Click here for Full Issue of EIR Volume 8, Number 45, November 17, 1981

The Fed looks forward to a controlled depression

by Kathy Burdman

All available evidence indicates that the Volcker Federal Reserve is now engaged in the attempt to "ride the economy down," to allow an agonizingly slow drop in interest rates while putting the physical economy through a series of "controlled" shocks with minimal political risk to the Fed itself.

The Fed's reduction of the basic discount rate to 13 percent on Oct. 30, which led to a drop of the prime to 17½ percent on Nov. 2 did not represent an effort to restart the economy, but a commitment to an interest-rate drop curve calculated to maintain the current rate of fall in real industrial production, without causing mass industrial bankruptcies and panic. In fact, industrial and construction loan demand is falling faster than the Fed is providing funds to the banking system: this is the only factor allowing the Fed to drop rates. The Fed is following the loan-demand collapse, in other words, not attempting to mitigate it.

This is nowhere clearer than in Volcker's treatment of the U.S. bank and savings system, and the housing market which depends upon it. On the one hand, despite reports flooding the financial press that the $2 billion Greenwich Savings Bank and three other major New York thrifts, along with dozens of savings and loans, are about to collapse completely, Volcker reiterated that he will not change his basic tight-credit stance. Volcker told the Senate Banking Committee Oct. 28 that the thrifts will have to "live" with an average 16 to 17 percent cost of funds, when their average return on mortgage assets is half that at 8 percent.

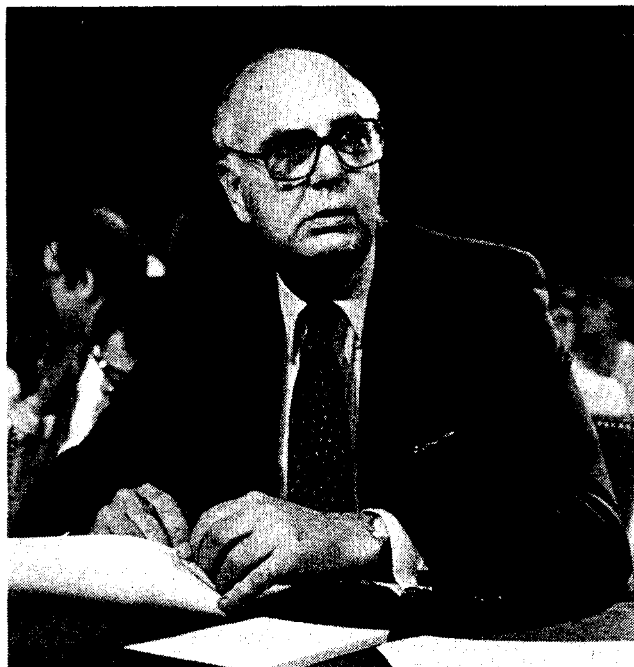
The Chairman's policy is to "ride" the bank crisis, by forcing "discrete discontinuities," as the Fed staff put it. Volcker demanded congressional authority to simply shut down selected ("discrete") banks by merger, and end their home lending (see Banking). Such "triage" of banks might work, for at least as long as the federal insurers' combined $19 billion in funds holds out. Yet Volcker's overall policy is guaranteed to blow out the U.S. industrial economy altogether, and no one can guarantee the banking system under those conditions.

In fact, what emerges is that the closer that the economy and the banking system get to a point of being blown out, the more that certain individuals in the Federal Reserve, the banking community, and academia, who are deemed experts on the subject, delude themselves that they can "absorb the shocks" and prevent everything from going haywire. These gentlemen are like the person who jumps off a cliff and convinces himself that the law of gravity doesn't hold true during the first few seconds of flight because he hasn't hit the ground yet. The illiquidity of the U.S. banking and industrial system is so great that any "shock" could be the monetary system's final undoing.

'Take a walk'

I had a rare glimpse into the Alice-in-Wonderland thinking behind Mr. Volcker's staid monetary pronouncements Nov. 5-6 at a New York University symposium with the memorable title "Crises in the Economic and Financial Structure: Bubbles, Busts, and Shocks." The participating professors of finance, all of whom seemed fit population for "Behind the Looking

© 1981 EIR News Service Inc. All Rights Reserved. Reproduction in whole or in part without permission strictly prohibited.



