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Springing a monetary trap on the White House

by David Goldman

President Reagan, according to briefings by senior aides, is determined to be rid of Federal Reserve Chairman Volcker by early summer. But he reluctantly accepts the view of his senior officials—David Stockman, Murray Weidenbaum, Beryl Sprinkel, Norman Ture, and Lawrence Kudlow—that he must cut the federal budget to ribbons to bring interest rates and inflation down. This must be done "to clear firing Volcker with Wall Street," a senior Republican aide says, meaning that the large money-center institutions have dictated the terms under which Reagan may avoid the market disaster Volcker threatened would ensue on his dismissal.

Meanwhile, *EIR* continues to stand by its September forecast that the economy will enter the second phase of depression during this quarter—Reagan's ability to prevent economic downturn is slipping away. The columnists are now warning that the "supply-side" program of tax and budget cuts will fail and leave the new administration in jeopardy months after it took office.

What the public sees via the news media is a Venetian *commedia dell'arte,* with the President cast unwillingly in the role of the old infatuate surrounded by scheming and dishonest servants. *The cited officials designed the "supply-side" program to fail in its given objectives.* A group of economists led by "supply-side" guru Robert Mundell lifted at least part of the curtain to the inner workings of how this came about. Here and in the accompanying report on the origins of "supply-side economics," we introduce the scriptwriters and stage managers.

The Siena group

In a set of presentations before a financial community audience at New York's Pierre Hotel March 1, the "International Monetary Advisory Board" of the Securities Group warned 1) of a monetary crisis brought on by the U.S. Federal Reserve; 2) of a general flattening of advanced-sector living standards, followed by 3) a return to the sort of gold standard that existed before the creation of national central banks.

Ten years ago, the group's core came together under the auspices of the 500-year-old Monte dei Paschi Bank in Siena, the living symbol of the continuing power of the old Venetian-Genoese financial oligarchy. Chaired by a Jesuit-trained Canadian, Robert Mundell, the Siena conferences were a summer outlet for the staff of the super-secret Bank for International Settlements, the "central bank for central banks" founded half a century earlier at the old palace of the Cassa di San Giorgio in Genoa, the bank that had once held title to the debt of the Spanish Empire. In that group were the Bank for International Settlements' chief economist Alexandre de Lamfalussy; Italian central banker Rinaldo Ossola; Swiss banker Nicola Krul; Dresdner Bank economist Kurt Richebächer; and the Cassandra of world monetary affairs, Robert Triffin.

Minus Triffin, now in semi-retirement at the Jesuit Louvain University in Belgium, the same group presented a scenario last week that, however extravagant, has two claims to be taken seriously. First, they represent the immediate continuation of the old European oligarchy that has never accepted the legitimacy of the sovereign nation-state—a point Mundell rubbed in during an interminable review of the last two centuries of the gold standard. Second, the speakers at the Securities Group symposium trained the entire corps of advisers who sold "supply-side economics" to Ronald Reagan

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in the first place. This was underscored by the presence, as the defender of the administration's chances of success, of University of Southern California economist Arthur B. Laffer, the best-known spokesman for "supply-side economics," and Mundell's prize pupil.

Conference chairman Eugene Birnbaum, a Siena regular when he was Chase Manhattan Bank's economist, opened the meeting with what he called "an unpleasant introduction," warning of monetary chaos.

"It is amazing to me that the newspapers and other media have taken little or no notice of the fact that for some weeks now we have been witnessing unprecedented changes in the world's foreign-exchange markets. Just two and a half weeks ago, for example, on February 11, the dollar was trading at DM 2.15. On February 15 the dollar reached a high of DM 2.25 and on the very next day it was trading at DM 2.18. Last Friday the dollar ranged between DM 2.08 and DM 2.13. The volatility and thinness of the spot and forward foreign-exchange markets have equaled or even exceeded all earlier chaotic episodes in our experience with floating exchange rates. Spreads between bid and asked quotations for the major currencies have been beyond anything before witnessed. Last Friday there were one hundred basis-point spreads between bid and asked quotations for major currencies against the dollar."

Birnbaum continued, "The kind of behavior of the foreign-exchange markets is a matter of great significance. The paralysis spreads uncertainty through all financial markets. Such chaotic activity generates heightened uncertainty, higher interest rates, and at the same time magnifies windfall gains and losses from economic transactions. The lack of monetary stability and direction is global in character and it necessarily inhibits all investment and trading activity, domestic and foreign."

Birnbaum ridiculed "the belief that the dollar can be stabilized by controlling a measurement of a quantity which is referred to as the money supply" as the cause of instability. Instead, he argued, the Federal Reserve should set a dollar price against gold, and intervene to reduce the money supply every time the dollar falls against gold, a simple, and cataclysmic, solution.

