Will Reagan dump Volcker ...or get Thatcherized?

by David Goldman

Certain of Milton Friedman's collaborators in President-elect Ronald Reagan's entourage have already figured out how to sell a depression policy to the incoming chief executive, *London Times* Editor-in-Chief William Rees-Mogg reports. They will explain to Mr. Reagan that if he causes the Federal Reserve to tighten credit and force a monetary bloodbath as soon as he takes office, the economy will recover in time for the 1982 congressional elections!

In the meantime, Jude Wanniski reported in the *Wall Street Journal* Nov. 10, that the Friedman gang is hoping Fed Chairman Paul Volcker will enforce "mindboggling interest-rate austerity" between now and Jan. 20, when Reagan takes office, in order to remove the blame for the hideous consequences from the new administration.

It is hard to imagine how, except by such twisted and cynical arguments, the monetarists who now advise the President-elect could possibly persuade him to continue the Volcker program, after the economic disasters in both the United States and Britain during the past year. Fortunately, much more will shape Governor Reagan's outlook than the advice of Bill Simon, George Shultz, Alan Greenspan, Arthur F. Burns, and other certified losers. What is most important now is not the infighting around the cabinet but how Reagan views himself as a world leader, and how he responds to his peers among other allied world leaders—as opposed to mere employees in Washington.

The most important events with respect to the new administration's policies took place last week in Paris, Bonn, and Riyadh, where a deal emerged to stabilize the European Monetary System (EMS). The EMS is now a stable currency zone of the European Community members (excluding the recalcitrant British), and plans to become an alternative monetary power center to the International Monetary Fund, the leading enforcer of Friedmanite policies on the developing sector.

The Fed's putsch

As *EIR* reported Nov. 11, the Federal Reserve, i.e., FRB Chairman Paul Volcker and New York Fed President Anthony Solomon, decided to *pre-empt* the new administration's ties to European economic policy by breaking up the European Monetary System before Jan. 20. The chosen vehicle for the assault was what the French call "interest-rate warfare," i.e., a strong rise in dollar interest rates to draw hot-money flows into the dollar (and the pound sterling), and disrupt European monetary stability.

The dollar rose spectacularly, from less than DM 1.90 to over DM 1.96 Nov. 7, per the Fed's intention. But on Nov. 10, word reached the foreign exchange markets of negotiations between the West Germans and French for a $10 billion credit package, in advance of the European Community's scheduled $10 billion borrowing for next year. At the same time, according to

Saudi sources *EIR* considers authoritative, the Saudi Arabian Monetary Agency shifted funds from dollars into West German marks. In five hours, the dollar plummeted 5 pfennig, from DM 1.95 to DM 1.90, and fell below the 1.90 mark, where it remains as of this writing.

Of equal importance was the decision of Western European central banks to *support the price of gold* when it fell below $600 per ounce last week, apparently due to high interest rates. (Eurodollar short-term rates exceeded 17½ percent by the end of last week, forcing many gold holders who had bought gold on credit to liquidate their positions.) The European Monetary System functions on a gold reserve basis: 20 percent of the gold reserves of its members are pooled and valued *at market price,* and each member is permitted to draw currency in European Currency Unit (ECU) denomination in order to defend the parity of its currency. Strategically, the EMS gold-reserve system is the potential vehicle for a re-linking of the dollar to gold.

EMS, Saudi countercoup

The foreign exchange markets are now saturated with rumors concerning what the Europeans and Saudis are up to, particularly since the West German business weekly *Wirtschaftswoche* reported a $9 billion Saudi direct credit facility to the West German Bundesbank Nov. 11 (a report denied by the West German finance ministry).

However, what is clear is that Western Europe has carried off a political coup with the Mideast's richest oil nation, for the combined purposes of Persian Gulf security, currency stability, and oil price moderation (see International). There is no longer serious discussion of a major oil price increase.

European leaders can now tell the new administration precisely why Paul Volcker is the first Carter official it must get rid of. They can point to the economic disaster brought on by 18 months of Friedmanite policies in Britain, including production levels lower than those of 1969 and nearly 20 percent inflation: a more advanced version of what has occurred under Paul Volcker's direction in the United States. They can indicate the prospects for world economic recovery through expanded international trade, provided the United States cooperates with the European Monetary System.

The Federal Reserve's "interest-rate war" turned into a rout at a central bankers' meeting at the Bank for International Settlements on the weekend of Nov. 8 and 9. Called to discuss means of stabilizing the West German mark, the meeting produced no results whatever, according to wire service accounts, except the conclusion that "the monetary policy of the Bundesbank and the Federal Reserve are totally incompatible," as the London *Financial Times* put it the morning of Nov. 10. But the events on the foreign exchange markets following the meeting show clearly who won.

Reagan's choices

It will take some doing to transform this favorable strategic correlation into a policy profile for the Reagan administration in the United States. Regrettably, Reagan decided not to meet any foreign leaders personally in order to avoid Israeli Prime Minister Menachem Begin, and will delegate former Treasury Secretary George Shultz to meet with West German Chancellor Schmidt when Schmidt comes to the United States this coming week. One group of Reagan's advisers, including Rep. Jack Kemp and former *Wall Street Journal* associate editor Jude Wanniski, have started a spirited attack on the "Thatcherization of Reagan," as Wanniski put in his *Wall Street Journal* op-ed Nov. 10.

Kemp and his associates fall short, however, of being able to offer Reagan more than the suggestion that reductions in marginal tax rates will automatically cure the depression. Kemp told *EIR* that much would be decided at the four-day meeting the weekend of Nov. 16 among Reagan and Kemp, Arthur Burns, Milton Friedman, George Shultz, Alan Greenspan, and William Simon.

The New York congressman is probably wrong about the unique importance of this meeting. Reagan has a national constituency to answer to, one much broader than the spectrum of views among his advisers. Most of the Western senators who formed the backbone of his early campaign effort, including Paul Laxalt of Nevada, and Orrin Hatch and Jake Garn of Utah, are spoiling for a fight with what Wanniski called "The Eastern Establishment (Trilateral Commission, Council on Foreign Relations, international bankers)." The Democratic Party will have a resurgent conservative wing, characterized better by Lyndon LaRouche's National Democratic Policy Committee than the Americans for Democratic Action.

Whatever initial appointments Reagan makes for the senior cabinet jobs, he will have to come to terms with his peers among America's allies, and the real constituencies who voted him into office in protest against the consequences of Paul Volcker's atrocious blunders. All bets are off on what Reagan will finally do. It may be that the apparent dip in the Federal funds rate this week shows that Volcker fears the consequences of continued increases in the prime rate. It is too early to tell whether for political reasons interest rates have peaked, although the stock market apparently drew that conclusion Nov. 12. The point is that the rules of the game have changed in a fundamental way since the Nov. 4 elections, and unlike the Carter administration, Mr. Reagan has a margin for success.