

## Can Reagan avoid a depression?

by David Goldman

No results are available at *EIR*'s deadline from President-elect Reagan's meeting last week with economic advisers. But if the confirmation testimony of his cabinet officer-designees and recent actions on the part of Sen. Jake Garn, Rep. Jack Kemp, and other Reagan intimates truly reflect the character of the new administration, there is a chance yet that the United States may avoid a worsening depression during 1981. *EIR* has forecast a second-stage downturn of the U.S. economy during the first quarter of 1981 should Fed Chairman Volcker's monetary policy continue unimpeded.

At Senate Banking Committee hearings Jan. 7 convened by incoming committee chairman Garn, Volcker backed up against the ropes under pummeling from senators and a delegation of farmers, auto dealers, homebuilders and other small businessmen, who vehemently denounced Volcker's actions of the past year. Garn charged that Volcker's credit squeeze would wipe out every auto dealer and homebuilder in the country.

Volcker responded with the start of a lengthy description of the long-term problems of the auto industry, but Garn interrupted him. "I'm not talking about that," the Utah senator said. "I'm talking about the fact that you're putting the auto dealers and homebuilders out of business." Volcker began to say, "I understand and sympathize," and was interrupted by hoarse laughter from the hearing room.

A close reading of Merrill Lynch Chairman Donald Regan's testimony the previous day makes clear what the "consensus" in the Reagan camp has become. On mon-

etary policy, Regan denounced "the evils I see in a program of trying to control the flows of money and reserves that overshoot the mark and has an erratic effect on interest rates." Although the Federal Reserve should use monetary policy to control inflation, this should not be done "so as to get interest rates too far out of line."

Regan's formulation is identical to that of (for example) Chrysler Chairman Lee Iacocca, who recently counterattacked a *Wall Street Journal* editorial with a statement that monetary measures against inflation were acceptable, but that a Federal Reserve policy that doubled, halved, and doubled interest rates again in the course of the year represented "insanity." This is different from the monetarist criticism of Paul Volcker offered by conservative cult-leader Milton Friedman and his apostles at the Heritage Foundation. Reagan and his key people believe that Volcker has done something monstrously wrong, and that things must be done differently.

Treasury designee Regan did choose a side of the controversy over the priority of tax cuts versus budget cuts opposite Rep. Jack Kemp (see interview, page 10). However, this controversy takes place within a consensus that Volcker-style austerity is fundamentally evil. Regan himself was chosen over the earlier frontrunners, former Treasury Secretary William Simon and Citibank Chairman Walter Wriston, precisely because the Merrill Lynch chief is a pragmatic administrator with no ideological commitments.

In Reagan councils at present, former presidential adviser Alan Greenspan is throwing his weight against

early tax cuts along the lines of the Kemp-Roth proposal, and Reagan is still undecided about the issue of "timing of tax cuts," as it has been presented to him.

Representative Kemp is arguing forcefully not only for the tax cuts that have been his standard formula, but for a much broader international approach, as cited elsewhere in this issue. But he views the tax-cutting problem as the only one of real immediate tactical relevance.

The real issues have very little to do with the form of debate inside the Reagan camp. Reagan and his people are boosters and won't be shaken from their gut commitment to economic growth—a commitment displayed forcefully in the choices for the Interior, Energy, and Agriculture cabinet slots. They understand very little about the front-line problems the U.S. economy faces. This makes them susceptible to a set of potentially devastating traps which could ultimately stymie their best intentions.

The sudden entrance of Rep. David Stockman, the designated OMB director, into the Reagan economic summit on the evening of Jan. 7 with the news that the stock market had collapsed some 24 points that day captures the problem. As *EIR* has emphasized during the past several weeks, a big section of the international financial community is playing for a 1931 repetition. Ironically, the leading spokesmen for this form of shake-out were British bankers David Montagu and John Craven, who ran Merrill Lynch International until the brokerage firm fired them last week over "philosophical differences." The market drop had nothing to do with the well-publicized telegrams from the Granville letter, or any other such nonsense. It was a straight hit, on hard European selling before the New York market ever opened.

### Policy planners

A brief examination of the present deployment of the Washington-based Heritage Foundation—which *EIR* has exposed as a British intelligence front—indicates what the dangers are. Styled as "new right" ideologues, the Heritage group found itself shut out of most policy deliberation in the Reagan transition team. A list of 3,000 prospective administration appointees Heritage submitted found its way into the wastebasket rather than the transition team's personnel computers. However, according to Foundation sources, the group still holds significant prospects of taking the key policy positions relating to international financial institutions.

The immense importance of these positions has not dawned on the Reagan inner circle. Currently, about one-third of the total \$1.2 trillion offshore dollar market is locked into bad loans to developing countries. These countries face a deficit of *at least* \$120 billion in 1981, *twice* the 1980 level, due to 1) higher interest rates, 2)

lower commodity export prices, 3) recession-shrunk markets in the industrial world, and 4) higher oil prices. That is well outside the bounds of what the commercial banks, the International Monetary Fund, the World Bank, and other official institutions can possibly finance. Bankers have already taken measures to create special new lending categories which will not be affected by the collapse of pre-existing debt (see International Credit), an unprecedented, pre-crisis maneuver.

### The uncontrollability factor

If Volcker's monetary squeeze continues—and the Fed is taking action as of deadline to ensure that the fed funds rate does not drop below 19 percent—the entire debt structure of the international markets is in extreme jeopardy. So is the equally unbalanced edifice of consumer, real estate, and corporate debt in the American economy. In the most elite discussion forum of international banking, the so-called Group of 30, fear is spreading that a crisis may become uncontrollable.

The Reagan administration may yet stumble into a crisis which a section of the international financial community wants. Sen. Jake Garn, despite his rough treatment of Fed Chairman Volcker, has a foot caught in one of the ideological traps involved. At the same set of hearings cited earlier, he advanced the proposal of New York investor Lewis Lehrman that the Fed should poise the discount rate about 2 percent above market rates. Although Garn cited the plan, which is also backed by Representative Kemp, as an alternative to the Fed's mismanagement of the past year, the actual content of the proposals is a chain-reaction of bankruptcies. Lehrman's associates are completely frank on this point.

Volcker's initial premise for monetary policy is false from the start, a point that Kemp and Garn have not grasped. There are not one, but two monetary systems: the bulk of the American banking system, which provides credit to producers and consumers, and the Euro-dollar pool, to which most of the large commercial banks owe their first loyalties. Volcker's squeeze undermines the healthy sector of the credit system, while permitting the unhealthy section to flourish.

At the Senate Banking hearings, Volcker had to defend himself against charges to this effect, pressed forcefully on the Democratic side by the National Democratic Policy Committee (with which this publication's Contributing Editor Lyndon H. LaRouche, Jr., is associated) and numerous Democratic congressmen. "It is beyond human power to distinguish between legitimate and non-legitimate uses of credit," the Fed chairman said. The Republican senators did not challenge him on this point—a flaw in their attack which ultimately could prove fatal.

# Senators confront Volcker at hearings

*The following are highlights of the Jan. 7 Senate Banking Committee hearings.*

**Paul Volcker:** Tight money policies are not enough. The federal government has got to exercise restraint in spending. Large new borrowings by the federal government aggravate interest-rate pressures. We don't know the number of private borrowers who are more productive than the federal government, who are shunted aside because of government borrowing.

... It is beyond human capabilities to distinguish between legitimate and illegitimate uses of credit and then try to allocate credit. ... The period will be difficult and painful but we must attack the problems with a broad range of activity, both monetary and fiscal.

**Garn:** You remember that I supported you last spring, I supported the high interest-rate policy of the Fed because there was no other alternative. But this time there seems to be some artificiality involved in your high interest-rate policy. Inflation is at 12½ percent, yet your interest rates are at 21 percent. ... Last spring we may have been putting marginal businesses out of business, but that's not what we are doing now. We are crippling good substantial small business, we're putting auto dealers and homebuilders out of business who have been in business for years. I guess my question to you, Mr. Volcker, is: Are there going to be any good small businessmen left when you are finished?

**Volcker:** To blame the problem of the auto industry on high interest rates is fallacious. ...

**Garn:** I'm not talking about the auto industry, I'm talking about small businessmen like auto dealers and homebuilders.

**Volcker:** I understand and sympathize [laughter].

**Don Riegle (D-Mich.):** I think you're kidding yourself if you are trying to say that high interest rates aren't affecting the ability of the auto industry to recover.

**Volcker:** There's going to be some pain and strain in the short run.

**Riegle:** But we're doing a level of damage this time that's

different from last spring. We're doing terrible damage to the country. And if it doesn't work this time [high interest rates], I don't think the economy can take a third ratchet.

**Volcker:** We have to use a broad range of capabilities at our disposal, both monetary and fiscal.

**Alan Dixon (D-Ill.):** Do you have other specific recommendations outside monetary policy?

**Volcker:** We have to make sure that on the deregulation front we continue moves to ensure that more economic decision-making is done by market pressures. A whole broad range of different kinds of regulations help build inflation into the economy such as ... things like Davis Bacon, those kinds of policies.

**Garn:** The Fed has concentrated on non-borrowed reserves at the same time that borrowed reserves have grown rapidly. Isn't part of inflation being caused by the low discount rate and a wide-open discount window? Wouldn't it be advisable to rescind the lag reserve accounting policy? ... What about setting the discount rate at 2 percent above T-bill rate?

