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Will Reagan accept Europe's lifeline?

by David Goldman

West Germany's cabinet and the assembled finance ministers of the European Community formally petitioned the Reagan administration to bring interest rates down last week, dispatching French Finance Minister René Monory and West German Bundesbank President Karl-Otto Poehl to the United States to press their case. Western Europe is not merely seeking to keep its own house in order after severe currency disruption stemming from record dollar interest rates. Instead, the proposal they have made to President Reagan opens a way out for the United States.

In a nutshell, Europe wants to undertake a joint stabilization of the international markets to permit the orderly financing of both the American and European deficits, rather than the "government debt-financing and interest-rate competition" that West German Finance Minister Hans Matthöfer decried in a speech Feb. 13. The intent is not much different from de Gaulle's great credit-markets coup, organized by Jacques Rueff, after taking power in 1958. There are $1.3 trillion in now-unusable savings in the volatile Eurodollar market, most of it hedging against currency and interest-rate fluctuations (and increasing the volatility of those fluctuations). Joint action to break the speculators will free up the long-term funds required to handle the deficits at noninflationary interest rates.

That is the import of Bundesbank chief Poehl's extraordinary offer to the United States in a speech two weeks ago before the European Management Forum meeting in Switzerland: "If the dollar can be brought back to long-term stability, then the dollar and the European Monetary System together provide the foundation of a stable world monetary system for the 1980s." Linking the dollar to the EMS would create the stability Reagan has, catastrophically, left to Paul Volcker to obtain.

But Europe's initiative received a shock in President Reagan's budget message to Congress (see National). The West German cabinet made the evaluation that night that Reagan did not "have the courage to take on Volcker," as a source close to the German chancellory put it. As a matter of short-term crisis management, on Feb. 20 the Bundesbank took the most brutally deflationary steps in the past decade, in order to prevent further runs against the German mark. The weakness of the mark—which fell last week to 2.24 to the dollar before recovering spectacularly to 2.14—has come on so fast that it threatens the viability of the European Monetary System, the eight-currency stability zone backed by a pool of European gold reserves. But the EMS is West Germany's ace in the hole, its card for negotiating on terms of mutual strength with the American White House. If necessary, West Germany will sacrifice short-term economic considerations in the fight to preserve the EMS.

The Bundesbank shut down, except for emergency purposes, the central bank "Lombard" facility, which discounts commercial paper from the big commercial banks—the central bank's principle tool of liquidity management. This implies a formula for zero monetary growth at least in the short run. For an economy already subject to sharply falling current real output, the impli-

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cations of this step—if applied for more than a few weeks—will be deadly. According to Bundesbank sources, the move will force German banks to obtain refinancing on the open market, driving up interest rates. Short-term rates are now at 10 percent, and a rise to 12 to 13 percent would surprise no one.

At the Bundesbank's press conference Feb. 19, president Poehl warned that "it is difficult to imagine that U.S. monetary policy would be eased while double-digit inflation prevails in the United States." There is still a possibility, Poehl added, that rates abroad might fall, "but there should be no illusions on this subject."

That is a grim assessment, but, unfortunately, one shared by some leading Reagan supporters on the Senate side. "The President is extremely unhappy with high interest rates, as he indicated in his speech," said one well-placed Senate Banking Committeee aide. "But he sees no other policy to fight inflation. That's why he won't do anything to get rid of Volcker." Reagan did characterize high interest rates as "absurd," and some of his senior staff people have told Republican contacts that they expect Volcker to be out by April—a prospect that is not to be excluded, but which raises the question of what kind of successor he will have. The bottom line is that Reagan has fallen into a monetarist trap, and that Western Europe has no choice but to make preparations for new monetary storms.

For all his good intentions, Reagan's approach to economics has sidetracked onto the Austrian and University of Chicago prejudices of advisers like Stockman, Murray Weidenbaum, and Jack Kemp. Having taken up the instruments of state without the competence to use them, he has become the prey of a classical Venetian intrigue played on both his left and right flanks.

The first problem is the Basel-based Bank for International Settlements and its ally, Fritz Leutwiler's Swiss National Bank. To shore up the mark, the West German monetary authorities had to strike a deal with the Swiss, a species of monetary Spenglerian conditioned by 600 years of management of oligarchical family trusts. The Swiss and the BIS, with some factional allies in the Bundesbank, want a global deflation and are unconcerned with its terrible consequences (see *EIR*, Feb. 10, 1981 for the current view from the Swiss central bank). This is the European stronghold of the Mont Pelerin Society, the semiconspiratorial organization founded in 1947 by Friedrich von Hayek, which includes the contingent of economists the White House brought in from the Hoover Institution of Stanford University.

