LaRouche-Riemann model debunks the Fed's swindles

by David Goldman

The U.S. economy continued to decline during 1983, and will shake out recent short-term gains in consumer-goods production between September 1983 and April 1984, according to *EIR*'s just-released Quarterly Economic Report.

The report, which has the only accurate forecasting record among economics services over the last four years, uses the LaRouche-Riemann economic model as a basis for judgments about U.S. economic behavior. Developed by *EIR* founder Lyndon H. LaRouche, Jr., the model has successfully tracked the decline of the U.S. economy since Paul Volcker took office in 1979.

Although the tangible output of the U.S. economy will rise at a 2.6 percent annual rate during 1983, the productive potential of the economy (measured by net investment in labor and capital) will continue to decline, the report shows. This contradictory situation includes strong rises in auto and housing production, combined with continued deterioration of basic industry.

Auto production now exceeds 7 million units per year at an annual rate, and housing starts are at a 1.7 million annual rate, low levels by historical standards, but substantially higher than the 1982 low. The financial means by which these increases have been achieved are rapidly exhausting themselves. The 1.5 percent rise in short-term interest rates from the January low point will continue, and an additional 1 percent increase in short-term rates will be sufficient to trigger an end to the consumer-financing cycle. The housing boomlet, the most important single factor in the supposed recovery, depends on a $100 billion per annum flow of "off-budget financing" to the secondary mortgage market; this in turn depends upon Federal Reserve provision of funds to the banking system, which is carrying a disproportionate share of financing a total $350 billion per annum Federal borrowing requirement.

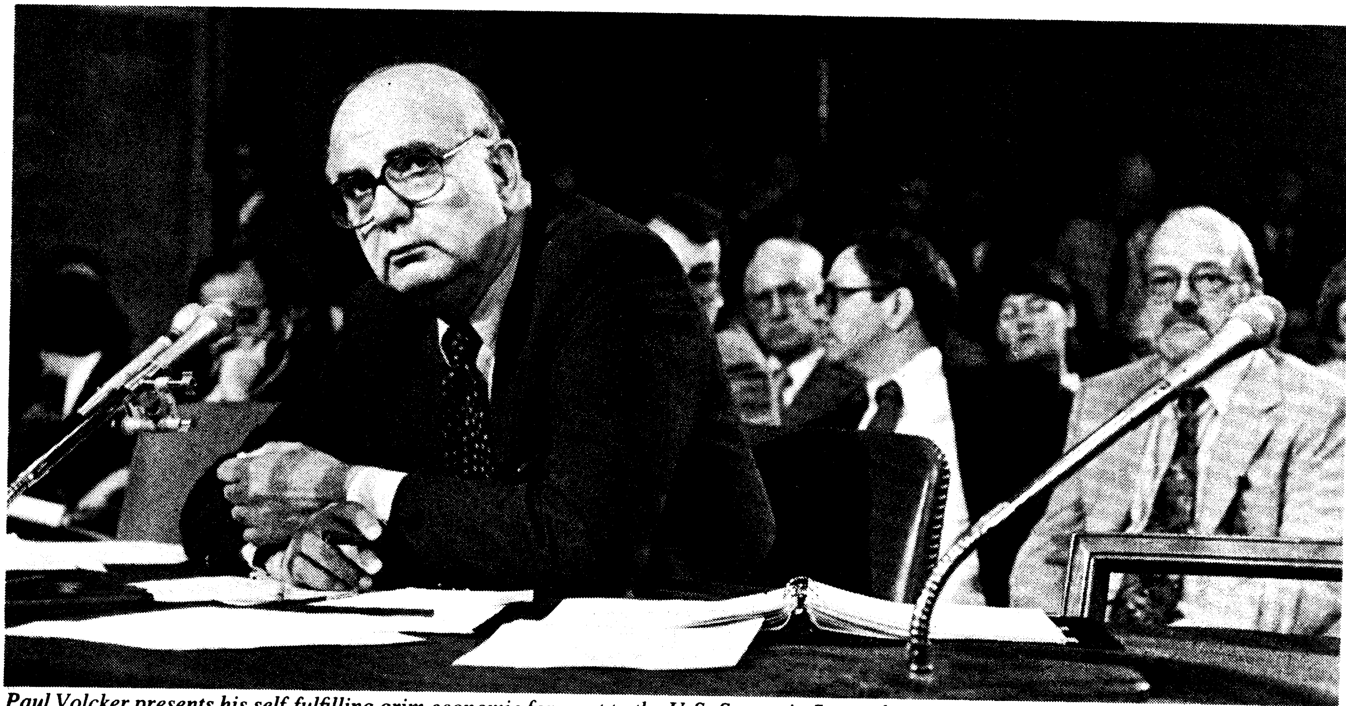
The apparent recovery in the consumer sector will be aborted either when short-term interest rates reach a "trigger" level of roughly 10.5 percent, or when major trouble emerges in the international banking market. With the effective default of Brazil on $3 billion of interest payments since May, the international debt crisis has reached its penultimate phase; barring a comprehensive debt reorganization, the crisis will continue to unwind, with deleterious effects upon the American economy.

