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EIR Economics

Deflationary policy urged on Reagan

by David Goldman

Even when the likelihood of an international credit-market disaster has been publicly announced by some of the world's most influential banking spokesmen, there is absolutely no need for such events to take place. There is nonetheless a strong possibility that the Volcker Federal Reserve, with help from a number of financial centers, will succeed in bringing about a paralyzing crash in both the domestic and Eurodollar markets before Ronald Reagan takes office on Jan. 20. The more than 90-point drop in the Dow-Jones index of the New York Stock Exchange during the past 10 trading days is sufficient evidence that most market participants are running for such cover as they can get.

But it must be understood—and especially among the Reagan transition team—that the origins of the threatened catastrophe are political, not monetary.

The financial scavengers who have set the events in motion that might lead to a depression worse than that of the 1930s want to confront the new administration with a set of ineluctable policy directions due to the gravity of market conditions. And, for the record, we name their names: the Mont Pelerin Society and its public relations man Paul Fabra of *Le Monde*; David Montagu and John Craven of S. G. Warburg's and now Merrill Lynch London; the "Siena Group" of economists, including Robert Triffin, Eugene Birnbaum, Robert Mundell, and Nicola Krul; and the so-called Group of 30 chaired by former IMF Managing Director Johannes Witteveen.

Two months ago, *EIR* reported the deliberations of the Group of 30, known more formally as the Consultative Group on Economic and Monetary Affairs, at a Virginia gathering following the annual meeting of the International Monetary Fund. The gathered discussed "shock treatment" for the Western economies, disingenuously ignoring the effects of monetary "shock treatment" on the fragile, overextended international lending markets. At a conference in Amsterdam last week, the Group's Executive Director, Robert Pringle, remedied that omission.

Pringle warned that the new monetary policies pursued by central banks (strangling credit growth without regard to its consequences) led to "volatility of interest rates" and "frequent and deep recessions." These, in turn, created the conditions for a general crisis on the international lending markets.

To avert such a crisis Pringle proposed that the central banks create an "international safety net" whose mere announcement would calm the fears of market participants. Since no such safety net is likely to emerge, the content of the Pringle announcement is to give the weight of the Group of 30 to rumors and fears of international markets crisis. He is pouring gasoline on the fire.

In brief, the real situation is the following: the world's poorest countries collectively owe about $400 billion in debts tied to the 6-month Eurodollar rate. If that rate stays above 20 percent for any significant period of time (it is now above 21 percent) the interest charges on that debt alone will exceed $80 billion, and the total debt

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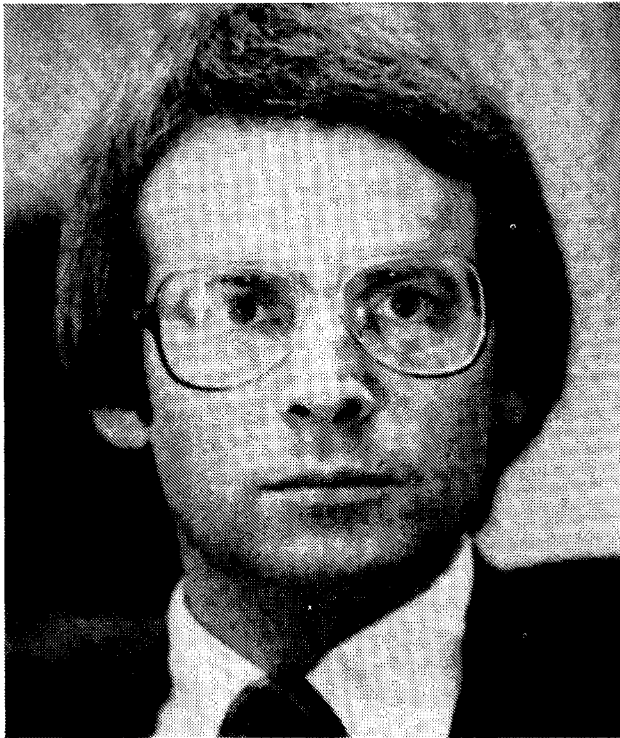

OMB designee David Stockman.

service $120 billion. *That* means that the International Monetary Fund's estimate of an $80 billion current account deficit for the developing sector during 1981 may miss the boat by *half*. Even that deficit was considered barely financeable by financiers interviewed at the last annual meeting of the IMF. One hundred twenty billion dollars and up is an amount the public institutions and the international banks cannot possibly raise.

