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A gameplan for the interest-rate summit

by David Goldman

Finance Ministers of the Group of Five—the United States, Britain, France, Germany, and Japan—convene in London on April 10 to debate the European proposal for a global lowering of interest rates. The Treasury Department, which has been closed-mouthed concerning the conference, does not report what other consultations Treasury Secretary Donald Regan will conduct with his European counterparts in the course of the trip, although an Associated Press dispatch March 28 claimed that he would also travel to Bonn and Paris for separate discussions.

The convening of the extraordinary conference itself shows how far the influence of the Franco-German "superpower" has come in the United States. Despite the refusal of either the Treasury or the Federal Reserve to consider Europe's proposal—reiterated at the highest executive level by the heads of government of the European Community last week—the White House accepted the European agenda as a matter of urgency in the foreign policy realm.

As National Security Council senior staff member Henry Nau reports (see interview below), the view of the White House is that the alliance cannot proceed as long as this economic issue is outstanding. *EIR*'s European economics correspondents report that even among pro-American and anglophile banking circles in West Germany, the Federal Reserve's interest-rate policy is considered disastrous, for strategic and military reasons. West German Chancellor Helmut Schmidt and his principal public and private advisers firmly believe what a German defense expert warned that country's leading annual defense conference in February: that the monetarist policy is a national security problem.

The view that the NATO allies will not have sufficient resources to conduct a credible military program if the Fed succeeds in pushing the country into recession is supported by *EIR*'s own computer econometric study of the economy's capacity to mobilize (see *EIR*, March 31, 1981). But it does not require computer analysis to assert that Volcker "could turn the United States into a military dwarf," as a leading Hamburg banker put it.

This is one reason why the American motivation for the convening of the Group of Five meeting emerged not from the cabinet departments normally responsible for such matters, but rather from the White House itself. President Reagan and his leading staff have noted the February fall in housing starts, industrial production, real personal income, and construction spending, as well as the three-month consecutive decline in the index of leading indicators, and are not blind to the fact that Fed Chairman Volcker has led them into a trap. Unfortunately, the White House still believes that it must complete the cuts in the federal budget, regardless of the impact of these cuts on national productivity (see p. 13). But the imminence of new declines in the economy puts the White House in the mood to talk with the Europeans.

A six-month stall?

Through private channels, the Treasury has made known its intention to *deflect* the European proposal for interest-rate reduction for the next six months. The Treasury version of the scenario for the April 10 meeting runs as follows: Treasury Secretary Regan will begin by reading back to the Europeans a list of their

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past complaints about the instability of the American dollar, and remind them that a stable dollar is essential to fighting inflation internationally—which is true, as far as it goes. He will then argue that the administration needs time to make its tax cuts and budget cuts work, and insist that the Europeans hold their peace for at least six months; to give the program a chance.

The Treasury viewpoint hinges on a plan to deliberately induce a recession during the next six months, in the supposed expectation that this will ultimately bring interest rates down.

Former executive director of the Atlantic Council of the United States Frank Southard, who maintains close ties to the Treasury, put it this way: "We will do what [British Prime Minister] Margaret Thatcher failed to do: we will actually cut the budget and money supply so sharply that housing and other sectors of the U.S. economy will significantly reduce activity. This will mean reduced credit demand in the U.S., and the Federal Reserve will then be able to lower interest rates. . . . Europe will agree to give the program time to work, and Regan will be able to mollify them."

However, Southard continued, "What's more likely is that the administration's program will fail, and then the fat will be in the fire. There will be a tremendous recession in the U.S. and in Europe, but inflation will still be at an underlying double-digit rate of 12 to 14 percent."

That is precisely what happened to Margaret Thatcher, for reasons that have nothing to do with Britain's failure to cut the budget deficit (which rose on a per annum basis by 50 percent over the past year). According to *EIR*'s econometric projection (published in November) the U.S. has reached a turning point similar to what occurred in Britain during late 1979 and early 1980, in which the debt-service increase ensuing upon higher interest rates creates a self-feeding spiral of new borrowing demand, leading ultimately to large-scale bankruptcies.

The difference between the situation of the United States and that of Britain is that not merely the debt of U.S. corporations or municipalities is denominated in dollars (and sensitive to changes in dollar interest rates), but also upwards of $300 billion of the developing sector's total $500 billion debt burden. As *EIR* has pointed out repeatedly, the most devastating impact of the Volcker measures is likely to be on the Third World's capacity to pay its debts.

The LDC debt squeeze

Very suddenly, the financial press has admitted that this is the case. Leonard Silk of the *New York Times* based an April 1 column on a new Wharton School study on the Third World debt problem which offers no new information, but argues that the "credit shock" to the domestic banking system following a series of major defaults by LDC debtors could be devastating. *Far East Economic Review,* in an extraordinary supplement March 20, said with gallows humor, "Ayatollah Ruhollah Khomeini and Paul Volcker may make an unlikely pair. But from the developing world's viewpoint, the fiery Islamic revolutionary and the rather dour chairman of the United States Federal Reserve Board have conspired, albeit unwittingly, to produce another Third World balance-of-payments crisis every bit as threatening as that brought on by OPEC seven years ago."

