Volcker's Depression

INTERNATIONAL CREDIT

American markets settled back this week to a slow decline after last week's dramatic collapse in the wake of Federal Reserve Chairman Paul Volcker's announcement of a new era of U.S. monetary stringency. The reason for the markets' quiet is uncertainty about what steps Vocker will take next. "Volcker must be very pleased by this," commented a partner of one of New York's big investment houses. For the moment—and we stress "moment"—Volcker has succeeded in pulling off the one kind of maneuver at which he is really proficient. Without actually doing anything at all, the Fed Chairman has virtually all market participants off balance, waiting for his next move. Judging from the reaction at the Deutsche Bundesbank, West Germany's central monetary authority, the Fed chairman has nudged that institution into major policy blunders.

Volcker's advantage lasts precisely up until the point that he is compelled to take action that will definitely commit the Fed to a certain policy direction. The stock, bond, and mortgage markets gave ample evidence this week that the economy cannot sustain even a credit squeeze of a far milder sort than Volcker proposed without hitting a major collapse. Volcker does not yet know whether he can deal with the political consequences here and abroad.

According to the best informed analysts, Volcker's next move will not be a simple monetarist approach to reducing monetary aggregates, but a type of credit dictatorship.

As columnist Joseph Kraft put it in his Oct. 14 Sunday column, Volcker is now the de facto President of the United States, and the Federal Reserve is the only institution through which policy is actually being conducted. A better way to put it might be that the Fed is the only institution preserving the illusion of having policy under control.

Among the commercial banks, the buzzword is "non-price rationing." In other words, consumer credit, loans to small businesses, mortgage lending, loans to finance corporate tender offers, and a few other categories of loans will be sharply reduced. Credit lines to major corporate customers will remain intact; indeed, among the major corporate borrowers, enough credit lines are probably in place to keep funds flowing for some months. Similarly, the banks have locked in sufficient funds on the long end of the Certificates of Deposit market to maintain this type of lending without having to pay the additional 8 percent to the Fed for "excess managed liabilities."

The Fed, however, has already alerted commercial bank officers that "voluntary credit controls" are in effect to make sure that the above takes place. For the banks, this is both good news and bad news. It will badly hit banks who have expanded loans to lower-tier businesses. However, it will overcome some of the initial reservations which the large American-domiciled international banks expressed over the Volcker package. The Fed, in particular, has warned foreign banks that they will not be permitted to take advantage of the restrictions now imposed on American banks. It was earlier feared by big American banks that the application of the 8 percent special reserve requirement on repatriation of Eurodollar from foreign branches would give an unfair advantage to foreign banks (who book headoffice loans to subsidiaries of American corporations abroad).

All this is the least of the problem.

The real target

Most financial commentaries have ignored the most essential element of the Volcker credit-squeeze package: it is aimed not only at the American banking system but at Western Europe. According to well-informed senior American banking sources, the primary motive behind Volcker's decision is to abort the European initiative towards a new monetary system generating giant new long-term dollar credit for industrialization and energy investment in the so-called Third World. This initiative has received a considerable boost at the Belgrade meeting of the International Monetary Fund earlier this month. The foreign press, including *Le Monde*, *Le Figaro*, the London *Guardian*, and the London *Financial Times*, has referred to Volcker's policy as raising the "danger of interest rate warfare." It is more complex than that.

Banking and congressional sources predict that in addition to the voluntary credit controls already seeping into effect, Volcker will impose capital flows controls of the type used by the Johnson administration to little effect. Volcker's controls will reportedly be much stricter, pushing Eurodollar credit into a much tighter position than American credit. This, from Volcker's vantage point, could abort the Europeans' expanded lending plans before they took institutional form.

"The Eurodollar market is a two-bit affair compared to the American credit market," reasoned one New York investment banker. "If there are higher interest rates in the United States, they will be paid by Americans to Americans, and just recirculated within the same system. The foreign banks are much more vulnerable. They have been booking short-term dollar liabilities to fund dollar losses. The German banks are holding their reserves in dollars."

West German Bundesbank officials are also predicting some form of attrition in the American balance-of-payments deficit. Bundesbank directorate member Gletzke made a prediction of a reduced current account deficit for the United States and hence tighter Euro-

Volcker must be impeached

In a statement released Oct. 16 from his Manchester, N.H. campaign headquartes, Democratic presidential candidate Lyndon LaRouche demanded the ouster of Paul Volcker from office. We quote his statement here in full:

I herewith submit a demand for the prompt impeachment of recently appointed Federal Reserve Chairman Paul Volcker.

Yesterday, appearing before a committee of the United States Senate, Volcker either lied or manifested gross incompetence in the course of a reply to Senator Paul Sarbanes, Democrat of Maryland. He stated falsely, in his response, that the Federal Reserve System could not channel the flow of constricted liquidity in such a way as to ensure adequate credit for maintaining the operating capital of business employers.

In fact, the Federal Reserve System has the capability, with the consent of the Executive Branch and Congress, to conduct precisely the sort of anti-depression measures which Senator Sarbanes proposed.

