A replay of 1980?

Richard Freeman tells how American business stayed afloat through Volcker's latest crunch, and why it can't withstand more of the same.

Leading New York banks have told Federal Reserve Board Chairman Paul Volcker that they stand fully behind his assault on the U.S. economy, in the form of cutting money supply and maintaining sky-high loan-shark interest rates. This backup guarantees that Volcker will attempt to repeat the destructive economic policy that gutted the U.S. economy in 1980—regardless of what the GNP figures say—and will plunge the U.S. into a second phase or "dip" of recession.

It is evident on two levels that the U.S. economy is not in good shape. On the first level, the month-to-month economic activity of the new year, there is enough disturbing news to discount whatever short-term economic statistics are spilled out. The economy has been held together for the last seven to eight weeks by a daisy-chain financial arrangement, which will fall apart the moment that Volcker forces personal incomes to fall. On the deeper level, the U.S. economy is in very bad shape, looting its profits and capital formation. With all the talk about how the U.S. economy "may recover, if only" now dominating the financial press, no one is facing the fact that the U.S. economy has had negative re-investment of its surplus for well over five consecutive quarters.

As the LaRouche-Riemann economic model has conclusively demonstrated, an economy that undercuts its future ability for growth is digging its own grave. If the Volcker high interest-rate credit shutoff policy is tolerated much longer, the U.S. economy will soon reach a point of having destroyed its very capacity for economic recovery.

Monetarist assault

In testimony before the Senate Banking Committee on Feb. 25, Volcker told the assembled congressmen: "Our intent is not to accommodate the inflationary forces; rather we mean to exert continuing restraint of money and credit to squeeze out inflationary pressures." Volcker stated that he will impose "further deceleration in the monetary aggregates," and that this would include such measures as "frequent adjustment of the discount rate, more forceful adjustment for the course of nonborrowed reserves and a return to contemporaneous reserve accounting." In saying this, Volcker simply mouthed the views of the semi-secret, monetarist Mont Pelerin Society, which is run by the old and wealthy oligarchical families of Europe.

The day before Volcker testified, the New York banks, which have led the slash in business loans nationally by $4.2 billion since Jan. 1 of this year, sent up a clamor for Volcker to become even more restrictive. In delivering this stamp of approval, the New York banks were also sending a message to President Reagan. "It is pointless to lock the door on an inflationary policy," stated Leif Olson, chief economist for the explicitly monetarist Citibank, "and leave the key hanging outside. You have to throw the key away," he added. Paul Markowski, chief economist for the New York investment bank of Sterling, Grace & Company, said, "The go-slow approach always leads to confusion. The Federal Reserve has to prove that it means business and I'd rather see Fed overkill than Fed underkill."

The inflation record

A review of 1980 shows that from the very start, Volcker was hell-bent on the policy that he worked on for several years at the New York Council on Foreign Relations called "controlled disintegration." While intoning that his policy intent was to halt inflation, Volcker fed inflation by his behavior.

Volcker took over as Fed chairman from G. William Miller in August 1979. It was Volcker who started pushing interest rates into the stratosphere. For 1978, the average level for federal funds was 7.93 percent. Following Volcker's installation at the monetary helm at the Fed—just months after Margaret Thatcher was made prime minister of Great Britain—he managed to push up the price for overnight interbank federal-funds money to an average of 11.19 percent for 1979, an increase of 226 basis points.

In 1980, Volcker moved again, sending the federal funds rate up to an average of 13.35 percent for the year. Volcker has imposed such a psychotic regime on the U.S. economy that when he brings federal funds down to a record-breaking 15 percent, he is applauded for "loosening" up on the credit reins.

Under Volcker, the average prime rate charged by banks skyrocketed, as banks had to pass on the higher cost of federal funds. Volcker pushed the prime rate charged to the best corporate customers from an average of 9.06 percent in 1978, to 12.67 percent in 1979, and up to 15.27 percent.

All other money-market instruments and loan rates were sent shooting up. The average rate on a Moody's triple-A corporate bond was 11.94 percent in 1980 and for a Moody's BAA-rated corporate bond, the rate was 13.67 percent. This second rate—at which most medium-sized U.S. companies qualify for financing—pushed issues off the bond market. Only the big companies could get money.

Many companies went to the commercial paper market to get short-term cash infusions for 60 to 90 days, but this wasn't large enough to accommodate all comers. Nonfinancial commercial paper started 1980 at a volume of about $31 billion and rose to a level as high as $42 billion in late June, before falling off to $35.5 billion in late December.

While commercial paper was making up only a relatively small part of the financing slack, the annual net increases in bank loans to business fell through the floor. They went from a level of net increase of $49.7 billion in 1979 to a level of $28.7 billion in 1980, a drop of more than two-fifths, before adjusting for inflation! (Corporate stock offerings did rise in 1980, but not enough to offset the drop in loan demand.)

The collapse in business loans made the rate of overall net increase of new bank loans for all purposes fall from $101.2 billion in 1979 to $34.1 billion in 1980.

Production effects

The calculated effect of Volcker's policy was the decimation of the U.S. economy. Net new credit extensions to both consumers and business sank—net supply of new credit of all kinds to the entire U.S. economy fell from $400.4 billion in 1978 to $377.6 billion in 1979 and $310.6 billion in 1980—making a collapse inevitable.

