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Central banks bicker over global policy

by David Goldman

Swiss, British, and American central banking sources report a three-way difference of opinion between those countries' central bankers at the regular monthly meeting of central bankers at the Bank for International Settlements in Basel.

The Bank of England's outgoing Governor, Gordon Richardson, and Swiss National Bank chairman Fritz Leutwiler were unanimous that the Fed's excruciatingly middle-of-the-road monetary posture would lead to the "worst of both worlds," a sharp upward spike in interest rates, and no U.S. recovery during 1983. However, they disagreed bitterly as to how the Fed should proceed. Fritz Leutwiler, the Alberich of the world financial community, wants the central banks to trample the "illusions" of the Third World and the "wishful thinking" of the industrial nations under heel, and use monetary policy to reduce demand—essentially what Volcker did during 1981 and 1982 (see interview this issue). The British want the Federal Reserve to lower the discount rate fast and throw out concessions to so-called inflationary expectations.

According to a source close to the Bank of England's Richardson, "The Europeans' view [by which is meant Bank of England and the Bundesbank] is that they are annoyed at the Fed for listening to what they consider to be the wilder views on the European markets (that is, the Swiss), who are worried about inflation. In particular, they think that Volcker is paying too much attention to the price of gold. They think that the Fed should put more emphasis on the success achieved so far in combatting inflation. The Bank of England and the Bundesbank both think that the Fed should give the markets a clear view of what it is doing. Now the Fed is just doing what it thinks the market wants, and that leads to the worst of all possible worlds. That's why the market is so jumpy. I have never seen a market so jumpy, so susceptible to wild swings; there could be a very sharp run-up in interest rates.

"We are now moving back into the sort of psychology we had last June and July, with major differences between the Europeans and Americans. The Europeans worry that American monetary policy is much too tight, that it will abort the recovery and leave them much worse off than before."

Compare this to Leutwiler's formulation:

"On the U.S. budget, I have become a fatalist. We have to accept it as it is. If the U.S. administration cannot reduce the deficit, who could? I am more concerned with U.S. monetary policy. In which direction is it going? I would be pleased to think that any of my U.S. colleagues know what they are doing. I am very serious on this, very serious. But they do not know where they stand. How will the Fed react to a recovery, to increased credit demand, to the impact on international interest rates? The market knows of the deficits. This could set off false reactions, false anticipations of the market concerning monetary policies."

The evaluation is identical, and is not unfair relative to the actual problems entailed in meeting the Treasury's possibly over $300 billion financing requirements for this year, as shown in the accompanying table (updated and corrected slightly from a chart first published in *EIR* Feb. 15).

The International Monetary Fund's Financial Studies division guesses that the resultant gap will be met by massive foreign inflows at the expense of Europe and Japan; little wonder that the Europeans would want the Fed to reflate instead, and that European-American relations would be tense, as the Bank of England notes. Private analysts like Alan Lerner at Bankers Trust believe that the money will ultimately come from private savings drawn by higher interest rates with the result of a renewed economic downturn; Lerner thinks rates will rise sharply in the second or third quarter. The disastrous impact of a rise in American interest rates upon the bankruptcy proceedings now taking place, in fits and starts, on the international markets, was a major subject of IMF Managing Director Jacques de Larosière's talk to the Interim Committee of the IMF in early February.

Volcker's testimony before the Senate Banking Committee Feb. 16, in which he revealed his credit and monetary targets for the coming year, confirmed the profile feared by both the Bank of England and the Swiss. The chosen targets are essentially the average growth for each category during the past three years, with a 1½ percent band of fluctuation on either side.

Long-expected was the official burial of "M-1" as a policy instrument, and the adoption of credit in addition to "monetary aggregate" targets, since bank deregulation has made chopmeat of the monetary targets, poor as they were in the past. Volcker's target of 6 to 9 percent growth for bank credit corresponds roughly to the 7.2 percent growth rate during March-September of 1982, i.e., when the economy was contracting (in terms of industrial output) at a 7 percent annual rate. His total credit target of 8½ to 11½ percent also assumes a continued reduction in economic activity, given the extraordinary increase in the Federal deficit.

For the economy to receive net new credit, total credit expansion must be in excess of interest payments on old debt; otherwise, the expansion of credit will reflect net repayment of debt after interest costs are taken into account. With a nominal interest rate of 11 percent or higher on both bank debt and bonds, Volcker's targets do not make recovery possible: his Feb. 16 testimony to the Senate Banking Committee, with its dire warnings about the effects of high government deficits, implies that, although Volcker did not say

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so directly. The only official agency to state the obvious in writing has been the International Monetary Fund, whose North American Secretariat warned in its current (confidential) report on the American economy that Federal financing demands would squeeze out the private economy.