Paul Volcker

Glass," applauded the Fed's strategy.

"Volcker is determined to prevent a general banking collapse and preserve the basic sanctity of the system," Fed economist Robert P. Flood said in a discussion. "He won't allow uncontrolled bankruptcies, and will print money to bail out the banks as necessary if that occurs." Flood cited the disclosure by the Federal Deposit Insurance Corporation Nov. 4 that it had arranged for $430 million in Fed discount window borrowings for the Greenwich as proof that Volcker has the situation in hand.

"What is happening," said Flood's colleague Peter Garber, "is not a bank 'run,' but a leisurely 'walk.' People are slowly walking out of S&L and savings bank deposits, and the Fed and the insurance regulators are slowing walking in and reorganizing their assets. There are no lines in the street."

Mr. Flood, a member of the Washington Fed's International Finance Division, and Mr. Garber, who is at the University of Rochester, are the authors of "A Systematic Banking Collapse in a Perfect Foresight World," the econometric model published this April for predicting banking crashes.

What Volcker is trying to do, explained the conference chairman, Prof. Paul Wachtel of New York University's Salomon Brothers Center for the Study of Financial Institutions, is "allow for a series of absorbable shocks to the economy which will permit the necessary structural changes in industry and personal consumption to take place."

Although Professor Wachtel did not say so, Fed and Treasury economists have made it clear to *EIR* what this "structural change" is supposed to be: an inexorable cut in U.S. auto, steel, agriculture, housing, and other production; a slow but grinding rise in unemployment; and a permanent "reduction in the standard of living of the average American," as Paul Volcker demanded in October 1979. What is afoot is an effort to de-industrialize the economy without unduly alarming the poor, dumb American public before it is too late.

The participants at the NYU conference represent the leading financial advisers to the Federal Reserve Board, Donald Regan's Treasury, and David Stockman's Office of Management and Budget as well as the rest of the White House economics staff. Gathering at the Salomon Brothers Center just behind the cemetery in back of Wall Street's Trinity Church, what was billed as a "purely academic" exercise shed much light on events in Washington.

The point of the conference, Professor Wachtel reiterated to me, was to "identify varieties of shocks to the economy, show that they are absorbable, and that in fact many of them should be allowed to proceed." He declared with detachment that, especially from the "academic" standpoint, the "great crises" of American economic history have actually been beneficial. "These shocks are always with us, we must take a centuries-long historical view," he said. "This view will show that the system will not only survive, but be strengthened by monetary and economic discontinuities and shocks." The good professor seemed perfectly oblivious to the fact that shocks such as the Panic of 1884 destroyed whole sections of U.S. industry.

Professor Wachtel cited in particular a paper given the first morning by Prof. Richard Sylla of North Carolina State University, titled "Monetary Innovation and Crises in American Economic History." Crises are "useful, because they underscore the limitations of existing monetary systems, and lead to monetary innovation," Professor Sylla writes, characterizing the panics of 1873, 1884, 1893, and 1907 as having led to the creation of the Federal Reserve System, the "ultimate monetary innovation" in America.

Sylla concludes by saying that the current crisis among savings and loans and other banks under the Volcker interest-rate policy will be beneficial if it forces the total deregulation of banking in the United States.

The "net impact" of protective U.S. bank regulations introduced during the Depression, he writes, "was to reduce the ability of the banking system to innovate and compete in the money and capital markets. As a result, non-bank financial institutions gained competitive ground." The current U.S. banking crisis, he strongly implies, à la Donald Regan, will force the welcome demise of these regulations.

Another paper by Jack Guttentag and Richard

Herring of the University of Pennsylvania argued that no matter what the Fed does with interest rates, the banking system as a whole is now "crisis-proof." "The development of deposit insurance has eliminated the possibility of runs at most financial institutions," they write, "and converted potential runs into 'walks' at others," they begin. "Deposit insurance aims at preventing runs altogether, by making the soundness of banks irrelevant to depositors."