Some of the biggest industries of the U.S. economy got hit the worst:

- **Auto sales,** after falling 10 percent in 1979, fell another 20 percent in 1980.
- **Housing starts,** after falling 14 percent in 1979, fell another 23 percent in 1980. Housing and auto combined did represent almost $250 billion in output and sales.
- **Steel shipments** in 1980 were 83.5 million tons, down 16.4 million tons (16.4 percent) from 1979 levels. Automotive steel consumption fell 6.5 million tons in 1980, while steel consumption of housing fell by 2.0 million tons. Some economists, such as Penelope Hartland-Thunberg, formerly at the economics desk of the Central Intelligence Agency, and now at the Georgetown Center for Strategic and International Studies, argue that U.S. steel production "is no longer of national security importance to the U.S." Perhaps this is Volcker's view as well.
- **Production levels** of many key industries also fell. Nonelectrical machinery, whose industrial production index (1967 = 100) was 167.1 in January 1980, reached 161.5 by November 1980 (after some mid-year recovery). The industrial production index of electrical machinery dropped from 181.7 at the start of 1980 to 171.9 by November; lumber and wood products had an industrial production index in January 1980 of 131.6, which skidded to 121.4 by October; and so on.
- **Official unemployment** went from 6.3 million in December 1979 to 7.8 million in December 1980, a growth of more than 1.5 million in one year. From December 1979 through December 1980, the number of workers unemployed for longer than 27 weeks more than *doubled.*

The wipeout of profits

Volcker's 1980 "Operation Overkill" had the further effect of wiping out profits. This is the fund out of which capital spending, or current borrowing for future capital spending, must be paid. Along with consumer savings, profits represent, in crude form, the surplus available for reinvestment in expanding the basis of the economy. As noted above, this surplus pool has been negative for five consecutive quarters in the United States.

In 1980, corporate after-tax profits pegged at $189.9 billion, were estimated to be 3.5 percent less than their level of $196.8 billion in 1979. But at $43.3 billion, the inventory valuation for 1980 was the largest for any year ever, and so was the depreciation allowance at $18.1 billion. Adjusting for these facts, corporate after-tax profits were down 7 percent from their 1979 levels. Furthermore, when inflation is taken into account—the GNP deflator was at least 9 percent in 1980—corporate after-tax profits had dropped 16 percent from 1979 levels.

Oil profits, which represent the huge runup by Exxon et al. were estimated to be $26 billion in 1980, about one-eighth of all profits. If oil profits are netted out, non-oil corporate after-tax profits fell by 18 to 20 percent in 1980 as a result of Volcker's policy.

Personal consumption expenditures in 1979, priced in 1972 constant dollars, were $930.9 billion; priced in the same 1972 constant dollars, they were $933.0 billion in 1980, i.e., completely flat. Yet inflation pushed people into higher tax brackets and took 1 to 3 percent out of incomes in 1980. Moreover, personal expenditures represent a wide range of incomes including rental income and the like, so that some incomes fell while some gained to keep the 1980 gain over 1979 completely flat.

It can be concluded that for many wage-earners, incomes fell by 3 to 5 percent in 1980. Savings accounts, which had been partly restored at the beginning of 1980, were raided by the end of 1980 and into 1981, as the savings rate attests: October 1980, it was 5.5 percent; November, 5.1 percent; December, 5.2 percent; January 1981, 4.6 percent.

Volcker's crunch on corporate profits, personal incomes, and savings cannot be sustained indefinitely. Such looting destroys the underlying infrastructure of industrial, agricultural, and household capital formation in the most profound sense. A negative surplus economy is an economy that is going straight into hell's worst nightmare.

More monetarism?

The fact that Volcker decimated the 1980 real U.S. economy and is accelerating his credit shutoff policy in 1981 leads to the question: what is holding up the U.S. economy?

The answer is a little-noticed but powerfully operating *financial daisy-chain* arrangement. The daisy chain works as follows: high rates of speculative profits in the secondary New York real-estate market, the $200 billion per year in illegal narcotics revenues trade, and so forth, have generated a certain level of profit to hire especially white-collar workers. While blue-collar jobs dropped by 600,000 since April 1980, white-collar jobs have grown by 1.3 million. This had led to sufficient personal income growth for individuals to invest in such instruments as money-market funds. In the last four weeks, money-market funds grew in size by $10 billion. These funds are being invested in short-term commercial paper. Thus, while short-term bank commerce and industry loans have dropped, according to the Bankers Trust newsletter, by $4.2 billion since Jan. 1, commercial paper for non-financial corporations has skyrocketed in the same time-frame by more than $7 billion, thus offsetting the drop in commerce and industry loans. This keeps corporations solvent on a short-term basis.

Inflation was still continuing at a 10 to 12 percent rate for November through January. Auto sales for the mid-10 days of February fell 23 percent from last year's bombed-out levels. The basics of the economy haven't improved.

If Volcker then moves to tighten further, he will only succeed in cutting off the one remaining source of liquidity: the growth in some categories of personal income that feed the commercial paper market. This is exactly what Volcker proposed to do at the Feb. 25 Senate hearings on the economy; this is what the leading New York banks are asking him to do. If he does it, then the commercial paper market activity will dissipate. The seven- to eight-week lull in the U.S. economy's collapse will be over.