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June economic summit: under water in Venice

by David Goldman

No new American policy initiative will surface at next month's summit of the major Western industrial nations in Venice, administration officials are warning the financial press. Washington now concentrates on making it through the week. In the first week of May, Japanese charity postponed a further crash of the dollar and U.S. securities markets, by absorbing more than 40% of U.S. long-term bonds offered at auction May 7. The U.S. Treasury took the unprecedented step of telephoning the major Japanese institutions individually, to persuade them to purchase American long-term paper, whose value has lost about 12% since April 1.

By June, the entire question may be moot, since the Treasury may well run out of funds on May 28, through the expiration of its borrowing ceiling, and default on its obligations. To avoid this, the Treasury and the Fed may take the same sort of fiscal and monetary austerity measures the IMF has imposed on third world debtors, crushing the U.S. financial system.

That the Japanese rescue of the American Treasury was no great source for joy, is evident from the dollar's position on May 8, namely at about 139 yen, or 10% below its position Feb. 21, when the summit countries' finance ministers pledged at a Paris meeting to stabilize currencies. The West German mark is hovering right around its historical low against the dollar, reached on Oct. 31, 1978, during the Carter administration's ebb-tide.

Although it had been feared widely that Japan might boycott the Treasury auction, heavy Japanese participation barely moved the dollar off its all-time lows—which means that everyone who has speculated against the dollar has won heavily, and the central banks who tried to defend the dollar have lost heavily. The dollar is now set for another ratchet-collapse, perhaps around the May 15 deadline for congressional extension of the federal debt ceiling.

Japan, as the economic leader of the free world, has acted responsibly. Japan's Prime Minister Yasuhiro Nakasone refused American demands to turn on the central bank printing presses, in order to flood the market with yen and depress its value. He also refused to subordinate Japan's foreign economic policy to the International Monetary Fund/World Bank, the institutions which are responsible for the disaster now underway.

There was, in fact, no "interest-rate agreement" between Nakasone and Reagan. Nakasone said only, "I've instructed the Bank of Japan and the Finance Ministry to start operations to lower interest rates, and it has started." A Japanese senior official told U.S. reporters that this was not an order, merely a request; that no timetable was agreed for a lowering of interest rates; and that no specific interest rate was agreed upon.

Secondly, Japan refused American demands to use its promised increase in overseas aid to bail out U.S. banks with bad overseas loans. Asked by a reporter whether "Japan is actually being asked to bail out the U.S. banks" with this fund, a spokesman for Prime Minister Nakasone said, "The purpose is not [to bail out the banks]. The purpose is to assist the recycling process mainly through the development—promoting the development projects." In addition, the spokesman emphasized that the funds would be controlled by the Japan Export-Import Bank and the Japan Overseas Economic Cooperation Fund, rather than the World Bank, as U.S. officials were demanding.

However, according to Japanese press accounts, the finance ministry made an 'unusual' unofficial appeal to indi-

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vidual institutions to buy U.S. bonds. Since Japanese news accounts reported in advance precisely how much of the $29 billion bond offering Japanese institutions would buy, and Japanese brokerage houses informed market participants of their intentions in advance of the auction, it would appear that the institutions were even assigned quotas. Japan conceded nothing on basic policy, but gave Washington breathing room; what will Washington do with the borrowed time?

The May 15 time-bomb

European institutions indicate that the point they may choose to dump their U.S. bond holdings, may come May 15, when the Treasury's authority to borrow expires. Last time the "federal bankruptcy" cliffhanger was enacted, the administration accepted the Gramm-Rudman-Hollings straitjacket on federal spending. GRH has failed hideously, with a budget deficit projected officially at over $170 billion for Fiscal 1988, when the GRH law dictates a ceiling of $108 billion; and that doesn't count $45 billion for the Federal Savings and Loan Insurance Corporation (according to a New York Times report May 8), or even more; or an additional $6 billion to bail out the bankrupt Farm Credit System, or an additional $7 billion for the Commodity Credit Corporation, or the costs of higher interest rates—even assuming the administration's ludicrous recovery scenario comes through.

