

EIR Special Report

LaRouche-Riemann model projects destruction of U.S. living standards

by David Goldman

EIR released a computer-based econometric projection of a first-quarter 1981 economic downturn on Nov. 11, employing the LaRouche-Riemann economic model to evaluate the consequences of the Federal Reserve's decision to push interest rates back up to their early-1980 peaks. What the computer-based projection showed is that the multiplied cost of debt service in the U.S. economy due to a prime rate of 17 percent or over would, by the first quarter of next year, force the liquidation of inventories and the layoff of more of the labor force.

Since our forecast appeared, something of a consensus has appeared among leading forecasting services that the Fed's policy would, indeed, throw the American economy back into a downslide early in 1981. Even the New York Federal Reserve Bank, in its most recent quarterly report, warns that continued tight money will produce a "double-dip" recession, an indication that this is exactly what the New York Fed wants.

In addition to the aggregate economic projection—whose premises have been more than borne out over the past three weeks by the continued ferocity of Fed interest rate policy—we present here the same projection, broken down into the key economic sectors. The projections accompanying were produced with a 30-sector model of the U.S. economy, employing a data base prepared by the Inforum group at the University of Maryland and updated by *EIR* staff. Apart from the overall course of the economy, we obtain a margin of important additional information from the multi-sector breakdown of the next leg of the recession: it shows us that the division of the American economy into "sunrise" and "sunset" sectors, as advertised by the now lame-duck economists of the Carter administration, will be complete if the Federal Reserve program completes its present course.

There is a big element of fraud in the way in which the "sunrise" versus "sunset" industry distinction has been presented. What is true is, of course, that a number of American industries are technologically obsolescent and cannot compete with manufactured goods produced in Japan and, increasingly, in the newly industrialized countries (NICs). What is fraudulent is the