On the foreign side, we expect a trade deficit in the range of $65 billion, prompted by a 10 percent overall reduction in exports during 1983, including a 50 percent reduction in exports to Ibero-America as a result of the world debt crisis. The size of the trade deficit, combined with problems for the dollar emerging from the international debt crisis, may produce a sharp fall in the dollar later in 1983.

As a result of falling foreign sales, rising interest rates, and possible trouble in the banking system itself, we project a 5 percent drop in output during 1984, bringing the economy as a whole below the 1982 low point. This may be avoided only if Reagan deals satisfactorily with the world debt crisis.

For two fundamental reasons, the economy remains in continuing decline, according to the LaRouche-Riemann model's measure, despite the short-term, and short-lived, increase in tangible output.

First, the economy's productive base of labor and capital



NSIPS: Stuart Lewis

Paul Volcker presents his self-fulfilling grim economic forecast to the U.S. Senate in September 1981.

continues to deteriorate. The rise in output occurred while productive investment into the goods-producing sector declined; corporations financed the output increase by reducing capital spending and extracting more production from a shrinking segment of their existing plant and labor force.

Second, the Treasury and Federal Reserve financed the public-relations recovery through the "off-budget" agencies of the federal goverment and the printing-press.

To summarize the events of the past six months: the Federal government undertook a $100 billion annual subsidy to the housing market, a $30 billion subsidy to the nonfinancial corporate sector through various tax breaks, and a $20 billion increase in agriculture supports, among other forms of largesse, raising the actual deficit (including the various off-budget operations) to the range of $350 billion. This astonishing exposure of the public credit of the United States did not crush the domestic credit markets because:

1) The Federal Reserve increased non-borrowed reserves at an unprecedented 13 percent annual rate during the last quarter of 1982, and the first two quarters of 1983;

2) Federal Reserve chairman Volcker's "banking deregulation" diverted the entire expansion of the financial sector into commercial banking deposits, while drastically lowering the reserve requirements for such deposits;

3) The banking system, in turn, bought government debt at a $100 billion annual rate during the first half of 1983, quintuple its previous highest rate of purchase of government securities;

4) Goods-producing corporations financed themselves through attrition of capital and labor, rather than obtaining credit from the banking system. In short, the banking system became, to a great extent, a captive financing agency for the Federal Reserve and the Treasury, and the "banking multiplier," enhanced by the manipulations of "deregulation," financed the enormous Federal deficit.

To sustain this chain-letter expansion, the American financial system undertook a vast program of arbitrage, i.e., turning short-term money pouring into the banking system courtesy of the Federal Reserve into medium- and long-term financing for the Federal government and its agencies. The U.S. government dominated the housing "recovery." In 1981, the U.S. government accounted for 28 percent of all funds advanced for housing. But in the fourth quarter of 1982, the start of the 1983 federal government budget fiscal year, the government accounted for $88 billion, or more than 100 percent of the total $84.1 billion housing money advanced in that quarter (the S&Ls and commercial banks drew down their mortgages, in that quarter). In the first quarter of 1983, the government accounted for $76.9 billion or 57 percent of all funds advanced.

