hand, virtually announced that it is backing Franz Josef Strauss for the next Chancellor of West Germany. On the other, it is aiming its biggest economic guns at this U.S. creditor.

The *Financial Times* of March 18 elaborates the approach: "This time because of the less buoyant world economy and particularly the LDC (less developed countries) situation, they will find (increasing exports) more difficult. The Germans can finance a balance of payments deficit for a short time, but what if it's a long time? The question is whether the measures taken by the Germans, the loan from OPEC, etc. will have enough effect to attract a capital inflow.

"That question is doubly delicate in the light of the Carter measures. The Bundesbank president warned of the dangers of interest rate warfare; Schmidt certainly has no desire to get involved in such warfare in an election year. But it may not be so easy for either of them to resolve this dilemma."

The backfire effect

There is no question that the Volcker measures have hurt both Germany and France. But the likely result of this escalation will be to drive them even more rapidly and firmly into establishing their own financial arrangements with the Arabs, which are open to the Soviet Union as well.

To the Germans and French, after all, this is not simply a matter of an economic chess game. Giscard and Schmidt took the action of establishing the European Monetary System in the belief that the collapse of the world economy was dragging the world dangerously close to war, that economic collaboration between East and West to develop the developing sector was the only way to build conditions for a lasting peace.

If anything, the Carter administration's sabre-rattling postures over Afghanistan, and moves toward Hitler-like economics in the United States itself, have hardened the European leaders' conviction.

Volcker is imitating Hjalmar Schacht, Hitler's financial plenipotentiary, in attempting to control the American economy through the Reichsbank, and accepting the proposals of Schacht's leading exponent in the economics profession, Milton Friedman, in placing a straight limit on credit expansion. However, Schacht had the benefit of Bank of England loans and sympathy in running his autarky.

As Jacques Rueff pointed out, Schacht's policy was set up for him by the 1931 Standstill Committee on German payments. Volcker, who must juggle a shaky reserve currency against both domestic and international financial crises, and try to crush the European economics, has no such luck.

The program

What Volcker's measures will do to lending

by Lydia Schulman

"You can kill a lot of sheep with incantations if you add a little poison, and the three percent surcharge on the discount rate is poison." This is how American Enterprise Institute economist Gottfried Haberler, quoting Voltaire, evaluated the new package of credit tightening measures decreed by President James Earl Carter on March 14.

Other economists polled by the *Executive Intelligence Review* said that they believed that the nine percent "volunary" limit put on bank business loan expansion for the rest of the year—the part of the new package dismissed as mere incantation by Mr. Haberler—will immediately result in the rationing of scarce supplies of credit to competing borrowers.

All told, the view among bankers and credit market observers is that the new credit curbs will cause a severe credit crunch, which will immediately impact upon residential and commercial construction, the auto and other already weakened consumer industries, and the financial institutions themselves.

As Dr. James O'Leary of U.S. Trust explains in the interview printed below, phase one of the Volcker strategy—the package of interest rate hikes and other credit restraint measures imposed by the Federal Reserve chairman last Oct. 6—resulted in the demise of functioning capital markets in the United States. From December through February, many corporations who were closed out of the bond market turned to the commercial banks to lock up short-term credit lines instead.

This shift is reflected in the accompanying chart, in the surge of commercial and industrial loans in December after November's negative growth, and also in the continued growth through the March 7 reporting week (these figures, it should be noted, are not adjusted to even out seasonal fluctuations in loan demand, nor do they include substantial loan operations of foreign banks operating in the U.S.).

Phase two of the Volcker strategy is to put the clamps on further bank loan expansion, "turning off all escape routes," in Dr. O'Leary's words. With the inflation rate currently running close to 20 percent annually, the 9

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Domestic commercial and industrial loans on the books of large commercial banks (in millions of dollars)

Industrial classification	Net change during III Qtr. 1979	IV Qtr. 1979	Nov. 1979	Dec. 1979	Jan. 1980	Feb. 1980	Outstanding Jan. 30, 1980
1) Total domestic loans*	7,066	3,189	−1,389	3,403	168	1,800	138,056
2) Durable goods mfg.	2,689	1	− 616	737	na	na	23,721
3) Nondurable goods—total mfg.	1,503	298	− 714	826	na	na	19,211
Food, liquor, tobacco	535	314	− 57	252	na	na	4,963
Textiles, apparel, leather	328	−686	− 241	−266	na	na	4,153
Petroleum refining	6	705	− 309	805	na	na	3,206
Chemical and rubber	179	209	− 61	87	na	na	3,744
4) Mining	673	317	− 195	495	na	na	12,244
5) Trade—total	685	230	− 332	−192	na	na	24,230
Commodity dealers	−58	275	− 330	273	na	na	2,118
Wholesale and retail	743	−44	− 3	−465	na	na	22,112
6) Transportation communication, other public utilities	1,434	1,070	327	618	na	na	18,058
7) Construction	309	−133	16	56	na	na	5,757
8) Services	1,108	1,040	142	475	na	na	19,776

* Lines 2 through 8 do not add up to total
Source: The Federal Reserve

percent ceiling on business loan expansion portends a sharp contraction in nominal Gross National Product.