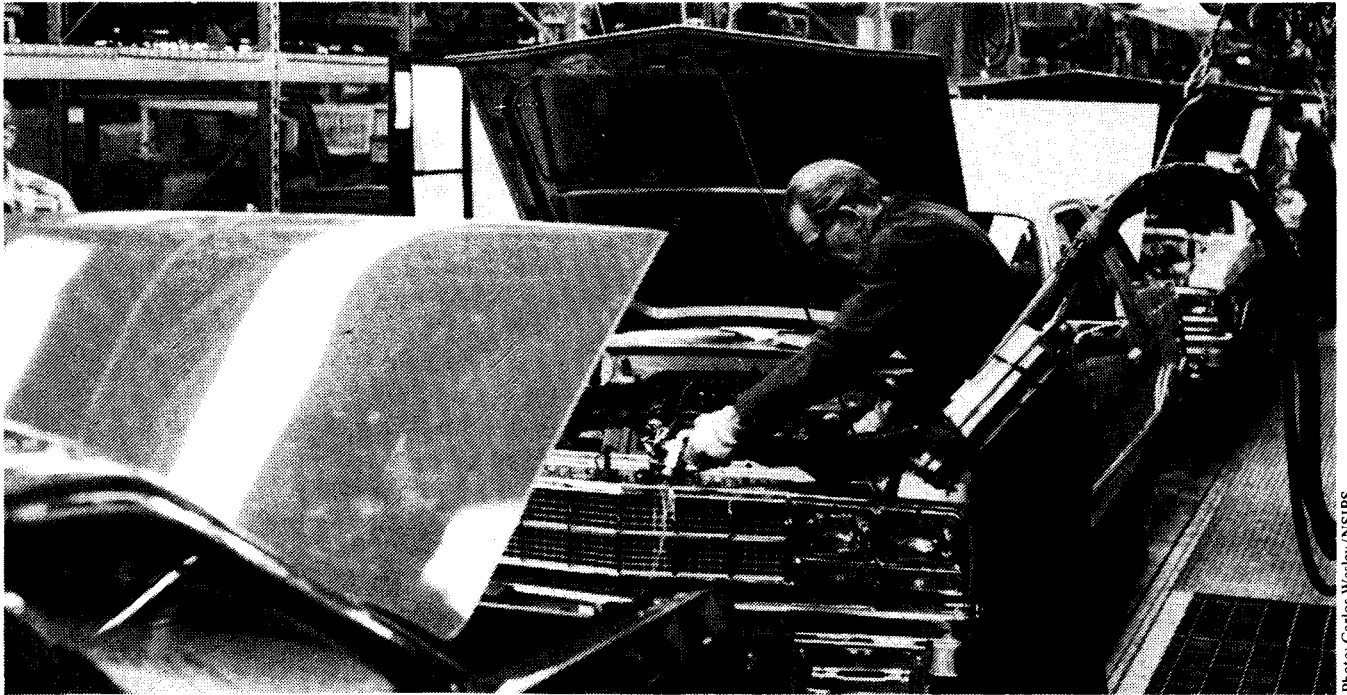


Photo: Carlos Wesley/NSIPS

An assembly line just before Ford's Mahwah, New Jersey plant closed in June.

purported concern by such bodies as President Carter's Economic Commission on the 1980s, chaired by General Motors economist Marina von Neumann Whitman, for technological obsolescence as such.

The computer-based analysis conducted with the LaRouche-Riemann model demonstrates what the actual concern of the proponents of industrial triage is. The thrust of the present, and continuing, economic depression is the destruction of American living standards. The collapse of the economy is not uniform, but directed against those industries which produce the material components of that living standard. Since Fed Chairman Paul Volcker, at the outset of the October 1979 credit crunch, informed the Senate Banking Committee that "the American standard of living has got to fall," in Oct. 15, 1979 testimony, we conclude that the picture presented here represents what Volcker had in mind.

The LaRouche-Riemann model begins with a cleaned-up set of national income accounts for the U.S. and other economies. Rather than Gross National Product, which indiscriminately lumps together machine shops and gambling casinos, the model's data base breaks down the economy's tangible output into:

- 1) Consumption of the productive (i.e., goods-producing) work force;
- 2) Industrial consumption of raw materials and semi-finished goods;
- 3) output in surplus of the replacement cost of production, or (1) and (2);
- 4) the division of the surplus output into overhead expenses—white-collar workers, office buildings, na-

tional defense, and so forth—and the margin of reinvestible surplus. This form of national income accounting, which derives from classical economics pre-John Stuart Mill, enables us to ask and answer basic questions which GNP accounts blur over:

- 1) How much of our output will contribute to expanding output, and how much is consumed as overhead that does not directly enhance the capacity to produce?
- 2) What is our actual rate of profit in real terms, i.e., how does the reinvestible surplus product compare to replacement costs (the total productivity, or potential growth rate)?
- 3) What is the global productivity of labor, i.e., how much increment of labor is required to produce an additional increment of surplus?

The total size of output, as such, is irrelevant; what counts is how the composition of such output determines the future direction of economic growth or decay. By analyzing the internal composition of output of both the total economy and the individual sectors of the economy in this fashion, we can accurately state the true state of affairs. The LaRouche-Riemann model, in its present generation of development, treats the economy as a thermodynamic system, with a set of causal equations that ask how a given force—labor—acts through a given medium, the capital stock at a given productivity.

This enables us to simulate the economic impact of political decisions which determine the reinvestment of the surplus tangible product, or, in the case of the monetarist credit crunch, prevent its reinvestment and cut its circulation. This is not a "crystal ball forecast,"

but an accurate measurement of how the real, tangible economy will operate under changed political (i.e., monetary and fiscal) circumstances.

What is immediately evident from the projections for the total economy, the first set of computer-generated graphs, is the steepness of the decline that will ensue, according to the LaRouche-Riemann model, after the present round of interest-rate increases. (The data presented are a moving yearly average of values, rather than a representation of monthly or quarterly fluctuations.)

But most important are the consumption data, the graph displaying the consumption of the productive (goods-producing) work force. This is projected to fall from \$91 billion (in constant 1976 dollars) to \$67.5 billion between 1979 and 1982, a fall of 26 percent. That appears out of line with the fall in real after-tax income since the recession began, by only a few percentage points on a year-to-year basis since the recession began.

