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EIR: Does the Federal Reserve have the powers to hold the banks to the 9 percent annual limit on the rate at which they are allowed to expand their loans to business?

O'Leary: Most banks will be very scrupulous. There will probably be some policing mechanism set up that will periodically check to see if the banks are staying within the limits ... I was part of the national committee that was set up to watch over the banks when this type of effort was made during the Korean War. A pattern similar to that will develop. A committee structure of bankers will be instituted to see how well the banks are doing. There is no one more scrupulous than bankers ...

Mr. Volcker set up the measures in a way that no one will attempt to escape. He anticipated businesses trying to borrow elsewhere—in the commercial paper market, the Eurodollar market. Having put foreign banks under the same constraints, he turned off all the escape routes. [Foreign banks operating in the U.S., which account for around 20 percent of the loans to industry, were called down to Washington along with the U.S. bankers on March 17, and are subject to the same 9 percent "voluntary" limit on business loan expansion.]

We're going to see a tremendous crunch. With the first round of measures Volcker affected both the availability and cost of credit, and forced borrowers in the capital markets back to the banks. Now with the limits on bank lending we could see a very severe crunch ... It is wrong to think that higher interest rates won't come out of this.

EIR: What are the international implications of the U.S. going into a severe recession now?

O'Leary: Our recession will have an impact on our trading partners. This is all pretty well anticipated by the OECD and other forecasters. The danger is that in the climate we're in, with some of our industries like auto already so depressed, there will be a new hue and cry for trade sanctions. That's where the problems lie.

By next Labor Day, when the economy will clearly be in a recession, the Fed will have to decide how tight to keep monetary policy. They're going to have to be very careful, because they could provoke something much worse.

If by that time there hasn't been any improvement in inflation, Carter will have to decide whether to go to direct wage-price controls. This might seem like a bad route for political reasons, but Carter might just figure that there would be something to gain politically by taking strong measures to fight inflation. He might decide to forget about the labor vote and the inner city vote and go for what has traditionally been the Independent and Republican vote.

The victims

Who is going under in Carter's sacrifice?

by Richard Freeman

In his March 14 address on the economy, President Carter stated that his new program of budget cuts, credit rationing and oil import fees, were not intended to collapse the economy, nor to affect the auto and housing industries, because these industries were going to be "protected." Either Carter was severely misinformed, or deluded, because it is precisely his policies that will hit the most credit vulnerable sections of the economy, with auto and housing in the lead.

Indeed, Carter's budget, and Volcker's credit policy leaves only one question unanswered: will the industries producing for Carter's military build-up program or the shift to synthetic fuels and pollution control measures, be brought down in the general collapse that the President's program will touch off? Carter hopes not. Indeed, the treasurers of some large companies, such as International Telephone and Telegraph, report that they are not planning to make cuts into their capital spending. IT&T's treasurer reported March 19 that it will simply go to Europe—where half of IT&T's operations are run from, to borrow money which IT&T will then bring into the U.S. The telephone and electronics company giant is planning on increased electronics orders from military as well as commercial aircraft (which are gearing up to meet fuel efficiency standards) to keep it going.

But there are general laws of economics and it is nearly impossible to maintain one part of an economy in health, when other sections are in radical decay. The experiment of Finance Minister Schacht in Germany in the 1930's showed that the protection and build-up of a core of military and synthetic fuel related companies within the framework of credit controls and fiscal conservatism meant cannibalization against other sectors of the economy, introducing fundamental imbalances that were not possible to correct. The Schachtian solution to this problem is well-known in the volumes written about the Nazi war economy and concentration camps.

In any event, the first phase of the Carter high interest rate policy leaves little doubt that Carter's hit list in the consumer and credit-dependent sectors of the economy will be devastated by his and Volcker's latest measures:

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Housing. According to the National Association of Home Builders (NAHB), the latest Carter policies will further wipe out the housing industry. NAHB economist Bill Young stated March 19 that "housing starts this year will be a little above 1 million units, which is only half 1977 and 1978 levels." Young explains that the Volcker measures come at a critical time." In the winter months, not much building goes on. But it is in the spring and early summer that homebuilders concentrate on their major building. Now, they are postponing those building starts."