But there is another reason for the extreme instability of the foreign-exchange markets than the actions of the Volcker Federal Reserve. Birnbaum revealed—and was backed up by attending Bundesbank director Norbert Kloten—that the "Siena" tendency had pulled off a coup in West German monetary affairs (see Foreign Exchange).

Bundesbank President Karl-Otto Poehl, under the pretext of stabilizing the West German mark, introduced what Birnbaum praised as the same system into West Germany. Whenever the dollar rises against the German mark, the Bundesbank now intervenes to reduce the German money supply. Poehl's action, as Arthur Burns explains in an appended interview, was taken in direct contravention of West German Chancellor Helmut Schmidt's monetary program. The Bundesbank two weeks ago suspended all regular refinancing of the banking system, forcing the West German capital markets into crisis conditions, with interest rates on overnight money swinging wildly between 14 and 30 percent.

This policy action by the Bundesbank, which Birnbaum hailed as the leading edge of the "Siena" program, produced the crisis results Birnbaum cited in his speech! This "very important monetary-policy flaw in the Reagan economic strategy," Birnbaum concluded, leaves Reagan with "absolutely a zero probability of success in the effort to end inflation and start economic growth."

Reagan will end up steamrolling living standards through the federal budget mechanism, Birnbaum said. "For the last 50 years the government has continued to extend its insurance umbrella to the point where coverage is now available for fatherless children, import competition, the inflationary erosion of pensions, various occupational hazards, and almost any kind of potential disaster that can befall humanity. . . . The insurance industry is well aware of this danger. For example, the current nationwide plague of arson is attributable to a significant degree to the fact that fire insurance policies exist. The risk that the mere existence of insurance may encourage episodes of the disaster insured against is known in the insurance industry as 'moral hazard.' "

In fewer words, Birnbaum argued that forms of social insurance encourage laziness and eliminating such insurance will provide work incentives. Arthur Laffer, who followed him to the lectern, accepted the same principle, with the extraordinary claim that OMB Director Stockman "is not cutting the budget, but changing the incentives and disincentives [for work] built into the [social insurance] system. This is on the same principle as the tax cuts, and the two will work together very well."

Laffer delivered a few one-liners against austerity economics, acting as the de facto administration spokesman in the gathering. Attacking Carter's claim that the problem is too much consumption, Laffer said, "You can almost hear old Arthur Burns saying 'It's going to hurt me more than it hurts you—*whack*!' Arthur Burns is the only guy I know who can project a father image without ever having gone through puberty." Satisfied with the guffaws, Laffer turned the floor back to his elders and teachers.

The path of collapse

Dresdner Bank economist Kurt Richebächer—who

is more influential in the U.S. and England than inside his own bank—described, with some accuracy, the conditions for a deepening depression. "This is a different type of recession than the last one. The previous 1973-1974 recession was characterized by commodity speculation and inventory buildup leading to a quick drop and quick recovery. Now instead of a few imbalances, the whole ship is out of balance."

"My monetarist friends," Richebächer continued, "ignore two important things. One is the growth of debt as opposed to income, and the second is the content of debt formation. Has it gone for productive or unproductive purposes? What is particularly frightening is that debt has gone less into real productive assets and real capital formation, and more to finance consumption, company losses, inflation hedges, and so forth."

But Richebächer concluded *not* by proposing a redirection of credit flows to real capital formation—the "Irish" model—but by advocating a decisive monetary crunch. "The sharp retreat of the Federal Reserve last year to easy money was a fatal mistake. It is not high interest rates that Europe shudders at, but the perspective of continually high interest rates due to the blunders of the monetary authorities, their failure to act decisively. In 1929, the same policy put the whole of Europe under extreme pressure, and triggered a depression." Privately Richebächer predicted to his friends a sharply falling economy for at least the next two years, and continued wild fluctuations on the foreign-exchange market.

Minneapolis Federal Reserve economist Thomas Sargent, a graduate of the Defense Department's systems analysis group and a star of the "Siena" tendency's second generation, summed the proposal up without ambiguity: "The end of inflation occurs when governments stop running big deficits [as when] the League of Nations imposed restrictions on fiscal policies on central European countries during the 1920s. This means austerity. We tried austerity once before [with the Specie Resumption Act—ed.] in 1875, and it worked." Of course, the Specie Resumption Act produced the great 1879 crash, and one of the worst depressions and civil-unrest periods in American history, and also left the post-Civil War United States beholden to foreign, especially British, capital.

Arthur Burns on Germany

Part 1 of a March 2 interview with former Federal Reserve Board Chairman Arthur Burns, prospectively the next U.S. ambassador to Bonn, that was provided to EIR.

Q: Dr. Burns, what is your prescription for the long-term economic ills facing West Germany?