The Federal Reserve staff has no good answer to this problem; one senior staffer commented, "The private market agrees with you [*EIR*]; it can't see how the deficit is going to be financed. That's why it's so jumpy."

Restrictions and solutions

Within the present boundaries of monetary policy, i.e., without some form of directed credit, there is no means to close the "borrowing gap" without accelerating the slow-motion" collapse of the monetary system. That is one good reason for central bankers to bicker over the subject; as the Bundesbank must be thinking, different Federal Reserve policies imply different victims, at least in the short run. A tight Fed policy implies more capital outflows from Europe, which is precisely what Europe does not need; Denmark, Sweden, Belgium, Portugal, Spain, Austria, and perhaps even France already will have to borrow from the international agencies this year.

There is also a matter of audience. The Bank of England cannot stray too far from the blandishments of the British government respecting the British Commonwealth and British relations with the Third World; where Fritz Leutwiler projects a policy environment in which the Third World can get no money under any circumstances, the Bank of England has difficulty doing this. On the contrary, the Bank is more disposed to promise world reflation and perhaps even the "new Bretton Woods" that former British Prime Minister Edward Heath, in his capacity as a Brandt Commission member, has promised to Britain's former colonies. Leutwiler is not only more "realistic"; he also has no former colonies with whom to maintain appearances.

The conclusion is identical from the standpoint of both the United States and the developing countries—who now, ironically, appear to be pitted against each other. The United States must take urgent measures to throw out Volcker's entire set of methods (not merely his particular set of targets), or suffer a gigantic internal and external crisis; and the Third World, as Leutwiler warned, will get no money under the Volcker regime in any event.

As *EIR* has demonstrated, the United States must spend its way out of this crisis, not by "creating demand," but by financing exports, infrastructure, high-technology research, and investment, and at precisely the time when American financial reserves appear exhausted. Nothing else will work. *EIR* founder Lyndon H. LaRouche's proposal to remonetize American gold at $500 per ounce would provide an immediate backup of liquidity with which to reduce interest rates on U.S. government debt and put the required programs into motion. Ordinary monetary tinkering will lead to the consequences which both the British and Swiss indicate.

Sources and uses of Treasury funds

	3RD Quarter 1982*	1983 (est.)
Borrowing	$288.7 bn.	$319 bn.**
Funding Sources		
Private non-financial	$146.3	$120
Federal Reserve	35.4	20
State and local government	36.7	15
Commercial banks	10.9	40
Households	34.8	35
Foreign	8.0	−12***
Corporations	7.0	3
Borrowing gap	$ 0.0	$98.3

*Latest complete data from Federal Reserve Flow of Funds tables.

**$319 billion includes $69 billion of "indirect," i.e., sponsored or guaranteed agency borrowing as announced and $8 billion for the International Monetary Fund, both not figured into the budget, with a lower growth assumption than the administration's. It applies the Congressional Budget Office formula that each point of GNP growth equals $10 billion in federal revenues, and concludes that the administration's $224 billion deficit projection is too low.

***Taking into account expected net OPEC liquidations of U.S. Treasury securities; this category could change drastically under conditions of market instability.

Under reasonable assumptions, the federal government of the United States will be unable to find the resources to finance $98.3 billion of its total requirements during the present calendar year. As the above table shows, the majority of the $288.7 billion per year deficit registered during the third quarter was financed through traditional savings sources, i.e., financial corporations and households; the projection for 1983 assumes that these remain stable. However, special factors were present to make funds available that cannot continue. First, the Federal Reserve bought government securities at a staggering $35 billion annual rate, bringing on the now notorious "money supply explosion"; this cannot possibly continue, as Fed Chairman Volcker insisted in recent congressional testimony; even the $20 billion figure for Fed purchases of government securities in the projection would represent an all-time record. The shift in the Saudi surplus to deficit implies a $20 billion net swing away from foreign purchases of U.S. Treasury securities, as shown. The enormous purchases by state and local governments reflects short-term arbitrage factors which market analysts agree cannot possibly continue. The added deficit plus reduced special factors bring the "borrowing gap" up to $98.3 billion, implying a fiscal catastrophe for the United States this year.