Through the Mont Pelerin Society link, this archreactionary group in Europe provides "positive feedback" to the Federal Reserve System, complaining that, if anything, U.S. monetary policy has been too lax. To the extent the French and West German leadership have stated Europe's view unambiguously, the BIS position remains an undertone. Nonetheless, the Federal Reserve still argues to the administration that Europe's proposal for global interest-rate reductions is a cynical pitch designed only for domestic consumption, and that European central bankers really want the Federal Reserve to continue the crunch!

More devious is the role of former House Banking Committee Chairman Henry Reuss (D-Wisc.), a self-described "monetarist-populist" with close ties to the Brandt wing of the German Social Democracy. Reuss's link to the Brandt crowd—who are doing their best to destroy Chancellor Schmidt's ability to rule—dates back to the congressman's postwar job as Counsel to the U.S. Occupation Forces in West Germany.

Reuss will shortly issue a report coauthored by House Banking staff economists Jamie Galbraith (son of John Kenneth Galbraith) and Richard Medley, calling for lower interest rates. In an interview Feb. 19 with the West German daily *Handelsblatt,* Reuss warned that "high interest rates in the United States will have catastrophic consequences on the international market, and put heavy pressure on our European partners." He called for "coordination of interest-rate policy between Europe and the United States," and lower rates at home. In hearings Feb. 19 before the Joint Economic Committee of Congress, Reuss challenged testifying Treasury Secretary Donald Regan to defend what he (accurately) called "Thatcher economics."

Reuss staffer Medley recently toured West Germany, meeting most of Schmidt's opponents, who are also vocal in denouncing the effects of high interest rates on the West German economy. These include, most prominently, the Berlin-based DIW, one of the country's big five economics research groups. The DIW proposed last week that Germany leave the European Monetary System in order to take the pressure off the home credit system.

Calculated to draw the maximum rage from the White House, Reuss's forthcoming report will call for "directed credit" to shut down old industries and invest in "sunrise" industries. That is Reuss's standard formulation on behalf of directed credit, and the Republicans hate him for it. A Reuss staffer admits that the initiative will sour President Reagan on the proposal. "We didn't give a damn what the President thinks. This is our plan," the aide said. As for Senate Banking Committee Chairman Jake Garn, the aide continued, "He doesn't talk to us." But Garn's old rival, Sen. William Proxmire, (whom Garn replaced as chairman of Senate Banking) is reportedly considering holding hearings on a potential link between the dollar and the EMS.

All this is hypocrisy on the part of Henry Reuss, who argued for years for an ultramonetarist formula to contain the growth of Federal Reserve credit. The

intended impact is to identify the West German plan with the man the White House likes the least in the sphere of monetary affairs.

Meanwhile, according to senior State Department sources, Secretary Haig will warn the President that Chancellor Schmidt cannot control the Willy Brandt wing of his own party, and is therefore dangerously soft on the Russians. In fact, the SPD left (the friends of Henry Reuss) have made a major effort to undermine Schmidt on two counts: arms control and nuclear energy policy. The merits of the armaments issue aside, the Brandt wing of the party has created a loud, if narrowly based, "claque" in favor of unilateral European arms reduction, for the principal purpose of disorienting the Reagan administration's policy toward West Germany. If Haig has his way, the sources added, the April meeting between Reagan and Schmidt will concentrate solely on Schmidt's alleged softness regarding the Polish situation!

If Reagan is led, Othello-like, into repudiation of the Western European plan, his last apparent chance to avert a depression will have disappeared. That is by no means certain at this writing. But for the moment the Europeans have assumed a burden in maintaining short-term currency stability that they cannot sustain for long.

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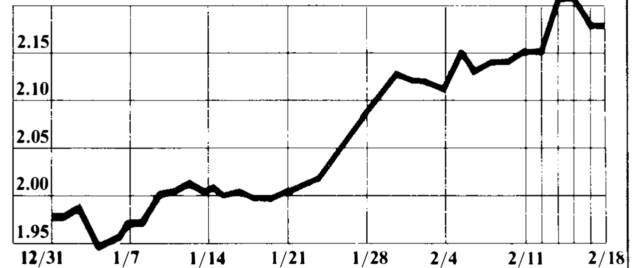

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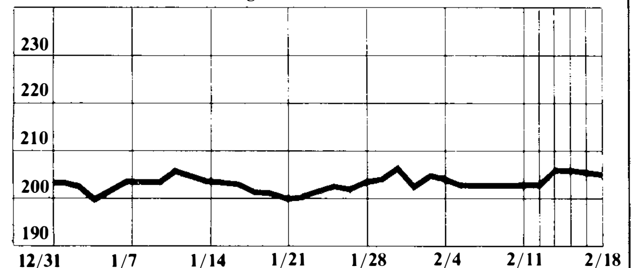

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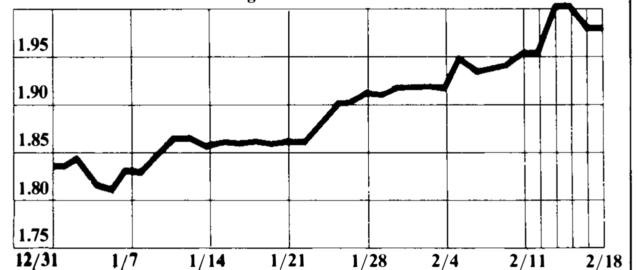