On top of this, the credit demand of the American economy has been artificially lifted by the rise in interest rates. At a 20 percent prime, the interest charges on current liabilities are sufficient in and of themselves to compel a rate of corporate borrowing several times in excess of what the Federal Reserve has said it will tolerate.

The implication is that corporations will have to withdraw *working balances* from the Eurodollar market to meet their obligations at home. Since the Eurodollar market is a $1 trillion pyramid built out of an initial monetary base of less than $200 billion in actual deposits, the withdrawal of these balances alone is sufficient to spark a general crisis on the Eurodollar markets, with or without the added pressure of developing-sector debt refinancing.

When the West German Herstatt Bank went under in July 1974, the pyramid nearly came down. Interbank transactions in the Eurodollar market temporarily stopped, and about 30 percent of Eurocurrency balances were repatriated to the relative safety of home markets. At that time, the volume of total third world debt was less than one-third what it is now. The Eurocurrency markets today could not tolerate a single bankruptcy in the order of Herstatt.

The above information does not represent a unique insight: Mr. Robert Pringle is aware that this is the case, because it was the subject of an interviiew with *EIR* two months ago. Fed Chairman Paul Volcker knows it is the case, as do virtually all the players in the game.

This brings us to the unpleasant case of M. Paul Fabra, financial columnist for *Le Monde*, a Dominican monastery that presents itself as a Parisian daily newspaper. Fabra recommended the virtual shutdown of all credit extension (except at a penalty discount rate) in a Dec. 10 op-ed in the *Wall Street Journal* under the headline, "Why Monetarism is Failing." He wrote, "The only way out of inflation is to curb the discretionary power of the central bank to create money, as well as the central bank's efforts to set the level of interest rates through its open market operations. These discretionary powers are the origin of probably the greatest anomaly and dysfunction of the capitalist system—namely, in the market where money is created, prices are permanently distorted."

Although Fabra—whose views were seconded by the *Wall Street Journal*'s own editorial in the same issue—masquerades as a disciple of the great French economist Jacques Rueff, these views stem from Friedrich von Hayek, the Viennese economist who hoped to bring about zero growth through the elimination of the credit function in the economy altogether. This "doctrinal" point is significant for only one reason: Fabra's views have been conduited into the Reagan administration as a supposed alternative to the monetary policies of Milton Friedman.

Some of the same Reagan advisers who have warned most emphatically against "Thatcherization" through the adoption of Friedman's policies, and have protested that the Friedman austerity doctrine is inflation-causing, are nonetheless promoting Fabra's version of the same program. Prominent in this particular woodpile is one Louis Lehrman, "everybody's choice for the number-two spot at Treasury," who rose to public prominence courtesy of the *Wall Street Journal* earlier this year with a version of the Fabra proposal: elimination of all open market operations of the central bank, and the provision of funds only at a penalty discount rate.

Lehrman's plan, according to Lehrman Institute fellow and Salomon Brothers Vice President Benjamin Rowlands, "would of course mean massive bankruptcies and a huge crash of the economy." Nonetheless, Rep. Jack Kemp, the most prominent voice in the Reagan camp attacking "root canal economics," incorporated the Lehrman plan into a memorandum he co-authored with OMB director-designate David Stockman.

Featured in a lengthy report in the Dec. 11 *New York*

Times by Leonard Silk, the Kemp-Stockman paper warns of an "economic Dunkirk" if Reagan does not take "emergency action" as soon as he takes office. As far as this goes, it is good advice. But the final portion of the draft recommends that the Federal Reserve ignore money supply, interest rates, the housing market, and all other economic variables in favor of restricting the rate of growth of Federal Reserve credit, period.