However, the consumption data employed by the LaRouche-Riemann model are different from the tax-derived national income data employed in GNP accounts. From the standpoint of the economy as a whole, it asks what total volume of consumer-goods production the economy requires to put in motion the total production of the economy. The collapse of actual consumer-goods availability, measured by the more than 30 percent declines in the auto and housing sectors, is much more extreme than the personal income figures indicate. If it were a temporary situation, all the discrepancy would show is that households are postponing necessary replacements of consumer durable items, including housing and autos, i.e., they have extended the useful life of these items past what is desirable.

However, what the LaRouche-Riemann model results imply—that this represents a permanent decline in the availability of housing and auto—is demonstrably the case. The financial effects of the Volcker policy, as Richard Freeman shows in the case of auto (see page 27) include the destruction of the infrastructure necessary to revive these industries. *EIR* showed in a cover story Sept. 29 that the deliberate policy of the Federal Reserve is to transform the American banking system along British or Canadian lines, absorbing most of the 20,000 commercial banks and thrift institutions in the United States into a national branch banking system controlled by the leading money-center financial institutions. If that transformation takes place, the likelihood that the flow of savings will resume and find its way to the intermediaries who finance housing will be negligible.

The strange but intentional result of the wholesale destruction of the consumer goods industries appears in the graph displaying labor productivity for the total economy. The LaRouche-Riemann model measures labor productivity with the term, S/V , that is, the tangible goods production above replacement cost (surplus) di-

vided by labor input, measured in terms of tangible consumables allocated to labor (variable capital). As noted, this ratio asks what margin of its total resources the economy must devote to the consumption of the households of goods-producing workers in order to produce an additional margin of surplus. This measure of labor productivity for the total economy is superior to the conventional output-per-manhour measurement.

It is possible to increase the output per manhour of workers digging holes in the ground and filling them up again, or, for that matter, of workers producing pollution-control equipment. However, no increase in their output per manhour will yield any increase in economic surplus whatsoever. In certain cases output per manhour provides a useful local index of productivity, but it is basically misleading in the case of the total economy.

The behavior of our productivity measure in the 1981-82 projection shows why Paul Volcker's ideological mentor, economist Milton Friedman, argued that the Nazi economy was successful. The accompanying graph shows an anomalous rise between 1979 and 1980 from an index level of about 9 to 9.8. Even though the total surplus of the economy is falling, and the net investible surplus is negative—meaning that the economy is not even replacing its capital and labor inputs at previous values—the apparent productivity is rising. The reason for this strange result is simple: consumption of the productive labor force falls dramatically, faster than the overall drop in output, such that the economy is momentarily able to function with relatively less consumption.

Volcker is adhering to Milton Friedman's textbook argument that Hitler succeeded in suppressing inflation because he successfully suppressed consumption. In fact, Friedman argued in his study of the Nazi economy that Hitler would have been even more successful had he suppressed consumption further, a conclusion shared by liberal economists like J. K. Galbraith and Wassily Leontief, who made the same point in the 1946 Strategic Bombing Survey, which provided much of Friedman's source material.

Friedman's hero in the matter of the Nazi economy, Finance Minister Hjalmar Schacht, did not—as Paul Volcker has—collapse consumer goods output upon taking power. The 1929-1931 depression had taken care of that before the Nazis seized power. However, he eliminated all investment in consumer industries and held current production static at depression levels. The replacement of the existing stock of consumer durables ended, and the living standard fell annually by the depreciation rate of the consumer durables stock.

It is obvious that if a national economy can operate for any period of time with less consumption, labor, capital goods, energy and other resources are more freely available for other uses, and the economy may show greater "productivity" in the short run. In the German

case, the result was a collapse of availability of skilled labor that gradually killed the Nazi war machine, a point ignored by the ideologues of the Strategic Bombing Survey or the University of Chicago. However, Volcker and his supporters have chosen to ignore what the effects of reduced consumption on the demographic potential for productivity are in reality. As we reported in a Sept. 2 economic survey, the perspective associated with the terms “sunrise” and “sunset” industries starts from a proposal to reduce consumption.

