation, in the European Monetary System nations.

West Germany's interest rates have risen from 6 percent a year to about 11 percent, both Belgium and France's to 14 percent, all of which makes capital investment and growth in living standards more difficult for industry and consumers in those countries.

Contrary to what happened in the United States, however, the Germans in particular have taken deliberate, tough measures to ensure that hyperinflation does not cause a decline in the heavy industry export area on which their national economic survival is based.

Credit expansion for export credits, and for the industrial investments which will produce German exports, has continued, especially as the Germans have sought and received heavy financing from the Arabs for their equity markets. This is the "inflation" the London *Times* is concerned about.

Why U.S. inflation and interest rates will rise

Judging from the yield curve on Certificates of Deposit, which falls from 17.75 percent on 90-day certificates to 15 percent on 120-day certificates, the market expectation is that U.S. interest rates will peak within six months. Astute observers such as U.S. Trust's James

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O'Leary believe that interest rates will not peak; O'Leary, Paul Volcker's old colleague from the trustees of the elite Ditchley Foundation, is correct on the point.

The recession the American economy is now entering is not an ordinary recession, but a Schachtian process in which capital goods production rises for military or energy-autarky investment while consumer goods production falls, and real economic resources are transferred out of the consumer sector. This ensures continued high interest rate levels and high inflation rates. As Volcker hinted in March 18 testimony, the opening of the Credit Controls Act can only be the beginning; much more drastic measures will be required.

The fact that overall industrial output rose during 1979, largely due to a 6 percent real increase in purchases of business equipment, despite a 10 percent drop in production of consumer durables, should be sufficient warning of the shift into non-productive capital goods expenditures (defense, synfuels, etc.). As Lydia Schulman's analysis (see below) demonstrates, credit—inflationary credit—will continue to be available to those industrial ventures demanded by government spending or regulatory programs.

For other industries, the result will be a chain of bankruptcies that will bring on a full-scale depression.

'Guessing who will go'

Incoming Chase Manhattan chairman Willard Butcher is announcing that the banks will carry out this policy even if it results in their own destruction. We have to be "as flinty-eyed and hardnosed as possible," and "learn how to say no," Butcher told an American Bankers Association meeting in Atlanta March 18.

Other bankers privately conceded that the deflationary policy will start sending a lot of companies under. "We sit around and guess who will go," said one. "The partners here are talking about a lot of mining companies, financial services companies, suppliers and warehousing companies who carry inventories on credit. This time the toughened marginal reserve requirements will bite."

But as some associates of Volcker admit, the Carter administration will have to prepare to impose any measure necessary, no matter what the cost to the country, in order to try to prevent the Europeans from realizing their alternative. After the primaries are over in three months, Carter will extend the measures and take control over every aspect of the economy, said one source. This is a polite way of describing a fascist economy.

The European danger

Writing in the current issue of *International Finance*, a bank newsletter, Chase Manhattan economist Douglas L. Bendt says, "Despite the drawdowns of the past year, foreign holdings of U.S. public debt are still substantial"—i.e., down to almost $100 billion from a June 1979 peak of $142 billion. "Billions of dollars of U.S. national income continue to flow abroad to pay the interest. But more importantly, the United States has surrendered a certain degree of control over its monetary affairs to foreign central banks."

In less staid language, bankers are concerned that the Fed's lack of control over its own liabilities and, much more importantly, Europe's evident ability to control the recycling of the estimated $120 billion 1980 OPEC surplus, place both the Treasury and themselves in grave danger.

Volcker's deflationary exercise will produce a banking crisis domestically, by putting some financial intermediaries against a wall; it will also make more onerous the almost unmanageable job of financing an $80 billion-plus non-oil developing countries' payments deficit during 1980. With the London Interbank Offered Rate, the key Eurodollar barometer, now at 19.5 percent, the volume of developing sector interest payments to be refinanced this year will exceed $80 billion.

The Fed requires all the flexibility in the world to handle both crises simultaneously, all the more so if European banking estimates are correct that the presently strong dollar is due for a sharp fall at the end of the second quarter. Bankers fear simply that the Fed cannot juggle all these balls at once.

The fears are entirely justified. The Arab world has no intention of following the Federal Reserve's standing advice (courtesy of Governor Henry Wallich) to invest in the debts of Third World countries.