The Credit Control Act of 1969

The recent actions taken by the administration and the Federal Reserve imply even more ominous developments. along the lines of the squeeze imposed by former Fed chairman Burns in the third quarter of 1974. In imposing the "voluntary" curb on business lending, the 15 percent reserve requirements on new consumer credit card extensions, and other measures, Carter invoked the Credit Control Act of 1969. The invocation of this act, which gives the president and the Federal Reserve sweeping, wartime authorities over the U.S. economy, means that we are moving into a period of mandatory controls of all types, strict allocation of credit, labor, and resources in the economy, a new depth of cuts in living standards, and other measures associated with a military economy.

The Credit Control Act of 1969, which was inspired by the congressional Joint Committee on Defense Production under the chairmanship of Sen. William Proxmire (D-Wisc.), awarded the U.S. president standby powers to direct the Federal Reserve to cut off credit selectively for the purpose of combating inflation, and, if necessary, of gearing up the economy for war. The act, in fact, grew out of plans drafted by the Office of Emergency Planning for standby credit controls on consumer credit and other mechanisms for ensuring the defense production capabilities of the economy in the event of conventional or nuclear war. The Credit Control Act was originally pushed through Congress in the inflationary climate touched off by the nonproductive defense spending associated with the Vietnam war and aggravated by the tight money policies adopted by then Federal Reserve Chairman William McChesney Martin.

According to U.S. Trust's Dr. O'Leary, it is probable that Volcker will establish a new policing mechanism—

patterned after the national committee which administered credit controls during the Korean War—to supervise the new constraints on bank lending.

George McKinney, economist at Irving Trust, expects that the current voluntay restraint program will be supplemented by a major step in the activities of the bank examiners—which he termed "a subversion of the examining process." According to Mr. McKinney, the Credit Control Act is one of the most absolute acts in force in the country.

Volcker's measures

An aide to Congressman Henry Reuss (D-Wis.), who in his capacity as chairman of the House Banking Committee has long been a staunch supporter of credit controls, predicted that the Federal Reserve would successfully keep the banks in line through "moral suasion and threats." "If the Fed sees that some bank is making loans above the voluntary limits, it can become rougher at the discount windows [a major source of the banks' relendable funds in recent months—ed.]. There is no real way that the Fed can refuse a bank loan at the discount window to allay liquidity problems. However, if the authorities see a bank making loans in excess of the new limits, the next time the bank comes to the window, the Fed will subject it to much tougher questioning to determine whether the bank intends to use the funds for relending purposes. Banks want to have the bank examiners on their side." Under the new rules, banks can borrow at the Fed only four times a month, and large commercial banks which have been borrowing excessive amounts are subject to a 3 percent surcharge on the 13 percent discount rate.

Three of the measures imposed March 14—discount rate surcharge, the reserve requirements placed on bank credit card loans and the higher reserve requirements placed on supplemental borrowing from the Eurodollar market—are designed to discourage additional lending by jacking up the cost of funds to the banks. The added costs will put a severe dent in bank profitability. Banks have been losing money on their consumer loans for months; now they will lose more. Banks have simultaneously seen their portfolios of Government securities depreciate daily. This becomes a problem when a bank liquidates these assets to free up funds for lending. Many banks are making the decision to liquidate government security holdings and take a loss now, on the expectation that government bond prices are going to fall still lower.

The decision to place a three percent surcharge on the discount rate rather than raise the rate will especially hit the regional banking system. Usury laws in force in many states tie the rate that banks can charge on loans to business and consumers to the discount rate. Since the discount rate is nominally being held at 13 percent—although the banks' actual cost of funds is well over 17 percent—the regional banks are being put in a vise from which many of them will never emerge.

The "Omnibus Banking Bill"

The next phase of the banking system and credit restructuring in the works is waiting in the wings in the form of the sweeping banking "reform" bill known as the Omnibus Banking Bill. This bill, which is the long-term pet project of Rep. Reuss and Sen. Proxmire, chairmen of the banking committees of their respective sides of Congress, is expected to pass the House and Senate shortly and be on President Carter's desk for signing by March 31. According to banking committee staffers who helped to draft the bill, it provides the Federal Reserve with the tools to address the present inflation crisis. Most importantly, the bill greatly enhances the power of the Federal Reserve by forcing all U.S. financial institutions, including non-member banks, savings, banks, credit unions, etc., to hold interest-free reserves with the Fed for the first time in history. In one swoop, the Fed's authority to control money supply and credit growth by raising reserve requirements will be extended from 5,600 financial institutions at present to 40,000.