The comprehensive statement of this policy appeared earlier this year in a volume released by the American Council of Life Insurance, *Capital, Efficiency and Growth* (Cambridge, 1980), edited by International Monetary Fund economist George von Furstenberg. Von Furstenberg concluded, “It is disquieting that household capital, primarily residences, has grown almost twice as rapidly as business capital. Before declaring a generalized capital shortage, one should also recognize that there is relatively too much capital in sectors with low efficiency.”

“Sunrise” and “sunset” industries

The LaRouche-Riemann model’s multi-sector analysis demonstrates plainly that a major shift in capital flow has occurred, along the direction von Furstenberg proposed. We show accompanying results for 10 representative sectors, divided into three groups. These are growth industries, including oil and gas production, aerospace and non-auto transportation equipment, and electric utilities; worst-affected industries, including construction, rubber, iron and steel, and motor vehicles; and moderately affected industries, including food processing, non-electrical machinery, and electrical machinery.

Although it should be obvious, on the face of it, why the American economy will suffer from reduced consumption, the profile we obtain from this projection of the continued recession makes the Fed’s policy errors appear monstrous. The only industries likely to sustain a modest growth rate are growing in large part for the wrong reason, or at least for reasons that are not encouraging for America’s economic future. In any event, the projected rate is likely to decline by 1982.

The three industries that showed growth are the sectors noted above. Aerospace will grow for the reason that the stock market suspects, additional defense procurement. However necessary—necessity is a matter outside the scope of this report—defense procurement makes no direct contribution to the economy, since its product is unusable for further production. And although oil and gas output shows considerable growth, its projected growth rate drops off from 5.6 percent in 1980 (estimated) to 3.2 percent in 1981 and 2 percent in 1982. Every oilman knows the reasons for the drop, and they include more than the windfall profits tax. There

are already severe shortages of oil-drilling equipment, particularly seamless pipe, at a moment when the industries that produce oil-field equipment lack the resources or the confidence for major expansion programs.

While it is encouraging that the United States is increasing oil and gas production, it is also the case that the expansion barely restores the level of drilling of 25 years ago, and that the rise is due to the jump in the oil price, which imposes a tax on the rest of the economy. Furthermore, as noted, the sector’s technological base is far too narrow for sustained growth.

In the case of the so-called “sunset industries,” there are no surprises except the severity of the collapse. What is most important in the series of graphs that include construction, iron and steel, rubber, and motor vehicles is that the “free energy” ratios for three of the four sectors turn negative in 1979 and remain negative for the succeeding years. That is, the model projects a massive disinvestment in auto, rubber, and steel by 1982 of a scale implying the corporate reorganization of most of these sectors. And, as the following case study of the auto industry implies, we are extremely close to shutting down the better part of the auto industry’s productive capabilities in the near future.

The intermediate group of sectors, which show fairly moderate decline, perform better than worst cases for intuitively obvious reasons. Food processing, for example, maintains output levels because food is the last item to be removed from the household budget. Electrical machinery and non-electrical machinery hold up compared to the rest of the economy simply because the capital stock of industry is so depleted that it is impossible to do without a certain level of replacement no matter what the economic environment. However, the basic distinction between the “sunrise” and “sunset” industries is the outstanding result of this analysis. To summarize the results, it is evident that the destruction of the consumption sectors has succeeded according to Volcker’s objectives. This has the intended effect of increasing the economy’s apparent productivity according to the wrongheaded criteria cited earlier. Yet it is equally clear that this rise in apparent productivity is insufficient to sustain real growth in even a handful of economic sectors, and creates the preconditions for irreversible dissolution of America’s economic strength.

What the monetarists who now advise President-elect Reagan to maintain credit-austerity when he takes office have in mind is not the simple-minded “stabilization crisis” which brings prices down and creates the basis for recovery. This is the public-relations feature of the program. The actual objective is to build in a decline in American living standards—as in Germany during the 1930’s—by eliminating the replacement of the stock of consumer durable goods for the remainder of the 1980s.