A: West Germany's biggest problem is inflation, and fighting inflation must be their first priority. To do this means they will have to go into recession, and Germany will just have to sweat it out. While many people have complained that Mrs. Thatcher has been unsuccessful—and we have now a new word in the dictionary, Thatcherism—nevertheless it is her program which must be followed. Only in Britain has inflation been brought down sharply, the cost of living has fallen much more than in other countries, and this is the model.

Q: Have the United States and Germany reached some deal on convergence of interest rates, now that short-term dollar and deutschemark rates are the same?

A: No. A deal cannot be struck. 1) Neither Poehl nor Volcker are personally willing to enter into a deal. 2) If they did, it would only increase inflation to act together to lower interest rates. Schmidt will continue to press his case, and he must, because convergence will not placate him. Convergence means that Germany will retain these very high interest rates, which Poehl wants to do. Of course, that will stabilize the deutschemark, and even buy some time, because the devalued mark at these rates will help exports and the trade balance. But convergence can never placate Schmidt, because he cannot politically tolerate the recession he's getting. He's coming under tremendous political attack for it, when unemployment is increasing. I don't see how they can placate Schmidt, I'm sure he'll press his case.

Q: But what will happen?

A: Fighting inflation is the priority both in Washington and at the Bundesbank, and Schmidt can continue to complain all he wants, but neither Poehl nor Volcker will pull back. What will happen? Nothing will happen for a while. Will Schmidt publicly lean on the Bundesbank? I doubt it very much. So let him complain.

But the penultimate word was given to Mundell, the spiritual leader of Siena. The Columbia University economist now lets his gray hair reach his shoulders, and wears incongruous sporty suits and tinted glasses. From a top place in the economics profession, he has personally deteriorated to the point that he no longer takes organizational responsibility for such conferences. But Mundell, with a rasping voice and awkward gestures, remained the authentic voice of Siena economics.

"The prime focus of the gold standard is predictability," Mundell began. "One-fortieth to one-fiftieth of all wealth has always been held in gold, and the proportion has not changed. The gold standard has never been at fault. When it was suspended in 1797 that was not the fault of the standard, that was Napoleon's fault. . . . When there was inflation in the 19th century, that was not the fault of the standard, that was the fault of the War Between the States. . . . We changed our monetary standard after 1968, and had inflation. The standard wasn't obeyed during the Vietnam War, when we printed money to finance the war. The standard led to crisis and collapse in 1971. But the fault doesn't lie with the standard. It lies with the operators and interruptors of the standard."

Reagan's policy would merely lead to "deeper recession" due to Stockman's "strict fiscal policy," the inventor of supply-side economics warned. He assailed Paul Volcker's "crude Friedman-type monetarism" as "absurd," arguing for the gold standard method Birnbaum had outlined earlier. And he concluded with visions of empire: "The United States still can be the leader of the West, if it pegs the dollar to gold. The Italians would be better off pegged to the dollar than to the mark [in the European Monetary System], the mark is in a terrible position. The whole Common Market would be much better off if they pegged to the dollar, than to the absurd system they are trying to work now, it isn't working," Mundell said, as Eugene Birnbaum tried to quiet him. The guru's speech had extended ten minutes over the alloted time limit.

The gold standard Mundell wants is the opposite of the European Monetary System approach, which uses gold as a backing for a currency stabilization fund. Rather, like the Specie Resumption Act, it imposes an ironclad limit on credit creation, removing the function of governments in the creation of credit—and reversing, if implemented, the entire evolution of the modern republic since the end of the 18th century. This is the plan, and the order-of-battle, of the old European family and financial power which never forgave the American Revolution or the introduction of Hamiltonian central banking. By springing this trap on President Reagan, it hopes to accomplish one of the great *revanchiste* exercises of all time.

Parson Thomas Malthus.

Why supply-side economics is an antigrowth swindle

by Kathy Burdman

Office of Management and Budget Director David Stockman and Rep. Jack Kemp (R-N.Y.) told President Ronald Reagan last December that unless he applied their new brand of "supply-side economics," the administration would face an "economic Dunkirk."

Now, two weeks after the President's major economic package has been presented, with Stockman firmly in the saddle of economic policy, the nation's basic budget for scientific research, nuclear energy, and vital water projects is being slashed dramatically. Federal Reserve Chairman Paul Volcker still has interest rates at 19 percent, with Stockman's blessing, and the economy is heading deep into recession.

We have Dunkirk. Is this some mistake, some miscalculation by the supply-siders, who so strongly preach the economics of growth?

Not in the least. According to a top source at the Volcker Federal Reserve, supply-side economics is "not a growth policy." "Supply-side economics is just a new public-relations argument to help the administration sell the same program Jimmy Carter failed to sell to the American people," said the New York Fed official.