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The BIS performs a sudden about-face

by David Goldman

Last week the Bank for International Settlements (BIS), the semiprivate Basel-based "central bank for central banks," issued an uncharacteristically frank and honest assessment of the state of world monetary affairs. The report threw out of court the Federal Reserve's supposed efforts at improved monetary management, and called instead for a "high degree of international cooperation" to act as "the most effective bulwark against a repetition of the kind of events witnessed in the 1930s, which ultimately resulted in a disintegration of the world economy."

A day after the report's release, the general secretary of the Organization for Economic Cooperation and Development, Dutchman Emil van Lennep, warned of a "danger of a world recession" caused by "too-stringent U.S. interest rates." The French, West German, and even the British finance minister lambasted the consequences of the reckless American interest-rate policy.

Only a week earlier, at the International Monetary Conference of the American Bankers Association in Lausanne, the world's most prestigious central bankers united around Federal Reserve Chairman Paul Volcker's banner, and Swiss National Bank President Fritz Leutwiler went as far as to threaten the United States with a run against the dollar should the executive branch take action to hobble the "independent" U.S. central bank chief.

What happened?

Contrary to the impressions they prefer to cast, central bankers are less oblivious to developments in the field of world strategy than most of their counterparts in other senior governmental posts. Days before the BIS convened its annual meeting in Basel, the editor of Italy's daily *La Stampa,* Arrigo Levi, surfaced the considerations that hung over the central bankers' deliberations. In a multilanguage supplement distributed through four European newspapers, Levi warned of a growing tendency toward strategic confrontation with the Soviets and concluded that the West must conduct an about-face in its economic policy, with the objective of sustaining rates of capital formation sufficient to support a major defense buildup.

'A military dwarf'

Coming from Levi, a leading Atlanticist and Trilateral Commission member, this argument represents a formal recognition of the accuracy of the West German government's often-stated warning to the United States: the United States cannot simultaneously improve its strategic posture and pursue a monetary policy with the consequences noted by Bank for International Settlements Chairman Jelle Zjilstra and OECD Secretary-General van Lennep. This was the substance of German Chancellor Helmut Schmidt's representations to President Reagan last month, and the continuous theme of West German private commentary on the Federal Reserve's monetary policy. As a leading Hamburg banker put the matter to *EIR*, "Volcker will turn the United

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States into a military dwarf."

Even at the Bank for International Settlements, the sanctum sanctorum of the old European financial oligarchy, founded at the ancient headquarters of Genoa's Cassa di San Giorgio in the 1920s, this issue has become the underlying subject of debate. Of course, the BIS formulation of the problem is ambiguous.

In its recommendations, the BIS comes out on the side of the Brandt Commission, the international body that argues for a radical scaling-down of technology and growth targets worldwide, and a global financial reorganization in favor of "soft" technologies. In the present monetary circumstances, the report states:

> [I]t would be singularly difficult for the oil consuming countries to adjust their productive base to the dramatic rise in the price of oil. Fundamental adjustment to the repeated oil shocks is inconceivable without an increase in investment; the substitution of new sources of energy for oil and energy-saving both require heavy capital investment. In virtually all the industrialized countries, however, corporate profitability is now much lower than before the first oil shock. Under these already difficult conditions, excessive real interest rates would place intolerable pressure on investment potential. It is for this reason that it is urgently necessary to alter the current policy mix by reducing public sector borrowing requirements.

In this sense, the BIS report's language tends to support the explicit advice of former Defense Secretary James Schlesinger (to *Newsweek* June 8) and *Foreign Affairs* editor James Chace that the United States should not even attempt to expand its defense budget, because the resulting pressure on the budget deficit would create financial chaos. This argument originated in Britain, where Defense Secretary John Nott announced massive cuts in British defense spending last month.

In fact, precisely because 40 percent of all U.S. industrial investment is now channeled toward energy production (of the most expensive varieties) and so-called energy saving, the United States is in no position to produce the volume of goods the Defense Department, under the proposed Weinberger budget, wants to procure.

As a matter of arithmetic, reduction of any of the industrial nations' public-sector borrowing requirements assumes no major effort for rearmament, let alone for the associated high-energy physics research that is a precondition for a competent response to Soviet arms efforts. The Volcker interest-rate policy has already thrown the OECD nations as a whole into the worst deficit position of the past 30 years on account of government expenditures, due to the combined effect of rising debt service on public loans, and the secondary effects of higher social security and unemployment payments resulting from higher unemployment rates.

As Jim Wright, the Houe of Representatives majority leader, forced Treasury Secretary Donald Regan to admit in a candid moment two weeks ago, the present interest-rate policy will cost the U.S. Treasury $50 billion in fiscal year 1982, starting Sept. 30. The potential disaster for federal finances contained in the Volcker policy is incompatible with the proposed $165 billion defense budget. As Morgan Guaranty Trust pointed out in its May 1981 *Survey*, the assumption built into the $165 billion number offered by the Defense Department is that the inflation rate for defense goods 1982-1984 will be only 6 percent; for every additional 1 percent, the DOD will pay an additional $9 billion. Should the inflation rate for defense goods be 12 percent, the Federal deficit would grow by $54 billion. Combine the effects of the interest policy and cost overruns, and the budget deficit would easily exceed $150 billion, double the previous record deficit.