Commercial banks bought 10 to 11 percent Treasury and "agency" paper with 8 to 9 percent short-term money; the Federal Reserve strove to suppress the rise in interest rates, which would, were rates to rise an additional 1 to 2 percent, shut down the arbitrage process in the financial system and terminate the "recovery." Once short-term rates cross a threshold at 10.0 to 10.5 percent—the interest rate on the government paper, financial institutions are now holding—the flood of mortgage-market paper will dry up, housing starts will collapse, and the economy as a whole will ratchet backwards. As described in this report, the financing of low-interest auto loans depended upon the same bag of tricks.

The appearance of recovery vanishes once the United States economy is examined in its proper, global, context. The same means which the Treasury and Federal Reserve employed to produce the appearance of recovery have pushed the world to the brink of the worst international financial crisis of the century. And, contrary to the usual mode of presentation, this "debt bomb" in the developing sector is not an exogenous threat to an otherwise healthy American recovery.

The disappearing foreign subsidy

The collapse of Brazil's, Mexico's, Argentina's, Venezuela's, and other nations' external finances is not the product of events internal to their economies, but of the methods employed to sustain the American dollar while the real-economic position of the United States in the world collapsed. Without the deterioration of the Third World's terms of trade by half between 1979 and 1983, and without an estimated $50 billion inflow of "flight capital" into the United States during the past year, the juggling act performed by the Federal Reserve would not have been possible. As noted, Paul Volcker and Donald Regan could not have ballooned the federal deficit into a $350 billion mechanism for sustaining major flows of mortgage and related consumer credit, except at a high price for the dollar and a low price for credit. The "strong dollar" has been subsidized by the collapse of the Mexican peso, the Brazilian cruzeiro, the Venezuelan bolivar, the French franc, and the Italian lira, as well as the deterioration of other currencies. American interest rates could not be suppressed, even temporarily, without massive flows of money across legal exchange-control barriers into the American banking system.

The financial subsidy exacted from the countries least able to provide it has a parallel in world flows of tangible wealth. America's estimated $60 to $70 billion trade deficit for 1983 is not the result of demand-led recovery: it is a subsidy by the rest of the world, emphatically including the developing sector. As documented in this report, the foreign trade deficit not only compensates for the unremitting decay of American capital-goods production, but the decay of electrical capacity. Electrical output has continued to fall through the first half of 1983, an unprecedented event during periods of postwar decline until last year's decline, and an inexplicable anomaly in a period of supposed recovery. The United States is importing embodied electricity in the form of chemicals and primary metals.

There are two potential breaking-points in the world flow of available capital into the United States, Ibero-America, and Western Europe. The present crisis over the Brazilian debt, to be followed within six weeks by parallel crises in Venezuela, Chile, and perhaps Argentina, represents the most immediate detonator for world financial crisis. In Western Europe, however, France, Italy, and Spain, are only somewhat behind the Ibero-Americans in an evolving financial crisis.

Europe's financial crisis is indissolubly linked to the Ibero-American crisis through the mechanism of the global interbank market. In financial terms, France, Italy, and Spain are moving rapidly into the position of Ibero-America now, except with a six-month delay. The other difference is that these three worst-off countries cannot go to the IMF: Although between them they can legally demand over $25 billion in loans under the "enlarged access" formula, the IMF does not have the funds and could not get access to them; the IMF is already struggling to reduce its commitments.

France, with close to $100 billion in external debt, is rapidly becoming another Brazil, but with perhaps fewer resources respecting the world market with which to postpone its crisis. Italy, if possible, is in even worse condition; Spain is on the verge of major political as well as economic dislocation. Federal Reserve specialists view the interbank market as the most visible fuse with respect to the European debt bomb.