What can now be accomplished, they conclude, is the orderly shutdown ("absorbable shock") and merger of "discrete" institutions. "This [the deposit insurance system] has largely transformed the bankruptcy decision from a market-driven process to a deliberate, administrative process," so that Volcker may proceed with his policy in full confidence.

Guttentag and Herring's only reservation is to call for the U.S. Treasury to make explicit its now implicit but "ambiguous" commitment to back up the federal insurance agencies should the insurance funds themselves be exhausted. "Complete credibility" is not possible without this, they write. "We believe that the federal government should explicitly assume full liability for deposit insurance commitments," adding that the failure to do so "would be morally, and perhaps legally, indefensible."

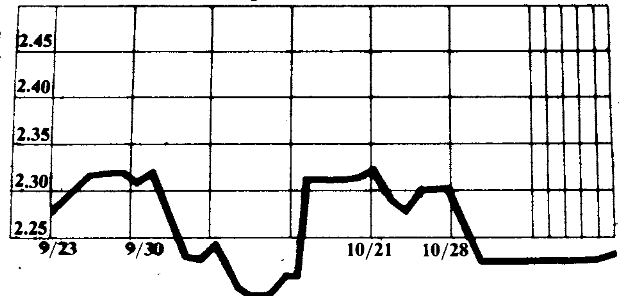
From there, the discussion went further downhill. Professor Wachtel objected to a paper by NYU Professors Thomas Ho and Ronald Singer in support of the government's loan-guarantee program for the Chrysler Corporation. "The U.S. economy can easily survive the shock of a Chrysler bankruptcy," he said, "and it would be healthy. The economy is telling us we are producing too many autos. We must allow the structural shrinkage of the auto industry to take place."

Two other papers then suggested the world economy and banking system can nicely survive 1) a Third World debt collapse and 2) the loss of all Persian Gulf oil production. In "LDC Debt in the 1980s: Risk and Reform," Jeffrey Sachs of Harvard argued that cooperation with the International Monetary Fund has made the risk of massed LDC defaults unlikely. Sachs proposed allowing a series of "orderly" defaults by negotiating default clauses, at appropriately high interest charges to cover lenders' risks, into LDC debt contracts.

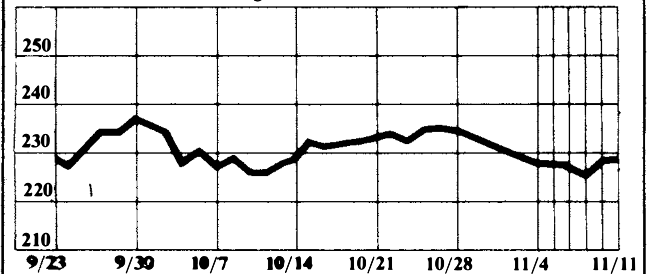
Professor Knut Mork of the University of Arizona, in "What If We Lose the Persian Gulf?" examined the U.S. economy before, and after, a projected total shutdown of Gulf oil supplies. He concluded that while U.S. GNP might drop by 15.5 percent in "Year 1" and 8 percent in "Year 2" after the "shock," consumption of energy would also decline, and the economy would stabilize! "After the shock, life is predicted to go on, although with not quite the same level of productive capacity," Professor Mork concludes.

Currency Rates

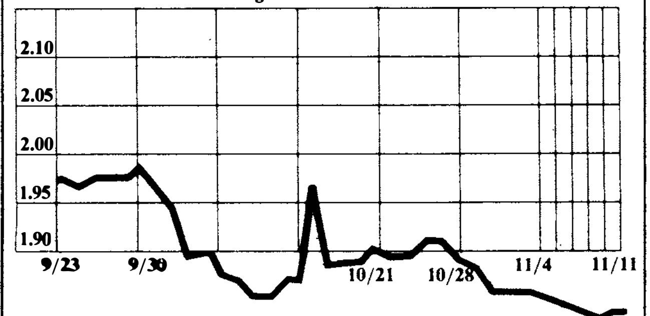
The dollar in deutschemarks
New York late afternoon fixing



The dollar in yen
New York late afternoon fixing



The dollar in Swiss francs
New York late afternoon fixing



The British pound in dollars
New York late afternoon fixing