Two conclusions can be drawn from this. One, argued by former Secretary Schlesinger, a product of the RAND Corporation School of cost-benefit analysis, is that more defense spending would yield only the same systems at a higher price. As noted, this is strongly felt by *Foreign Affairs* editor James Chace and his staff at the New York Council on Foreign Relations.

Morgan's economists, however, drew a different conclusion. The author of last month's study, economist James Fralick, says that European criticisms "have a valid point; you could accomplish a lot on capital formation by lowering interest rates." But in the present monetary environment, Fralick is pessimistic about the Pentagon's ability to meet its procurement requirements.

Strategy overtakes monetary debate

Leaving aside the financial problem, and turning to the physical capabilities of the U.S. economy, this publication has attempted to demonstrate that the United States could not conduct even the "in-width" (rather than in-depth) military buildup Secretary Weinberger proposes without a generalized improvement in industrial productivity. Our computer econometric study (*EIR*, March 31, 1981) showed that even under the most optimistic assumptions concerning availability of capital for military-related investment and availability of skilled labor and engineering personnel, the present military budget would produce a small initial surge in defense output followed by a rapid decline in availability of defense goods. As Arrigo Levi and others argue, the chaotic results of the Volcker policy rule out such optimistic assumptions.

Where America's allies in NATO are concerned, the

problem was put in these words by French Finance Minister Jacques Delor at the OECD meeting in Paris: "How can the United States expect its allies to provide the level of security cooperation it wants [i.e, a real rise in annual defense spending of at least 3 percent] if it is promoting economic conditions which make such cooperation impossible?"

What is new is not that the disastrous strategic consequences of the Volcker policy have been brought forward; the West Germans have argued this for months. The news is that the monetary debate is now subordinated to the strategic debate. At bottom, as the London *Times* reported June 16, Defense Minister John Nott is not going to defend his brutal defense cuts (including the phase-out of the Royal Marines) on budgetary grounds; his program, the *Times* noted, is based on the advice of old-line Russia experts who argue that internal dissensions in the Soviet Union rule out this power as a strategic threat to NATO for the next ten years! Apparently on the advice of National Security Council official Richard Pipes, President Reagan dropped passing remarks to the same effect at his June 16 press conference. Secretary Haig has been saying more or less the same thing as his British counterpart.

This line of argument drew an outraged, and frightened, response from *New York Times* columnist James Reston June 17: "It is one thing for aging journalists [referring to *Le Monde* columnist Raymond Aron] and former secretaries of state [referring to Henry Kissinger] to prophesy the decline of the Soviet Empire, and quite another thing for American Presidents and presiding secretaries of state to provoke the Russians by predicting their inevitable collapse."

Summit outlook

The debate on strategic policy has split the ranks of the Fed's supporters in the American East Coast establishment, and among Atlanticists in Western Europe. It is no coincidence that the BIS report, and the round of assaults on the Fed from previously sympathetic finance ministers at the OECD meeting, followed by one week the wintry response given to the disarmament negotiators of the Palme Commission in Moscow. At least at the more informed levels of the debate, the coincidence between Secretary Haig's largesse in the fields of arms shipments to the Chinese and Pakistanis, and the exacerbation of economic conditions in the West, is a principal subject of concern.

It is too early to identify the marginal drop in dollar interest rates with this concern. With U.S. housing starts down by 14 percent in May to 1.15 million units per year, barely above the March 1980 trough, and other indications pointing to an absolute decline in the volume of industrial production during June, it is not surprising that some short-term rates (although not the critical federal funds rate) are off a bit. Apparently the issue is still far from resolved in Washington.

But what is clear is that the end-of-July economic summit meeting in Ottawa will have no choice but to take on the issue of monetary policy, contrary to the expectations of the U.S. staffers now preparing the summit (see interview below). Strategic developments have overtaken the slick social engineers who viewed the monetary policy as a transition to a form of postindustrial society, and there seems no way to prevent the monetary-strategic issue from forcing itself into the supreme forum of Western leaders in Ottawa.

EIR*'s Stanley Ezrol interviewed Robert Hormats, assistant secretary of state for economic and business affairs, on June 10. Excerpts follow:*

EIR: You have been called "Mr. Summit." What are your responsibilities with regard to the Ottawa summit?
Hormats: Basically, what I have done in a number of summits is participated in the so-called Sherpa team, which prepares the President and the issues for the summit. There are two parallel elements. One is the interagency process. I'm chairman of the interagency group which is preparing for the summit, composed of Treasury, NSC, Commerce, STR [Special Trade Representative's office], Department of Energy. And what we've been doing is preparing the issues papers. In parallel with that is the international process where the seven summit countries, plus a representative from the European Community [EC], meet to prepare the issues. And ultimately the two processes converge.