At what point will the Federal Reserve's juggling act come apart? The fragile stability of the U.S. economy is at jeopardy in each of the series of cliff-hanger negotiations with Ibero-American debtors. The first significant default by a major debtor (Mexico, Brazil, Argentina, Venezuela, Chile) will at best force a sharp contraction of credit, and at worst, a general banking crisis. Such a crisis could emerge at any moment between now and next September.

The illiquidity of Ibero-America and Europe, the attrition of oil-producing countries' deposits in the Eurodollar market (due to the continued worldwide collapse of oil demand), and fears of a banking crisis have combined to drive Eurodollar rates up sharply during the past six weeks. It is possible that the warning tremors of financial crisis alone will be sufficient to force up interest rates and destabilize the juggling-act in the domestic American credit system.

Whether the short-run production indicators will head down rapidly upon the outbreak of a banking crisis, or slowly, due to a gradual rise in interest rates, is a political question whose answer lies outside the scope of economic analysis. In our present forecast, we indicate the direction of the economy defined by deterioration of domestic credit conditions through the remainder of this year.

Apart from slightly better results in auto, housing, and related sectors, the fundamental feature of our forecast has remained unchanged. The LaRouche-Riemann model views the economy as a physical system. Its most basic measure is the rate of free energy of the system: the portion of tangible goods output available to expand future production as a percentage of total output. This defines the economy's potential for future growth as a function of its present output.

Within the limitations of the present generation of the LaRouche-Riemann model, which can only treat the physical reality of the production process, i.e., its efficiency of energy-conversion, as an external input, this measure is nonetheless the most accurate "leading indicator" of economic development available. According to our forecast, it stood at negative

2 percent at the beginning of 1983, moving toward negative 6 percent at the beginning of 1984. This means that the economy is now destroying its productive capacity at a 2 percent annual rate, trending towards 6 percent. This corresponds to the continued collapse of capital investment, measured against the minimum replacement needs of American industry.

This measure is a potential rate of growth or decline; at what point the potential decline will be realized, or even exceeded under conditions of financial crisis, is a political question whose possible answers we may examine, but not specify in advance.

The economic forecast

We have adjusted our "baseline" scenario presented in April of 1983 to reflect the impact of the chain-letter financing game described above, taking into account the complex of means employed by the Treasury and Federal Reserve to promote the appearance of recovery. By one, most important measure, the scenario remains unchanged, in the sense that the "free energy ratio" of the economy, reflecting the change in its productive potential, has not changed. However, the artificial, and temporary, stimulus to certain industries has changed some of the sectoral forecasts. The accompanying figures show the difference, if any, between our April forecast and the present one. The present forecast is, therefore, doubly complicated. The relationship between the intentions of policy-makers and the outcome of specific decisions has been severed by the immediacy of world financial crisis.

The adjusted baseline scenario has the following conclusions and assumptions:

1) That the additional 1.5 percent rise in interest rates (six month Treasury bills at 10.9 percent) will lead to a resumed decline of the U.S. economy during the second half of 1983. This rise in interest rates, as noted earlier, will interdict the flows of housing and, to a certain extent, automobile consumer credit, shutting off the source of short-term production gains. The net gain of tangible output will be 1.5 percent, or approximately $17 billion 1972 dollars, for the year 1983, partly due to a projected 8 percent fall in the output of one of the largest sectors, agriculture. This projection is considered "most likely," with the proviso that it may be complicated by a sharp deterioration of the world monetary situation.

2) That the combined continued pressure of Treasury borrowings $150 billion in excess of normal sources of financing, as well as the continued rollover pressure of developing-sector nations on the international markets, will bring the interest rate for short-term credit to above 10.5 percent by the fourth quarter of 1983, as opposed to 8 percent at the beginning of January 1983.

3) That credit is widely available for users of short-term credit, but that long-term credit either for capital investment or for consolidation of debt remains in short supply due to the extraordinary demands of Treasury financing during the next two fiscal years.