It explains, "The effects of the Volcker shock have been passed directly into the balance of payments of the developing world through the mechanism of the floating-interest-rate syndicated commercial loan. . . . A comparison of the cost of oil and interest payments as percentages of the export earnings of 12 major non-oil LDCs shows that the 'Volcker shock' of 1979 has had as great an impact on Third World payments as the OPEC crisis of 1973-74."

The publication cites a Morgan estimate that the difference between a 10 percent and 15 percent London Interbank Offering Rate on six-month money, the benchmark for much of the Third World's debt, is $10 billion additional red ink on the Third World's books. The real number is closer to between $15 and $20 billion, but the point—which *EIR* has hammered at—is the same.

What this presages is an international debt crisis in the third quarter of 1981 of a magnitude sufficient to create real trouble in all the Western economies. Such a generalized crisis is not to be excluded should the Europeans accept Reagan's excuses at the Group of Five summit meeting next week.

The Belgian connection

The American Treasury will have some help from a Benelux "fifth column" in the European Community. Although the Belgians and Dutch will not be present at the Group of Five meeting, their behind-the-scenes machinations may influence the French and Germans to back off.

Belgian monetary sources warned the leading Swiss daily *Neue Zürcher Zeitung* during the European Community summit meeting at Maastricht two weeks ago that the European Monetary System faced severe pressures from within. The Italian lira had just been devalued against its central parity with respect to the other EMS currencies, a nuisance for a fixed-parities currency group. Now, the Belgian central bank reported, the troubles of the Belgian franc would contribute additional pressure.

Right on time, the Belgian franc went into a storm on the European foreign exchange markets, and was saved from devaluation only through the expenditure of

close to $1 billion in support. After a week of this, the Belgian central bank March 31 raised its discount rate by 3 percent to 16 percent as an emergency measure. The central bank's action caused a collapse of the government, still not resolved at deadline.

The Belgian events, in turn, are now being used to argue that West Germany's interest-rate problem is not high American rates, but the strains inside the European Monetary System, an argument made, e.g., by the head of the German Association of Public Banks, Herr Hans Fahnding. For that matter, Christian Democratic leader Gerhard Stoltenberg is arguing, just as spuriously, that high German interest rates are due to the country's budget deficit rather than to the Fed.

The point of these diversions is not to change the minds of the French and Germans, but—as Dutch Prime Minister Van Agt discussed with Secretary Haig in Washington March 31—to press Europe's leaders to accept the Treasury's delaying tactics.

The Fed's Wallich and the NSC's Nau

Dr. Henry Wallich, Federal Reserve Board of Governors member in charge of international monetary affairs, told banking sources this week that the Fed is in direct confrontation with West Germany and France on U.S. interest-rate policy.

Q: What is the Fed's reaction to the press conference Tuesday by West German Chancellor Schmidt and French President Giscard, calling on the U.S. to lower interest rates?
A: Oh, this view isn't shared in all circles. The criticism is not broadly based. The British don't agree and even the Germans and French admit there is nothing we can do, in practice. We ask them, do you want us to print money and reflate? They say, no, they certainly don't want us to create more money and end up with more inflation. I've met with all their officials right here in my office recently, [West German Economics Minister] Otto von Lambsdorff, [West German Central Bank President] Karl-Otto Poehl, [French Central Bank President] René Monory, they all agree that we can't print money. They're just expressing a wish. I, too, wish that interest rates could be lowered, but the only way to do it is to slow monetary expansion and slow inflation.

Q: That is the pragmatic view of pragmatic economists, but the West German chancellor and the French president have called in the international press and demanded we get our rates down. Clearly they must mean business.
A: [Angry] We don't have to respond to that! Why should we have to respond to that? I'm sure they are not completely happy with the situation but I doubt very much that they'd get any support whatsoever from this administration! It's one thing to demand we change our policy, and another to explain to us just what they suggest we do about it.

Q: Ronald Reagan is said to find gold remonetization attractive. I agree that the French and Germans may have had no ready answer to the usual pragmatic arguments about looser money being inflationary, but have they suggested anything new and unusual? Giscard is something of a Gaullist; has he suggested a gold-dollar link or a dollar-EMS relationship?
A: Certainly not that I'm aware of, how ridiculous. Who are they to tell us how to run our monetary policy? We are responsible only to the Congress of the United States. We are a creature of Congress and under the Humphrey-Hawkins [full employment] Act we report only to the U.S. Congress.

We don't respond to the demands of foreign governments. We don't report to foreign governments.

Dr. Henry Nau, acting director of international economics at the National Security Council, told banking sources this week that European demands for lower U.S. interest rates are causing an administration policy crisis.