The "supply-siders" have gone most of the way down the garden path. While Representative Kemp and economists like Arthur Laffer and Jude Wanniski have kicked up a storm over the implications of Milton Friedman's monetary recommendations, and helped prevent the appointment of Friedmanites like William Simon and George Shultz, they have made a deal with something potentially as bad, with raving monetarists like Louis Lehrman and David Stockman. They bought the same product under a different brand name.

To understand somewhat better how the setup worked: Lehrman used excellent contacts with the Warburg banking family (he was a protégé of the Warburg family's lawyer Maxwell Rabb in New York) to get access to the great French economist Jacques Rueff, immediately after Rueff's great collaborator, General de Gaulle, had been driven from power in France.

Lehrman presented himself as a disciple, and persuaded Rueff to give his Lehrman Institute the English-language rights to Rueff's collected works, now in publication.

In fact, the Lehrman Institute was the New York stopping-place for the strain of economics known as the Siena Club, an institution founded by the financial scavengers of the Italian nobility. Along with Mont Pelerin Society operative Fabra, Lehrman misappropriated the mantle of Jacques Rueff, who died in 1978 and hence could not protest.

Lehrman et al. therefore developed sufficient credibility to present themselves as an "alternative" to Friedman monetary doctrine.

Acting in its own best interests, the Reagan administration would find its way to an agreement with the French government of Valéry Giscard d'Estaing and the German government of Helmut Schmidt. The agreement would link the American dollar at a gold parity to the European Monetary System, preferably through a new gold-backed rediscount agency for international trade credits, and provide the credit base for the biggest expansion of international trade since the last war. This monetary agreement, which has been Giscard's object since the European Monetary System was formed two years ago, would make possible the final cleaning up of the Eurocurrency mess that has made the dollar a "suspect currency" (in the phrase of Lord David Montagu of Merrill Lynch London) for the past ten years.

At the same time, it would wipe out the power of the Eurodollar operators in London, the European continent, and New York, which depends on the ability to conduct unregulated (and reserve-free transactions) in a market which provides a haven to the world's black money.

Ultimately, the political question at issue is whether sovereign governments like those of the United States, France and West Germany will pursue policies in their national interests, or accept dictation of terms by "the market," as shaped by the likes of Paul Volcker and the other individuals noted above. The present level of interest rates and inflation is the result of—not the motivation for—the Federal Reserve's spiked-club monetary policy, as Democratic Majority leader Jim Wright pointed out in the House of Representatives two weeks ago. Therefore Paul Volcker's actions must be interpreted as an attempt to force a coup on the new administration, which came into power on a tide of popular anti-Volcker rage.

The Dec. 11 selection of Merrill Lynch chairman Donald Regan as treasury secretary is a matter of concern in this context. Regan's major concentration during the past five years has been the expansion of Merrill Lynch's international operations. To build up his London office, Regan brought on board the two men who had earlier built up S. G. Warburg to world status, David Montagu and John Craven. It may not reflect Regan's personal outlook, but it is still significant that Montagu and Craven were among the first to signal publicly the scenario depicted above.

Speaking next to former British Prime Minister Edward Heath at an International Herald Tribune conference in New York City at the end of November, Montagu warned of a general crisis of the "suspect currency," the dollar. And at the same conference in Amsterdam where Robert Pringle issued the warning of a general crisis, John Craven of Merrill Lynch announced the coming of a general structural transformation of the Eurodollar market as a result of the shift towards monetarism by central banks. "Many institutions will not survive," Craven stated.

Of course, the battle is not over, no matter who becomes secretary of the Treasury. The President-elect is more aware than anyone of why he was elected. A virtual lynch climate is evident in state legislatures and in the Democratic-controlled House of Representatives against Paul Volcker and interest rates in excess of 20 percent. Under the correct combination of measures from the new administration, the crisis atmosphere could be dispelled before any real damage is done.

The danger is that Reagan and the European leaders will treat the crisis as a self-evident phenomenon and order their priorities according to the demands of "crisis-management." If that occurs, the greatest opportunity for the advancement of the United States and the world economy to come by in two decades will have been lost.