'We're going to see a tremendous credit crunch'

In the following interview, Dr. James O'Leary, chief economist of U.S. Trust, commented on the impact of the credit curbs announced by President Carter on March 14.

EIR: Is the credit control aspect of the package announced by President Carter March 14 strong enough to significantly cut loan expansion?

O'Leary: That is the really important part of the package. I think it will be very effective. The measures taken last fall have almost closed down the availability of capital in the mortgage and bond markets. What the Fed is doing now is putting a highly significant limiation on the expansion of bank loans. We are entering into a period of real tightening and contraction of the *availability* of credit. There will be rationing of credit. As Mr. Volcker said, he is leaving it up to the banks to decide who gets the credit; market forces are working to determine this. A lot of credit lines were entered into over the last couple of weeks. Now where new credit lines are being sought, the banks realize that they will have to adhere to increasing pressure from the Fed.

EIR: Does the Federal Reserve have the powers to hold the banks to the 9 percent annual limit on the rate at which they are allowed to expand their loans to business?

O'Leary: Most banks will be very scrupulous. There will probably be some policing mechanism set up that will periodically check to see if the banks are staying within the limits ... I was part of the national committee that was set up to watch over the banks when this type of effort was made during the Korean War. A pattern similar to that will develop. A committee structure of bankers will be instituted to see how well the banks are doing. There is no one more scrupulous than bankers ...

Mr. Volcker set up the measures in a way that no one will attempt to escape. He anticipated businesses trying to borrow elsewhere—in the commercial paper market, the Eurodollar market. Having put foreign banks under the same constraints, he turned off all the escape routes. [Foreign banks operating in the U.S., which account for around 20 percent of the loans to industry, were called down to Washington along with the U.S. bankers on March 17, and are subject to the same 9 percent "voluntary" limit on business loan expansion.]

We're going to see a tremendous crunch. With the first round of measures Volcker affected both the availability and cost of credit, and forced borrowers in the capital markets back to the banks. Now with the limits on bank lending we could see a very severe crunch ... It is wrong to think that higher interest rates won't come out of this.

EIR: What are the international implications of the U.S. going into a severe recession now?

O'Leary: Our recession will have an impact on our trading partners. This is all pretty well anticipated by the OECD and other forecasters. The danger is that in the climate we're in, with some of our industries like auto already so depressed, there will be a new hue and cry for trade sanctions. That's where the problems lie.

By next Labor Day, when the economy will clearly be in a recession, the Fed will have to decide how tight to keep monetary policy. They're going to have to be very careful, because they could provoke something much worse.

If by that time there hasn't been any improvement in inflation, Carter will have to decide whether to go to direct wage-price controls. This might seem like a bad route for political reasons, but Carter might just figure that there would be something to gain politically by taking strong measures to fight inflation. He might decide to forget about the labor vote and the inner city vote and go for what has traditionally been the Independent and Republican vote.

The victims

Who is going under in Carter's sacrifice?

by Richard Freeman

In his March 14 address on the economy, President Carter stated that his new program of budget cuts, credit rationing and oil import fees, were not intended to collapse the economy, nor to affect the auto and housing industries, because these industries were going to be "protected." Either Carter was severely misinformed, or deluded, because it is precisely his policies that will hit the most credit vulnerable sections of the economy, with auto and housing in the lead.

Indeed, Carter's budget, and Volcker's credit policy leaves only one question unanswered: will the industries producing for Carter's military build-up program or the shift to synthetic fuels and pollution control measures, be brought down in the general collapse that the President's program will touch off? Carter hopes not. Indeed, the treasurers of some large companies, such as International Telephone and Telegraph, report that they are not planning to make cuts into their capital spending. IT&T's treasurer reported March 19 that it will simply go to Europe—where half of IT&T's operations are run from, to borrow money which IT&T will then bring into the U.S. The telephone and electronics company giant is planning on increased electronics orders from military as well as commercial aircraft (which are gearing up to meet fuel efficiency standards) to keep it going.

But there are general laws of economics and it is nearly impossible to maintain one part of an economy in health, when other sections are in radical decay. The experiment of Finance Minister Schacht in Germany in the 1930's showed that the protection and build-up of a core of military and synthetic fuel related companies within the framework of credit controls and fiscal conservatism meant cannibalization against other sectors of the economy, introducing fundamental imbalances that were not possible to correct. The Schachtian solution to this problem is well-known in the volumes written about the Nazi war economy and concentration camps.

In any event, the first phase of the Carter high interest rate policy leaves little doubt that Carter's hit list in the consumer and credit-dependent sectors of the economy will be devastated by his and Volcker's latest measures: