EIR Economics

Nation-states versus the central banks

by David Goldman

In the backwash of last week's confrontation between the finance ministers of the leading Western countries April 12 in Paris, the issue of *central bank independence* has emerged as the most pressing political question in Western Europe, as well as the United States. A point of crisis has been reached comparable to the 1575 "Spanish bankruptcy," which was not a bankruptcy at all, but a takeover of the Spanish state by Genoa-centered private bankers. This established for the first time in modern history the principle that the finances and currency issuance of a great nation could be directed "independently" of the national state. The Piacenza Fair of 1579 is the original of the present Bank for International Settlements.

The brutal and open acrimony between West German Chancellor Helmut Schmidt and the president of the German Federal Bank, as well as the *Sitzkrieg* between the U.S. Federal Reserve and the other branches of the American government, are symptoms of an historical turning point. As Renée Sigerson discusses the problem below, the monetarist program exercised in the United States, Britain, and West Germany during the past 18 months has put large sections of the world credit markets into de facto bankruptcy. The alternatives come down to a debt reorganization of one form or another under the auspices of private international institutions, in particular the Basel-based Bank for International Settlements, which performed the same offices in 1931; or a general repudiation of monetarist doctrine by the leading Western nations in the weeks or at most months ahead. The former alternative presumes a drastic program of austerity both for the advanced and developing sectors.

However, national governments have found that they confront a *constitutional issue* in attempting to roll back the monetarist program. Both the 1913 Federal Reserve Act and the 1955 *Grundgesetz* of the German Bundesbank establish monetary policy as a "fourth branch of government" independent of the legislature or executive. In this context the principal allegiance of central bankers in the United States, West Germany, Italy—and other nations where the "independent" banks of issue have created a self-selecting fraternity—is not to their home countries, but to the Bank of International Settlements.

The London impasse

Last weekend's sequence of events illustrates how urgent the constitutional issue has become. The finance ministers and central bank governors of the U.S., England, Japan, Italy, West Germany, and France (the Group of Five) met in extraordinary session in London, partly to plan next month's International Monetary Fund meeting in Gabon, but principally to air European demands for *global interest rate reduction*. The convening of the London meeting followed a public demand from European leaders at Maastricht in the Netherlands on March 24. To emphasize his personal role in the matter, Chancellor Schmidt sent his economic aide Horst Schulmann rather than finance minister Hans Matthöfer as chief of the West German delegation. As expected (see *EIR*, April 14) French Finance Minister René Monory demanded that the U.S. collaborate in bringing down interest rates, and in establishing emer-

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gency funds for condition-free aid to the developing countries, who have suffered worst from double-digit interest rates. Schulmann supported Monory (who made the opening European presentation), while the West German central bank governor, also in attendance, demurred that present high inflation levels made high interest rates inevitable, laudable as the objective might be.

The Japanese supported Monory on both grounds (Finance Minister Watanabe had stopped off in Bonn before the London meeting), but on condition that no open pressure be brought against the United States. "We share a similar feeling to that of the French," a senior Japanese aide told *EIR*, "that it would be desirable to have the United States lower interest rates. But we must agree reluctantly that the United States may need high interest rates now to fight inflation."

Donald Regan, the American Treasury Secretary, made the expected reply: that under no circumstances could the U.S. even consider lowering interest rates until the tax and budget plans of the administration had been approved by Congress. Once this was accomplished, Regan explained to no one's satisfaction but the British, rates would come down in and of themselves. Fed Chairman Paul Volcker, also in attendance, had already set the meeting's tone by pushing the federal funds rate in the U.S. money markets up by about 2 percentage points in the preceding week (to roughly 15½ percent).

The meeting broke up without results, and the fight at the level of financial diplomacy will resume in a month when the same ministers, along with their Third World counterparts, meet in Gabon for the Interim Committee, or steering group, of the International Monetary Fund. The central bankers immediately flew to Basel for the regular monthly meeting of the Bank for International Settlements, where the German central banker Karl-Otto Poehl reportedly offered full support to his American and British colleagues, while other central bankers praised Poehl's recalcitrance against the German government.

A central banker present at the meeting but who asked not to be quoted told *EIR*, "What Monory asked at the London meeting was unacceptably, unutterably stupid. The heads of state who put out that statement from Maastricht [on March 24] must have been dreaming that they will lower interest rates! Volcker is totally secure in the United States."

He added, "Not until there is a global agreement on fiscal stability will interest rates come down," that is, the central banks will accept the substitution of fiscal austerity, in the form of budget cuts, for monetary austerity. The same theme was a principal subject of a conference in Frankfurt the same weekend of the Group of 30, a private advisory group to the International Monetary Fund chaired by former IMF Managing Director Johannes Witteveen. Witteveen told a London press conference afterwards that he was concerned about the effect on the developing countries of present high interest rates (the LDC's as a group will pay an extra $15 to $20 billion this year in additional interest costs due to the June to January rise in dollar interest rates). Instead of the present "over-reliance on monetary policy," Witteveen urged Western countries to adopt *wage and price controls* as an alternative method of combatting inflation, an approach also urged editorially by the London *Economist*.

Schmidt's hubris

Chancellor Schmidt, however, is not playing by the usual rules. The signal importance of the previous week's joint Franco-German $6 billion loan on the Euromarkets, which will apparently be taken up substantially by Saudi Arabia (which has in any event doubled its rate of investment in West Germany from last year's rate of $10 billion per year), was the subject of a lead editorial in the April 15 *Frankfurter Allgemeine Zeitung*. The *FAZ* writer, Wilhelm Zeuss, wrote, "The *éclat* between the Chancellor and the Bundesbank is unsettling for those who want a stable monetary policy." He explained that the original form of the Saudi loan proposed by Schmidt, a subscription denominated in the European currency-of-account, the European Currency Unit (or ECU), was a plot to subvert the monetary authority of the Bundesbank. If the loan were denominated in ECU, it would have extended—at least symbolically—the role of that unit from a measure of drawing rights for temporary currency-intervention purposes from the European Monetary System to long-term credit issuance. This is the object of the European Monetary Fund, proposed as a second phase of the European Monetary System, which now maintains eight European currencies in a fixed-parity relationship by providing gold-backed credits for currency intervention. Karl-Otto Poehl, in a speech in West Germany last week, blasted the proposal to move to the second phase.

But, Zeuss continued, "Schmidt hadn't reckoned on the opposition of the Bundesbank." Poehl used his legal powers to prevent the assumption of an ECU-denominated credit, which is why the loan was announced in dollars, deutschmarks, and French francs. An additional benefit to ECU denomination would have been to link the Saudis and other Arab states more closely to the European Monetary System, but giving them an ECU-denominated portfolio asset.

Nonetheless, the proceeds of the loan, lent out to industries for long-term investment purposes at an interest rate 2 percent or more below market levels in both France and Germany, subvert Poehl and his colleagues. "The interest rates subsidies are a thorn in

the side of the Bundesbank," argued *FAZ* writer Zeuss. "It poses a danger to the order of the credit markets, by creating a two-tier system. Even the requirement for energy saving [Schmidt had targeted the high-technology sphere of the energy sector as a principal beneficiary for such loans] does not justify a split credit market, which will undermine Bundesbank monetary policy."

In other words, Schmidt and Giscard have played the Saudi card in West Germany, in order to deal with the Bundesbank from a position of strength, to the immense consternation of the central bankers. Poehl's position is not nearly as secure as the BIS meeting gave out. Last week, the prime minister of France, Raymond Barre, sent a letter to Schmidt officially complaining about the level of West German interest rates, in order to "provide Chancellor Schmidt with ammunition against the Bundesbank," as the London *Financial Times* commented in a front-page article April 14. Schmidt passed the letter on to Poehl with the comment that the Bundesbank president was only one of 15 directors of the Bundesbank, hinting at a government-inspired factional brawl inside the bank itself.

On April 2, at a regular policy meeting including the cabinet and the heads of the German *Länder,* or states, Schmidt blasted Poehl in a personal attack "that left Poehl personally angered and affronted," according to a participant. Finally, on April 14, the chancellor himself sent a letter to Poehl admonishing him for having missed several opportunities to lower interest rates, and insisting that he take the next opportunity to bring German rates down from their present 11 to 12 percent.

All of West Germany is in uproar over this unprecedented constitutional fight. Previous chancellors have put pressure on the Bundesbank, but none has ever kicked over the card table in this fashion. While the president of the German Bankers Association, Harald Kuehnen of the investment bank Sal. Oppenheim, openly defended Poehl in a statement released April 13, the chairman of the board of the Dresdner Bank, Hans Friderichs, warned that any further increase in interest rates "would have disastrous effects on the finances and investment capability of medium-sized companies."

The battle below the surface in Washington

The scramble over the Reagan tax and budget program has momentarily obscured the "fourth branch of government issue" raised by Democratic congressmen more than two months ago, namely, whether the Federal Reserve's independence was constitutional. However, it seems likely that the Federal Reserve will be under assault from several sides at once by the time this publication reaches our readers. In reality, Paul Volcker's position is less secure than it ever has been.

In a background conversation, a member of the Reagan cabinet who asked not to be identified said of the European proposals from Maastricht, "I think the Europeans have the right idea, but at the moment I am outnumbered" in the cabinet. By our count two members of the cabinet have told the President that the Volcker-Stockman combination is a disaster, and the European proposal should be taken up, and at least two others are sympathetic to this view (but less influential in economic matters). The President's ill-health appears to have been the principal advantage Volcker has had in dealings with the White House, postponing a fight which Reagan may be viewing as inevitable.

The vacuum of power in Washington has not entirely worked to the advantage of the "independent" Federal Reserve. Earlier, the White House, however much it disliked what Volcker was doing, had been at great pains to keep its own troops in line and avoid public attacks on the Federal Reserve chairman. This accounts for the switch in the attitude of the Senate Banking Committee, which nearly roasted Volcker alive during hearings earlier in the year, but conducted what one Democratic staffer disgustedly called a "love fest" with the Fed chairman last month.

Now the patience of the troops is wearing thin. The chairman of the Senate Banking Committee, Jake Garn of Utah, is reportedly studying the European proposals with great interest. Other Republican senators are looking for opportunities to take on the interest rate issue. The U.S. League of Savings and Loan Associations, one of the most powerful of the solid Republican lobby groups, spent months holding their fire against Volcker (although one of its senior officials told audiences around the country that they should "put out a contract on Volcker"); now the U.S. League (see Banking) feels it can't wait for administration action any longer, and is preparing to go after the Fed directly.

The most telling feature of the Schmidt-Giscard initiative on interest rates is that, instead of merely complaining about it, they have actually gone out and raised low-interest money. American corporations in Germany, among others, will see the benefits. The *International Herald Tribune* commented April 10, "The key issue being debated is whether restrictive monetary and fiscal policies should be relaxed in favor of stimulating growth and investment, possibly with coordination or lowering of interest rates on both sides of the Atlantic. 'Their plan could catch on elsewhere,' said a Western diplomat, noting that the promotion of expansion along with related questions, has been discussed intensively in the last few months at the 24-nation Organization for Economic Cooperation and Development. . . . [The Franco-German action] 'will certainly strengthen the hands of those within the OECD and EEC and elsewhere pushing for a relaxation of present restrictive approaches in favor of stimulation.' "