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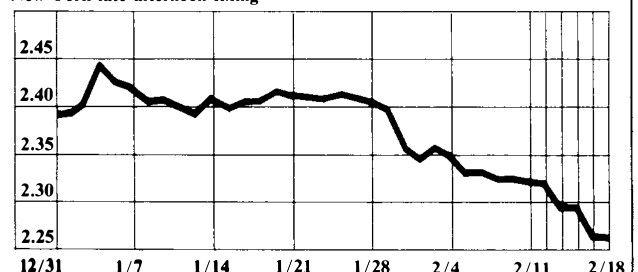

Interview

Volcker to Germany: 'Drop dead'

From an interview with a source at the New York Federal Reserve:

Q: What is the U.S. reaction to West German demands that we bring down interest rates?
A: The EC finance ministers, led by Karl-Otto Poehl from West Germany, met on this and did a bit of sabre-rattling this week, but they scare no one. There is nothing they can do. Volcker went to the Bank for International Settlements meeting with Henry Wallich this past weekend and told Poehl as much flat out. Do you remember the old Jimmy Carter New York poster?

Q: "Ford to City: Drop Dead"?
A: That's the one. They're stuck. The Reagan administration is taking the posture that rates will not come down, period. Supply-side economics is not just tax cuts, but tax cuts tied to a very tight money policy from which the administration will not budge. The fact that Volcker is still tightening proves Reagan is supporting Volcker. The President believes in tight money. There is no difference of opinion between him and Volcker. In fact, Reagan is urging us to be even more restrictive than we want to be. The markets were waiting for Reagan to resolve administration doubts about tight money, and [he] has resolved on Volcker's policy. The markets now know it, and they're buying dollars.

That's what's got the Europeans scared silly; they had been buying time, hoping rates would fall, and now they know they won't.

Q: But Reagan is political, he was elected to stop this.
A: Wrong. The difference between Ronald Reagan and Jimmy Carter on monetary policy is almost *zero.* Look, supply-side economics was invented by the central bankers at the Bank for International Settlements, I've been hearing about it for years at seminars there. The whole idea is to reduce taxes for people to invest in new, high-technology industries, to increase productivity in new industries, and to maintain tight credit to older, more inefficient industries.

Jimmy Carter lost the election because he failed as a leader, failed to take up the supply-side arguement. Now it is in vogue, and supply-side economics can help Reagan sell the same program Carter failed to sell to the American people. Look at the policy recommendations, they aren't all that different. What's the difference between Reagan's tax cuts and the across-the-board tax reform Carter tried to get through? Not much. Look at the budget cuts Stockman has, Carter tried to cut the same projects. And the monetary policy is identical.

Furthermore, the Germans know that the major world problem is U.S. inflation. For years, Emminger at the Bundesbank was screaming at us to tighten money, bolster the dollar. He was the man with the finger in the dike. Now, Volcker is the man with the finger in the dike, and the Germans know they have no right to complain. They do not even mean to accomplish anything, they're talking just for domestic political consumption. In the bars in Frankfurt and Basel, they tell us, "You're doing what is right." But they can't take this position publicly.

We've just seen the start of the Germans' squeaks and squawks, we'll see more, so what? Poehl is just trying to talk the deutschemark back up to 2.05. He wants U.S. rates lowered to where they will stop pressuring the mark, but forget it. Even if U.S. rates were lowered to parity with German rates, back into the single-digit range, it wouldn't get Germany out of the woods. The capital flows coming out of Germany are simply too tremendous, their deficit is huge.

Germany is facing a strategic shift, we've been in the barrel, going through the dying pains of aging industry, inflation, and currency collapse. Now it's their turn. Their wages are too high, their exports can't compete, their government programs are too expensive. The German economic miracle is over.

The choice Germany faces is excruciating and agonizing. The U.S. is following the lead of the Thatcher government in Britain, we're reversing course on social programs, reversing incomes transfers, and we're keeping money tight. And the more we do this the Germans will have to raise their interest rates to follow. Those countries like Germany, Switzerland, Sweden, who have bigger social programs, will now have to cut more, and go through agony. Capital flows will continue out of Europe, and keep Europe in a vise. The only actions they can take are to cut, and worsen their recessions.

It's crunch time for everybody, not just us.

Q: Do you think the reaction could topple Schmidt?
A: Sure, the reaction to this could easily topple Schmidt. Why do you think Poehl is so worried? The uproar is already starting over there.

Q: What about Reagan, will he be Hooverized?
A: Could happen, sure. We're going to have fun. There will be a huge political battle. The AFL-CIO is mobilizing already. It will be an uproar. Reagan will have to turn the poor against them, and hope for the best.