Figure 1.
Tangible profit and overhead in the total U.S. economy
(in billions of 1972 dollars)

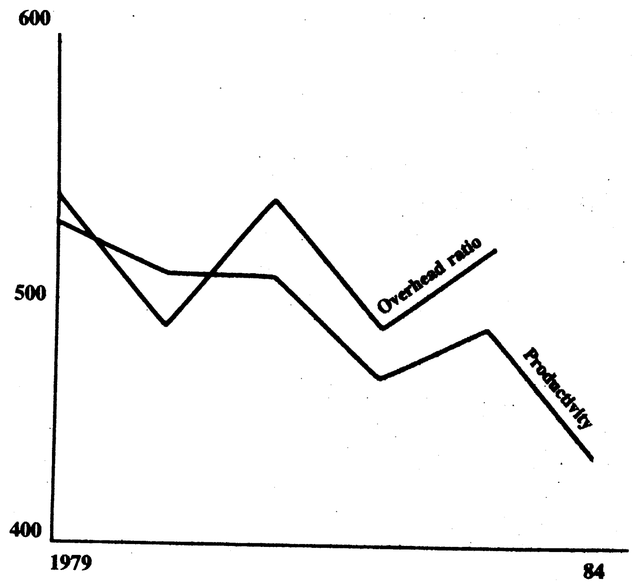


Figure 2.
Growth rate of tangible profit of the total U.S. economy in dollars
Percent growth