Mr. Volcker either knows this, in which case he committed perjury in sworn testimony before the Senate, or he does not know this, in which case he is impeachable for incompetence.

There exist other, more profound reasons for demanding Volcker's immediate resignation or impeachment.

In earlier public statements, Mr. Volcker has stated himself to be a supporter of a doctrine of "controlled disintegration" for both the United States and the world economy. Now, under the semantic pretext of "anti-inflation" "fiscal austerity," Volcker has abused his powers as Federal Reserve Chairman to implement measures which constitute an efficient effort to plunge the U.S. economy into misery, chaos and confusion of the sort ultimately worse than the conditions experienced during the Great Depression of the 1930s. In light of the evidence of a conscious intent behind Mr. Volcker's attempts to ruin the U.S. economy, his conduct in office must be regarded as no better than treasonous in character, if not formally treason by the strict language of the U.S. Constitution.

As one of the world's leading economists, I have caused my staff to conduct a computer-based analysis of the near-term consequences of Volcker's measures. Those results, coinciding with the estimates of other analysts reporting independently, indicate that the measures already enacted by Volcker will cause a 15 currency market liquidity in a speech reported in the West German daily *Handelsblatt* Oct. 16.

The last time a Eurodollar crunch occurred, it followed the breakup of the Herstatt Bank in West Germany in July 1974. There has never been a significant reduction of Eurodollar market liquidity since that time, and it is a matter of some dispute whether Volcker will succeed in this. "There will be no shortage of liquidity on the Eurodollar market, as long as no controls are imposed," said the chief of the Luxembourg branch of one of West Germany's large banks. "There will still be deposits coming in from OPEC and the usual depositors."

Indeed, the projected $40 billion-plus per year OPEC surplus is the largest single element in international transactions at the moment. Where it is deposited is a much bigger question than how much money Volcker's mooted controls could draw out of the Eurodollar market.

America's payments for imported oil will be $90 billion this year. If those funds are deposited in the Eurodollar market, no controls will be meaningful. Volcker is gambling to draw OPEC funds into American money markets, particularly into financing a Treasury deficit which may be expected to balloon when the recession hits.

An additional problem is the credit policy of the Bundesbank, which has made domestic credit availability tighter than a drum for the last several weeks. Short-term interest rates are now pushing 8½ percent, a real interest rate of 3½ percent (compared with a real interest rate of 1½ percent in the Unites States after the prime rate rose to 14.5 percent). Conditions in the bond market have varied according to the volume of capital inflows purchasing deutschemark-denominated bonds. Since the Volcker measure the deutschemark market has gone sour, and today Westdeutsche Landesbank withdrew from the market a DM 100 million-mark issue for the Finnish government.

"Emminger is not really going to pull off a credit crunch, unlike Volcker. His aim is different," another German banker said. "He wants to limit international lending by forcing us to accept controls. If you want to say that Emminger has declared war on the interna-

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percent recession in the U.S. economy, probably putting the United States into a recession twice as severe as that of 1974.

The computer-based analysis has been conducted for two cases. In the first case, the computer run assumed no increase in the average price of energy materials. The computer run showed the 15 percent decline in the U.S. economy over the months immediately ahead. The second case took into account the estimated 15 percent further increase in the price of world-market petroleum expected to occur at the end of this year. That case would bring us close to a depression. If loose money measures were used by the Carter administration beginning next Spring, because of election-year considerations, the near-depression might be postponed, but at the price of pushing present 20 percent inflation rates up toward triple-digit inflation rates around the close of 1980.

Furthermore, the argument that Volcker's "fiscal austerity" will hinder inflation is a hoax. Although there might be some temporary leveling off of inflation-rates during the weeks just ahead, by about January 1980, Volcker's measures would begin to send inflation-rates spiraling upward again. This new spurt of inflation would be caused by the effort to offset higher borrowing costs for operating capital plus efforts to bring total income-volumes of firms back above break-even levels under conditions of a substantially shrunken market.

There are two immediate measures which would ameliorate the present crisis. First, the U.S. gold reserves must be valued at an adjusted current world market value, a value to be negotiated with both the European Monetary System member-nations and the OPEC "petrodollar" holders. This would stabilize the value of the dollar and take the worst pressures off dollar liquidity. Second, the Federal Reserve must immediately implement the kind of selective credit-flow controls which Senator Sarbanes proposed. This would not solve our nation's problems, but would give us breathing-room for developing a comprehensive, long-term set of monetary and investment-incentive measures.

A depression is not necessary. Any official who adopts a policy of "controlled disintegration" of the United States economy is engaged in a treasonous undermining of our nation's overall security at this juncture.

It is time to cease playing political theater with the election campaign. It is time for the citizens to cease treating politics as a matter of attaching oneself to popular political actors in an electoral beauty-pageant, and to pay attention to the fundamental interests of our nation, especially to those vital interests which determine the condition of individual life and the kind of world and nation we work to leave to our posterity. It is time to force the impeachment of treasonous influences such as Paul Volcker.