Young's NAHB has just completed a study showing that in today's market, only 3 to 4 percent of the population can afford to buy a new home. A normal rule of thumb for home mortgage lenders is that the principal, interest, insurance and taxes for maintaining a house should come to no more than 25 percent of a family's income. The cost of financing a new house, at today's market prices, now takes for most families anywhere from 30 to 35 percent of their income.

The reverse side is that homeowners, who are interested in selling their homes are not finding any market.

From the standpoint of the homebuilder, the problem is not just that his prospective purchaser can't afford the house, but that he can't afford to build it. Homebuilders normally take out loans at a bank for materials purchase, at between 2 to 4 percent above the prime rate.

As a result, in February, housing starts fell another 6 percent to the 1.33 million units annual range and the projections are for below 1 million units by June. Carter's recent budget, by lopping off $10 billion from the off-budget mortgage repurchase agencies, such as Ginnie Mae and Fannie Mae, just means that a circulation of mortgage on the secondary real estate market becomes harder to do, further driving up mortgage money. Yet overlooked in Carter's attack on the housing market is what revenues the federal government is losing. According to the NAHB, the reduction of housing starts this year from their 2 million annual level in 1977 and 1978 to a projected yearly level of 1.1 million this year, will cost the country as a whole $6.7 billion in tax revenue.

Auto. The big four automakers—GM, Ford, Chrysler and AMC—have already seen their car sales levels plummet to a 7.7 million units per year level in the first 10 days of March, down 14 percent from last year's levels. Yet matters could get worse. "Carter said he didn't want to affect car sales, but he is going after discretionary income and that includes automobile purchases," said Richard Hayden, auto analyst for Goldman, Sachs investment bank March 20. "The 10 cents a gallon oil import fee tax will take $11 billion from the auto driver." Hayden added that "auto sales may go down to 7.0 million on an annualized basis." Some analysts are saying it could even go lower.

A frightened Ford Motor company is frantically lobbying to stop more auto imports—which have risen from 21 to 30 percent of the U.S. auto market—as its sole solution to the problem.

Yet the demise of the auto industry is already crunching rubber, glass and steel industries, which ship between 15 and 30 percent of their product to the auto industry. In addition, 200,000 auto workers are now on permanent or indefinite layoff.

Steel. Steel production in the first week of March was down overall from last year's levels by 12 percent at 2,503 net tons per week.

Overall, the steel industry provides 40 percent of its shipments to housing and the auto industry and must be hit by further drops in these two industries. The saving grace for steel is the fact that the nearly $150 billion that the collapsed auto industry needs for pollution control devices over the next 10 years as well as "alternative energy" and military resource demands for steel has kept the market from plunging further.

Rubber. The rubber industry is completely under siege. Firestone Tire and Rubber Company announced March 19 that, ostensibly because of an increased demand for radial tires, it will close five tire factories and a synthetic rubber plant by October, idling 7,265 hourly and salaried workers. Firestone announced that for its first quarter, ending Jan. 31, it had losses of $13.8 billion.

In January, Uniroyal announced the closing of two of its five tire plants, resulting in the loss of 3,300 jobs.

Retail Sales. At a private briefing for 200 retailers March 20, Volcker told the industry to drop dead. Volcker stayed only a few minutes at the meeting to answer questions, then haughtily left and told Nancy Teeters, a Fed Board member, to handle questions from irate retailers.

Describing the at times near-riotous conditions at the meeting, one retailer told the press: "I think they (the Fed) just opened all the cages at the zoo." Retailers will be faced with the requirement that 15 percent of retail store extended new credit above the volume of outstanding credit extended on March 14 must be placed in a non-interest-bearing account. The early spring months is when retail sales traditionally pick up following the post-December hiatus. Sears Roebuck and Montgomery Ward, the nation's two largest retailers, announced they will raise charge account fees for the more than 44 million charge accounts they have outstanding.

In the face of what the tighter credit restrictions would do, the Fed's Teeters could only maintain "We undoubtedly have not thought through every problem..."