**Volcker:** The point you raised is under consideration.

**Garn:** I hope you understand the spirit in which I am saying this Mr. Volcker, but now we are going to listen to some real people who are being killed by the policies of the Federal Reserve and U.S. Congress.

**Jerry Hayes, director for Utah, National Automobile Dealers Association:** As far as the small business dealer is concerned the attrition rate is staggering. Over 1,600 dealers have closed their doors since January 1980. ... There are hundreds of small business dealers that, in effect, are hanging on by their fingernails. If we continue to experience unreasonably high interest rates for several more months these dealers literally cannot survive. ... Existing policies are in the process of destroying two of the nation's largest, most productive industries. ... Something is gravely wrong and changes in government policy must be forthcoming quickly and decisively.

**Merrill Butler, president, National Association of Homebuilders:** My message today is simple and direct. ... The current situation in the housing industry is desperate. ... The continuing actions of the Federal Reserve Board to "control" inflation by holding down the money supply through high interest rates will only lead to a double-dip recession in housing which will last at least through the second quarter of 1981. 1980 has been the second worst year for housing production since

World War II, with production dropping by 57 percent from the peak of the housing cycle in November 1978. Business failure rates for construction firms in the first nine months of 1980 compared to last year are up 56 percent for general building contractors and 93 percent for subcontractors. . . .

**Jake Garn:** I wish it had been in my power to make Chairman Volcker, the entire Federal Reserve Board and the entire House and Senate listen to your testimony. Let me ask you a hypothetical question. If one year from now, things haven't changed, interest rates are where they are now, inflation is where it is now, and the federal government hasn't curbed spending, where will you be?

**Butler:** The housing industry will be totally destroyed. We will not exist. A few large publicly owned housing corporations which are about 1 percent of homebuilders in the United States might survive, but other than that, the only homebuilding that will be going on will be government-subsidized programs.

## Regan rejects the monetarist approach

*Prospective Treasury Secretary Donald Regan gave the following testimony before the Senate Finance Committee at his confirmation hearings Jan. 6.*

*Regan opened the sessions with a statement:*

**Regan:** . . . There are four main points. 1) America's income is not growing fast enough. 2) America is not investing enough. 3) The level of investment is depressed by the interaction of inflationary expectations and erratic fiscal and monetary policies. 4) World financial markets have lost confidence in the federal government's ability to bring spending under control.

I will not recommend to the President that he declare an economic emergency. We must have a sense of urgency, not emergency—urgency to control spending, have consistent fiscal and monetary policies, lower inflationary expectations, increase investment. We must have a single, integrated, long term plan . . . delaying some needed tax reduction so we can implement those that are essential, like Kemp-Roth reductions and some form of accelerated depreciation for business.

**Sen. Dole:** Are you talking about full implementation of Kemp-Roth?

**Regan:** That is our position at present. The Kemp-Roth proposal for individuals and also the accelerated depreciation for industry.

**Sen. Danforth:** What will be your policy toward the auto industry?

**Regan:** . . . Chrysler will have to be dealt with immediately. Within a few weeks, we will have a more general policy toward the auto industry.

**Sen. Danforth:** Some say that there should not be a separate policy for auto, but that the market should take its course. . . .

**Regan:** I prefer not to comment on Chrysler at this time. The auto industry is the underpinning of the U.S. economy. Like housing, it has to be dealt with on a priority basis. Our first priority is going to be the economy as a whole. Then we will look at the auto industry.

**Sen. Byrd:** Do you feel that deficits are the prime cause of inflation?

**Regan:** There is no doubt about it. There are other events like OPEC, but the chief engine of inflation is the deficit, monetizing the federal debt.

**Sen. Roth:** We must turn this nation again into a savings nation. What else can we do to revitalize our basic industries, which are essential to our defense posture?

**Regan:** If we just trust American businessmen, give accelerated depreciation, give a tax break, they are going to come up and revitalize their own industries.

**Sen. Symms:** Your views on wage-price controls?

**Regan:** I oppose them under any guise.

**Sen. Grassley:** . . . Will you be forceful with the Federal Reserve chairman on the ills of monetization?

**Regan:** Yes. I have already begun to meet with Paul Volcker weekly, but inflation must be held down using monetary means . . . but so as not to let interest rates get out of line.

**Sen. Boren:** I have been very concerned about the effect of high interest rates. . . . I am afraid we could snap the economy before the new administration has a chance to get the economy back on the track. What is your strategy for getting interest rates down and how sensitive will you be to the danger?

**Regan:** The first thing is to cut spending and have a program of deregulation. Then we cut taxes, at the same time, that is, encouraging business to spend for productivity. When people see that this is being done, the American people will get the sense that we are trying to get inflation down. As a result of this, you will see inflation coming down.

**Boren:** So you do not believe the economy could adjust to a 15-20 percent rate of interest?

**Regan:** If this program is effective, there is no need for 15 percent interest rates.