Q: What is the Reagan administration's reaction to the European heads of state criticism of high U.S. interest rates?
A: There has been no public comment because this is causing a potential major foreign policy problem. The European governments are, with increasing frequency and more and more urgently, demanding that we get our interest rates down because they are extremely uncomfortable with the effect on their economies. They cannot live with it. This is clearly a matter of intense concern to this administration because it adds an element of tension and conflict between the U.S. and Europe, especially Germany. Helmut Schmidt has been extremely vocal, in the press and in Bonn, commenting every day.

Q: We've had no public response to him. Is this because he's made no private overtures to us?
A: I didn't say that; he has communicated with us [at the White House]. We have no public response because we don't know how to deal with it. We're trying to figure out now how to deal with it. We're extremely eager to resolve this conflict by the time of the Ottawa economic summit, beforehand if possible. Or, our only choice may then be to preempt the issue by putting it into a larger set of foreign policy and diplomatic concerns.

Q: Do you mean military or East-West security?

A: I can't comment. The fact is that the administration is both extremely eager to tighten up relations with our allies, and totally committed to an unprecedented economic policy which has effects. The Europeans are complaining loudly of these effects, and we're really feeling the pressures on this issue. The Germans in particular are very concerned, very vocal, but we cannot abandon the basis of our economic policy.

Q: Thatcher seems to dissent from their view.

A: Nevertheless it is the Germans and French who are very vocal. That's what concerns us. Especially they are worried about the administration's relationship with the Fed.

Q: What is the relationship? Does the administration want the Fed to ease off, or does it follow [Treasury Undersecretary for Monetary Affairs] Beryl Sprinkel's criticism that the Fed should rather maintain a steady keel, and if necessary tighten more?

A: Beryl Sprinkel is a good man, he's a committed monetarist and there is no conflict with the Fed. That's why the Germans are concerned. They're concerned about the monetarist influence.

Q: But Sprinkel's influence on international and economic policy generally has been rated as very low. Is that true?

A: Not in the least. Monetarism is a major part of our basic economic package. The Fed will implement a monetarist policy. It was in the President's speech that we have a quite hard money policy, that we will insist on a stringent policy on the growth and supply of money and monetary reserves, and no one is backing off from this.

So clearly there is a basis for disagreement and that is why the Germans are very concerned. Schmidt clearly wants to see us loosen up.

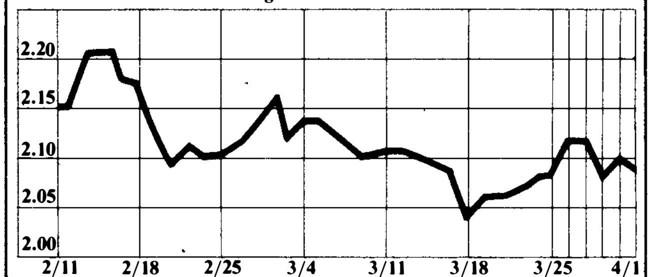
Q: Do they want us to back off a bit, or are they asking for a large reduction in rates? They talk about "interest-rate disarmament." Does that mean easing a bit to placate everyone, or a major jump down?

A: They are concerned about the future. The Germans are asking hard questions about our monetary policy, the complaint takes the form of many, many probing questions. They want to know just when do we expect our program to take effect, when do we expect a big fall in interest rates and inflation rates. They want to know all our econometric projections in detail, what do we expect interest rates and inflation to be six months from now, twelve months from now. What are our monetary aggregate targets, exactly? What is the nature of the administration's relationship to the Fed?

Currency Rates

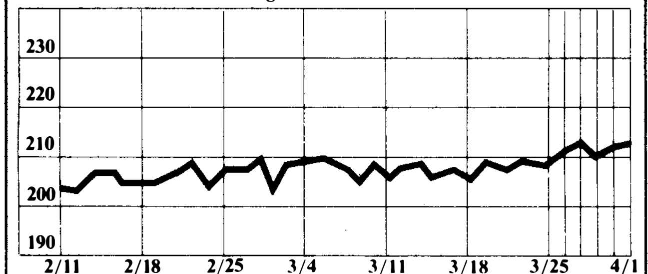
The dollar in deutschemarks

New York late afternoon fixing



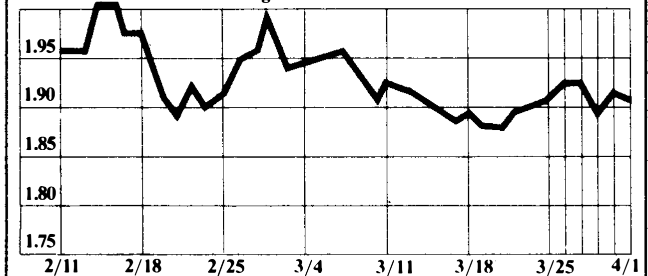
The dollar in yen

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