The federal deficit now looks towards a range of $330 to $400 billion, according to an estimate to be published in this publication's next *Quarterly Economic Report*. Nonetheless, Senator Warren Rudman (R-N.H.) and colleagues want to use the borrowing-ceiling deadline to force the administration to lie down in the Procrustean bed, *no matter what*. Even the *New York Times* is terrified by the prospect; an editorial May 4 warns, "The time bomb was concocted to give the Treasury no room for fiscal tricks, and to force a showdown in Congress over still another gimmick, the Gramm-Rudman-Hollings law. Its three cosponsors want new teeth in their misguided balanced-budget scheme, which the Supreme Court rightly defanged last spring."

Rudman et al. want new taxes, accompanied by huge cuts in defense spending, which coincides precisely with the published recommendations of the Soviet media. A news analysis by the Soviet press agency Tass April 28 notes the dollar, and concludes, "the ills are also a result of Washington's unfair play with regard to its partners. . . . The U.S. pays for the militaristic intoxication of the present administration with huge budgetary deficits."

It appears that the Democratic-controlled Congress will blow up the Treasury's finances, unless the administration agrees to not merely a tax increase, but further sharp reductions in the federal budget. Corporate tax contributions have already risen 22% over the last fiscal year, entirely due to the front-loading of tax increases into last year's so-called tax reform; these payments came directly out of capital spending. GRH sponsors want more. Defense spending, at a 3% nominal growth rate, is now falling in real terms, after congressional cuts had already eliminated $33 billion in projected spending during the past two years. GRH sponsors want less.

The interest-rate issue

The International Monetary Fund, the Organization for Economic Cooperation and Development, and the Bank for International Settlements have no confidence that the Administration and Congress will agree on means to treat the United States the way the IMF treats Brazil or Mexico. They demand that Federal Reserve Chairman Paul Volcker accomplish the same thing by raising U.S. interest rates. Among other central bankers, West Germany's Karl-Otto Pöhl made the first public demand that the U.S. tighten monetary policy, as the international organizations prescribe.

"Volcker has no choice left but to tighten," argues an International Monetary Fund consultant. "His options are damned limited. On the two occasions on which finance ministers promised to stabilize exchange rates, they were devastatingly smashed to bits. The credibility of such agreements is nil. *The only instruments left are monetary instruments*. It's a no-win situation, no matter what you do. If Volcker has to protect a fragile domestic and international credit system, I don't know how he can do it. If he doesn't tighten, he faces a run out of the dollar and a financial crash. So he has no choice but a tight but steady monetary policy, and to hope for the best. Not only are the thrift institutions in danger [with tight money], but the brokerage houses, and everyone carrying an inventory of long-term paper. It looks kind of grim."

The Secretariat of the Organization for Economic Cooperation and Development, which will sponsor its annual meeting of Western finance ministers May 12, "is screaming, it [Washington's policy] ain't gonna work!" according to an economist close to the Secretariat. Last month the OECD published a report attacking U.S. economic policy, "for the first time since the Secretariat was sat upon by Reagan and Thatcher, and told to keep their mouths shut. Beryl Sprinkel and the British insisted that everyone should mind their own store, and no one should attack domestic economic policy; so the statements of the OECD and IMF have been very bland. This is the first time someone has hoisted the red flag."

If the Fed tightens even another 100 basis points, the entire savings and loan system will collapse; as large deposits run off, it may collapse even with the present level of rates. Volcker, perhaps due to administration pressure, has refused to do more than "snug" short-term interest rates up by about half a percentage point, therefore inviting a new run against the dollar, probably coincident with the peak of debate over the debt ceiling. At that point, Volcker's profile suggests that he will repeat his infamous October 1979 "Columbus Day Massacre," and sharply raise interest rates; and, in the words of Budget Director James Miller, we will all be in "deep soup."