We have had three preparatory meetings for the summit—one in Ottawa, one in Paris, and the last one in Vancouver. At the same time there have been a number of peripheral meetings on specific issues. On energy, a meeting of what's known as the level-monitoring group. There has been a group chaired by Murray Weidenbaum which has been preparing the issues for the macroeconomic side, and so on. . . .

Now the broad areas that are likely to be discussed are, first, national economies . . . rates of inflation, rates of growth, interest rates inevitably will be discussed. The second set falls in the realm of East-West economic relations. There, I suspect, what it will be is not an attempt to reach specific agreement, but more an attempt to have leaders explain how they see East-West economic relations—how they relate to their other economic needs. Third, energy will be discussed. In particular, there's a very strong view that because we have a soft energy market we shouldn't be complacent. North-South economic issues, as you know, is one thing that Trudeau has focused a lot of attention on, and that will doubtless be discussed. And then trade will be the last item on the

agenda. . . .

You will have at least four new leaders at the table. You have Reagan, Mitterrand, Suzuki, and Thorne, the head of the EC Commission—and maybe an Italian—I don't know what's going on there. And I think there'll be a lot of interest in getting their views on these issues—where they're coming from. I think there was a feeling on the part of some of the people at the last summit that it was getting too detailed, too specific, too operational. I think they wanted to be a little loftier.

EIR: Do you expect any specific policies, agreements, resolutions?

Hormats: To be very honest, it's too early to tell. You really only get a sense of whether or not there's going to be agreement on anything at the last Sherpa meeting, and we still have one more to go. My general sense is there probably will not be agreement on a lot of specific issues. I think it'll be a little bit more of an exchange of perceptions, an exchange of approaches, rather than trying to work out specific policy issues.

Probably, if it's to be done, what the summit will do is encourage institutions such as the OECD, or the IEA, or the GATT, or the World Bank to do these things, but not really engage themselves. . . .

EIR: Let me ask you about one specific issue I know our readers are concerned about, the interest-rate question.

Hormats: I think that the basic point here is that the surest way to get interest rates down is to lower the rate of inflation. Interest rates really are the result of people's expectations as to what the future rate of inflation is going to be. And to the extent inflation comes down, interest rates will come down.

The second point is that it would not make much sense for the federal government—for the Fed—to create a lot more money in order to lower interest rates because the market is now sophisticated enough to realize that, while you might be, in the short term, lowering interest rates because you've created more money, in the long run that will simply be increasing inflationary expectations. And the net impact will be an increase in interest rates rather than a decline in interest rates. . . .

So that on both points it seems to me that the Europeans really cannot reasonably expect us to lower our interest rates artificially. And I'll tell you quite frankly, I really think that the Europeans understand this point. . . .

EIR: There has been some criticism of the administration for placing an emphasis on East-West as opposed to North-South issues.

Hormats: I think the administration clearly has taken a hard look at North-South relations. And in fact we have an interagency group going on right now which is doing that. The President feels very strongly that the private sector can play a more active role in our overall North-South relations. Some programs, as in the Caribbean, are already under way to do that. . . . I think both the President and Secretary Haig are interested in placing greater emphasis on bilateral aid, but have made a very strong point of doing so in an evolutionary way and not in a way which undermines the multilateral development banks. . . . Certainly the administration plans to place a lot of emphasis on North-South issues. I might also add that the President's going to the Cancún [North-South] summit in Mexico will really be a very unique opportunity to exchange views with developing country leaders.

I would maintain that we've done quite well in keeping our markets open to most developing country products. I think that the developing countries would be in a stronger position if, as they developed, they were willing to open their markets to a greater degree. . . . The developing countries, if they want investment, need to have a very fertile investment climate, and we, for our part, should try to give companies which are interested in investment, information on opportunities in developing countries—which developing countries have which types of policies, and that sort of thing. . . .

EIR: Peter McPherson, the AID administrator, has said that we should encourage underdeveloped nations to let market forces operate, instead of maintaining food subsidies, energy subsidies, and so on.

Hormats: In the food area you see the need most acutely, because many developing countries, by holding down the price of food, don't give an incentive price to the farmer, and as a result the farmers produce considerably less. . . . So that's one area where the desirability of market forces is, I think, quite evident. . . . It's a little more difficult to put your finger on it in energy, but there are a number of developing countries which, in effect through price controls, subsidize the users of oil, and that adds to the higher oil import bills.

EIR: There's a broad feeling that either food prices are subsidized or people will starve.

Hormats: I think what you need to do in a lot of these areas is to provide a substantial amount of assistance to help them produce food. That is, I think, very critical. It seems to me it's compelling from a moral point of view and from the developmental point of view. There are also instances where we should be providing food aid to countries where starvation is threatened. There's no doubt about that. . . . In general you want farmers to get incentive prices, but you do need, from time to time, to provide some aid to help them produce, because even if they're getting a market price it doesn't do them very much good if they don't have the tools to produce, or the seeds, or the knowledge.