The bulk of the petrodollar surplus will be invested instead in European government securities, equities, and bank deposits, and thence recycled into export financing (although, perversely, some spillover may aid the Federal Reserve in the form of European reserve purchases of Treasury securities). Ultimately, the new European-Arab financial relationship closes a circle which excludes the United States financial system at the point of greatest crisis.

Offensive against West Germany

There lies the great danger to Volcker. He and the British are desperate to stop the Arab-European political combination which could finally put the European Monetary Fund into operation as an instrument of technology transfer to the developing sector. The Carter administration and British policymakers are concentrating their financial warfare on West Germany, both because of its vulnerability as a NATO-occupied country, and because it is West Germany's economic weight on which the EMS depends. So, the Carter-Volcker crowd has, on the one

hand, virtually announced that it is backing Franz Josef Strauss for the next Chancellor of West Germany. On the other, it is aiming its biggest economic guns at this U.S. creditor.

The *Financial Times* of March 18 elaborates the approach: "This time because of the less buoyant world economy and particularly the LDC (less developed countries) situation, they will find (increasing exports) more difficult. The Germans can finance a balance of payments deficit for a short time, but what if it's a long time? The question is whether the measures taken by the Germans, the loan from OPEC, etc. will have enough effect to attract a capital inflow.

"That question is doubly delicate in the light of the Carter measures. The Bundesbank president warned of the dangers of interest rate warfare; Schmidt certainly has no desire to get involved in such warfare in an election year. But it may not be so easy for either of them to resolve this dilemma."

The backfire effect

There is no question that the Volcker measures have hurt both Germany and France. But the likely result of this escalation will be to drive them even more rapidly and firmly into establishing their own financial arrangements with the Arabs, which are open to the Soviet Union as well.

To the Germans and French, after all, this is not simply a matter of an economic chess game. Giscard and Schmidt took the action of establishing the European Monetary System in the belief that the collapse of the world economy was dragging the world dangerously close to war, that economic collaboration between East and West to develop the developing sector was the only way to build conditions for a lasting peace.

If anything, the Carter administration's sabre-rattling postures over Afghanistan, and moves toward Hitler-like economics in the United States itself, have hardened the European leaders' conviction.

Volcker is imitating Hjalmar Schacht, Hitler's financial plenipotentiary, in attempting to control the American economy through the Reichsbank, and accepting the proposals of Schacht's leading exponent in the economics profession, Milton Friedman, in placing a straight limit on credit expansion. However, Schacht had the benefit of Bank of England loans and sympathy in running his autarky.

As Jacques Rueff pointed out, Schacht's policy was set up for him by the 1931 Standstill Committee on German payments. Volcker, who must juggle a shaky reserve currency against both domestic and international financial crises, and try to crush the European economics, has no such luck.

The program

What Volcker's measures will do to lending

by Lydia Schulman

"You can kill a lot of sheep with incantations if you add a little poison, and the three percent surcharge on the discount rate is poison." This is how American Enterprise Institute economist Gottfried Haberler, quoting Voltaire, evaluated the new package of credit tightening measures decreed by President James Earl Carter on March 14.

Other economists polled by the *Executive Intelligence Review* said that they believed that the nine percent "volunary" limit put on bank business loan expansion for the rest of the year—the part of the new package dismissed as mere incantation by Mr. Haberler—will immediately result in the rationing of scarce supplies of credit to competing borrowers.

All told, the view among bankers and credit market observers is that the new credit curbs will cause a severe credit crunch, which will immediately impact upon residential and commercial construction, the auto and other already weakened consumer industries, and the financial institutions themselves.

As Dr. James O'Leary of U.S. Trust explains in the interview printed below, phase one of the Volcker strategy—the package of interest rate hikes and other credit restraint measures imposed by the Federal Reserve chairman last Oct. 6—resulted in the demise of functioning capital markets in the United States. From December through February, many corporations who were closed out of the bond market turned to the commercial banks to lock up short-term credit lines instead.

This shift is reflected in the accompanying chart, in the surge of commercial and industrial loans in December after November's negative growth, and also in the continued growth through the March 7 reporting week (these figures, it should be noted, are not adjusted to even out seasonal fluctuations in loan demand, nor do they include substantial loan operations of foreign banks operating in the U.S.).

Phase two of the Volcker strategy is to put the clamps on further bank loan expansion, "turning off all escape routes," in Dr. O'Leary's words. With the inflation rate currently running close to 20 percent annually, the 9