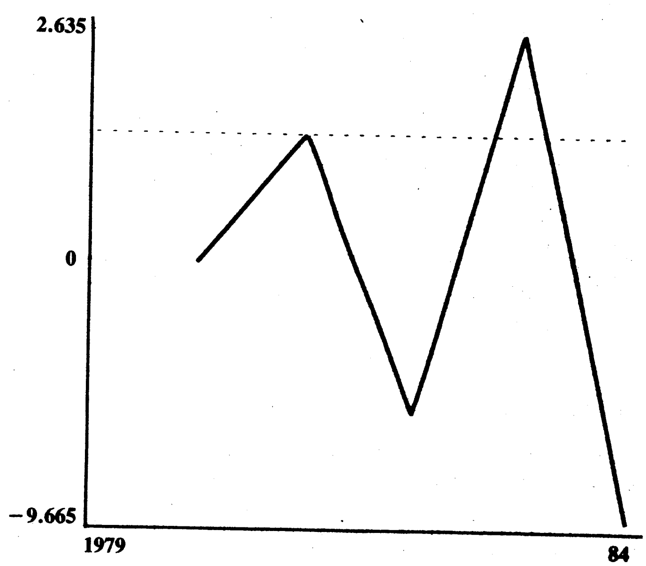


Figure 3.
Tangible wage bill (V) of total U.S. economy
in billion 1972 dollars

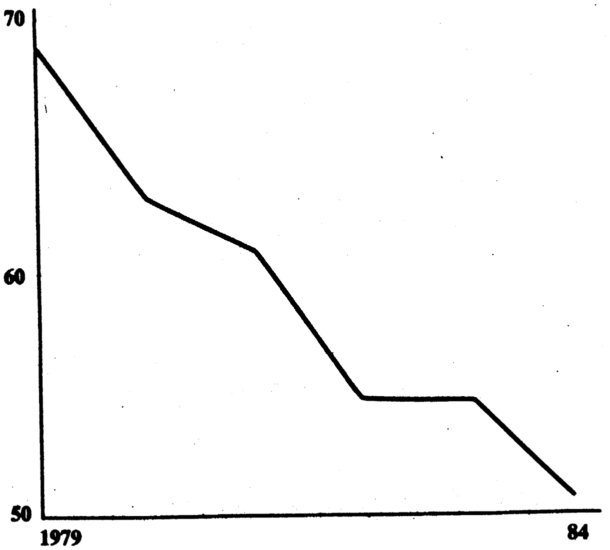


Figure 4.
Productivity (S/V) and overhead ratio (O/V) of total U.S. economy

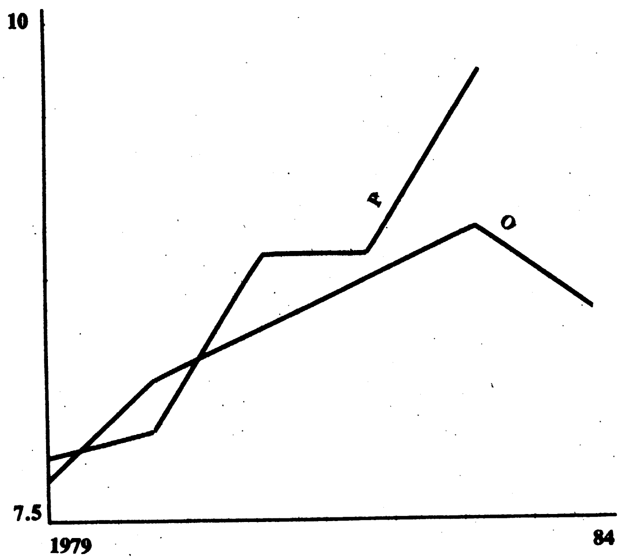


Figure 5.
Replacement cost of plant and equipment (C2) of total U.S. economy
In billion 1972 dollars

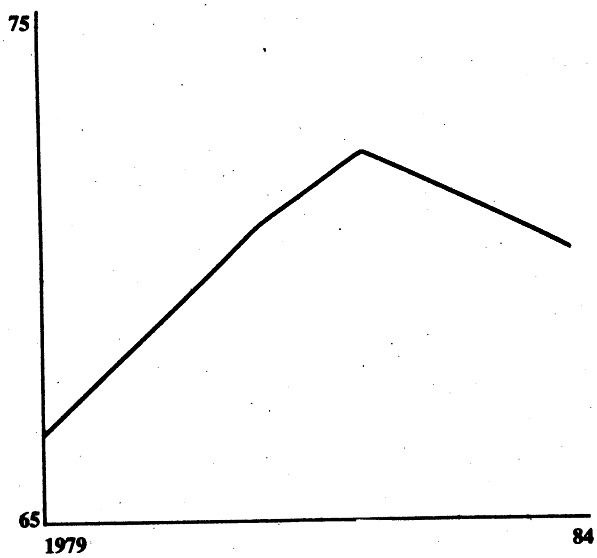
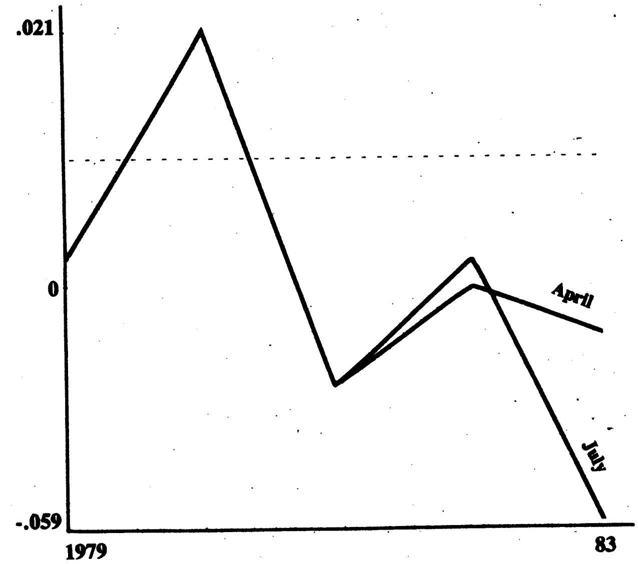


Figure 6.
Instantaneous growth rate (S′/(C+V)) totals for the U.S. economy: Comparisons of the April and July forecasts



4) That the rise in interest rates will trigger a general reduction of availability of large-scale mortgage credit and discount-rate auto loans.

5) That the overhead costs of the economy, defined by both the military budget and the additional cost of unemployment compensation and other social welfare programs, will remain high as a result of depression.

Figure 1 shows the production of tangible profit and the overhead spending in the U.S. economy from 1979 to 1983-84. Tangible profit has fallen from a 1979 level of $521 billion 1972 dollars to a level, in 1982, of $468 billion. As shown, overhead spending has exceeded tangible profit for three of the past four years, and this gap is shown to increase to $40 billion 1972 dollars in 1983. Note that no specific prediction of overhead is made for 1984, since this is a derived quantity in the model.

Figure 2 shows the growth rate of tangible profit. The figure indicates a modest rise (2.6 percent) in 1983, followed by a fall of 9.7 percent in 1984. This rapid decline is the consequence of both an anticipated worsening of the world financial situation and the exhaustion of the productive capabilities of the economy without reinvestment, during the current period.

Figure 3 shows the tangible wage bill for the entire productive economy. Wages considered net of inflation and "service" costs have been falling throughout the period from 1979, and the "recovery" of 1983 will no more than slow that fall. The figure indicates a new decline in 1984, in synchrony with the overall economic deterioration.

Figure 4 shows the labor productivity of the economy as defined by the LaRouche-Riemann model, the ratio of tangible profit to the tangible wage bill of the productive work force. This ratio has continued to rise and the increase between 1982 and 1983 is not unusual. However, the figure shows a decline between 1983 and 1984, as the increased productivity "wrung out" of the economy is not sustained. The ratio of overhead to the tangible wage bill is also shown, an indication of the burden placed on the productive work force by the current structure of the "service-oriented" economy, as well as by continued high costs of maintaining a large unemployed population.

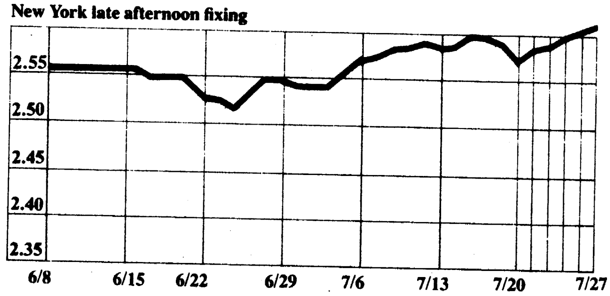
Figure 5 shows the replacement cost for all plant and equipment in the economy. The decline from $72.5 billion 1972 dollars in 1982 to $70.5 billion in 1984 reflects the decreases in capacity which are occuring as plants are shut and obsolete equipment is not replaced.

Figure 6 shows the ratio of net reinvestment to total operating cost, $S'/(C+V)$, as predicted in our April forecast and now. This ratio can be considered the potential growth rate of the economy, and while the economy is not declining in 1983, the potential for such a decline has not been reversed. In our forecast, the current expansion, based only on productivity increases without capital investment, leads to a more negative rate of reinvestment, and thus a more negative potential for growth in 1983-84.

Currency Rates

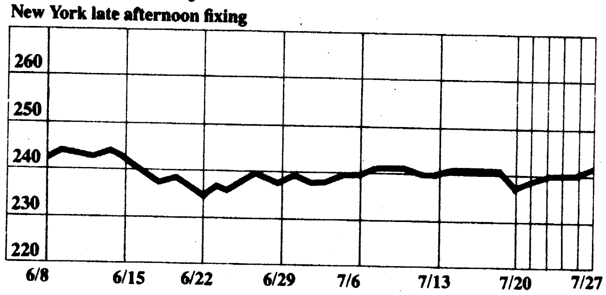
The dollar in deutschemarks

New York late afternoon fixing



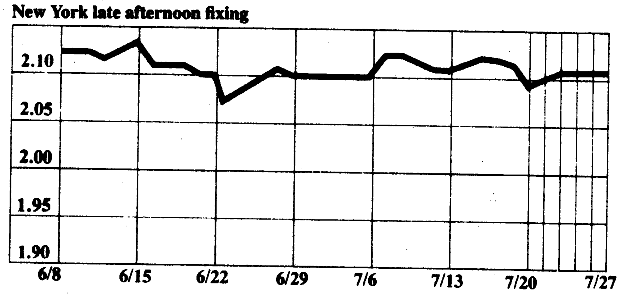
The dollar in yen

New York late afternoon fixing



The dollar in Swiss francs

New York late afternoon fixing



The British pound in dollars

New York late afternoon fixing