New phase in the global war over interest rates

by David Goldman

West German Chancellor Helmut Schmidt's consultations in Washington began May 21 with, according to West German aides, a polite but tough lecture to the American President on the interest-rate problem. Schmidt will tell Reagan precisely what he informed a West German television audience on May 18: that the Federal Reserve's high interest-rate policy has created a self-feeding spiral of rising money supply and further rises in interest rates.

After the electoral defeat of French President Valéry Giscard d'Estaing, the European leader in the best position to influence American economic thinking, Schmidt, and Mexican President José López Portillo are the foreign leaders with the most presence in Washington. They are both telling Reagan the same thing, i.e., that high interest rates are inflationary and therefore self-defeating.

White House counselor Edward Meese heard a similar argument last week from a delegation of the U.S. League of Savings and Loan Associations led by their executive director, William O'Connell, and League President Rolland Barnard. A League release of May 15 said the delegation told Meese that "the federal government should take decisive and dramatic action to promptly bring down today's intolerable interest rates."

Sensitive to the President's concern, Treasury Secretary Donald Regan and Undersecretary for Monetary Affairs Beryl W. Sprinkel spent most of the week of May 11 trying to talk interest rates down, arguing that the Federal Reserve's monetarist policy would successfully lower rates. The markets responded with rising bond and stock prices for all of two successive trading days, May 15 and May 18, before turning down again sharply in expectation of a further prime rate rise above the present 20 percent level. The predictable failure of the Treasury's bland assurances have made "Paul Volcker the number-one problem we have to deal with," according to a Senate source close to the White House. The events of the past several months make it difficult for the American President to reject, upon reflection, the arguments of the West German chancellor, which have been repeated in a barrage of statements from Mexican government and trade-union officials and newspaper editorials during the past week.

As *EIR* noted three weeks ago, the more than 12 percent per annum rise in the narrowly defined money supply M1B during the first quarter of 1981 is due to a staggering influx of Eurodollars into the U.S. credit markets. Most of the Eurodollar influx is not short-term movement of funds in response to high dollar interest rates—most of this activity has remained abroad in the foreign markets and not affected domestic money aggregates. Instead, the rise in M1B reflects massive foreign coporate borrowing to pay domestic expenses. The auto companies alone, according to a Department of Transportation internal study, have borrowed $12 billion abroad in order to pay domestic bills during the past 18 months.

In a period where corporate interest costs absorb about 60 percent of internal cash flow, higher interest rates force an increase in the rate of borrowing and the rate of money supply growth.

In an interview with nine American correspondents released May 18, Chancellor Schmidt expressed confidence that the U.S. administration would not revert to the Nixon-period policy of "benign neglect," a reference to the unfortunate phrase of then Treasury Secretary John Connally. "I think this will not be done again by the Reagan administration. They certainly want to listen to what the French and Germans feel about this," Schmidt concluded.

Whether Reagan will be in a position to reflect on the accuracy of Schmidt's analysis and recommendations, however, is a different story. The Treasury monetarists may have blown their credibility as interest-rate forecasters, but they are by no means out of ammunition. These boys and their ally Paul Volcker—who has actually drawn political strength from the Punch-and-Judy show with Treasury officials—are playing rough.

How rough Volcker can play was made clear during the third week of December 1980. On Dec. 18 Volcker met with the chairmen of the leading New York City banks, and brought their message to Reagan the following week: unless he respects the independence of the Federal Reserve, the banks would destabilize the markets through "loss of confidence."

At the Fed chairman's request, President Reagan met with Volcker again on May 18, and heard roughly the same formulation. The markets have rejected the President's program as inflationary, and are especially disturbed by Treasury Undersecretary Beryl Sprinkel's accusations that the Fed has let the money supply run out of control. Volcker demanded a moratorium on White House criticism of the Fed and, according to the May 21 *New York Times,* received assurances that Sprinkel would keep his mouth shut for the meantime.

That cuts both ways. The Treasury official, a long-time stand-in for monetarist Milton Friedman in Chicago economics circles, had indeed made the only public attacks on the Fed the administration has thus far attempted. But his argument was in favor of even more stringent monetary policy; if implemented, it would produce an immediate collapse of economic activity. A 12 percent per annum increase in money supply during the first quarter barely managed to finance an economy that in real terms was dead flat (the 8.5 percent rise in GNP reported by the Commerce Department is two-thirds statistical hoax and one-third economic fluff). For Reagan to censure the Treasury's house Friedmanite does not necessarily indicate underlying support for what Volcker is doing.

Volcker and the banks have one ploy, and that is to brainwash the President though the specter of "market instability." Reagan's own adviser Alan Greenspan now calls the 1982 budget deficit $20 billion higher than the OMB's forecast of $37.2 billion, while the Congressional Budget Office predicts twice the increment. These warnings are unfortunately correct (see Domestic Credit). The President's first response was to take some bad advice from OMB director David Stockman and seek additional budget cuts in the Social Security field. The 96-0 repudiation of this first effort by the Senate showed the President, at least, that Stockman's advice should not be trusted in this situation. But the September budget review, where the genie of higher deficits will come out of the bottle, is still a hurdle that Reagan has no means of facing down at the moment.

Meanwhile events on the financial markets will get worse fast. The extraordinary rate movements on the foreign exchange markets (see Foreign Exchange) of the last several days presage a situation in which the dollar could go back into the barrel. A new prime rate increase appears inevitable for the end of this week, and the stock market will probably continue floundering below the 1,000 mark on the Dow-Jones average.

September may be the trigger point for a conjuncture of events that will blow the Reagan economic program to pieces, including 1) a sharp downturn in real economic activity in response to unsupportable interest rates, 2) the congressional budget review, 3) a probable sharp fall of the American dollar (according to a scenario circulated by Bankers Trust vice-president David K. Sandburg), 4) the possible breakup of the European Monetary System through the exit of the French franc, and 5) difficulties in financing the $75 to $100 billion payments deficit of developing countries.

For the past several weeks, the Fed chairman has held President Reagan through a sort of monkey trap, of the type that involves food in a narrow-necked vessel. The tighter President Reagan holds on to the Kemp-Stockman economic program (see Special Report), the more firmly he is held in an economic trap. But he has made a commitment to this program and to advisers who have told him it will work out, and is too stubborn to abandon it "before it has had a chance to work." Volcker and the money-market barons hope to keep him flailing until it is too late to do anything else.

This is what made Schmidt's visit so pivotal. To the extent the West German leader can persuade Mr. Reagan that his complaint against high interest rates is neither a political ploy to satisfy internal West German complaints, nor a matter of narrow West German self-interest, but a question involving the survival of the Reagan administration itself, Schmidt might just do the trick.

Despite dug-in opposition from his own central bank, Schmidt has taken the first steps toward putting on line a form of two-tier credit system in West Germany, involving the proceeds of a DM 6 billion loan from Saudi Arabia, to be lent out through the West German economic development bank at low interest rates to West German industry. With Schmidt's close ally Giscard out of the picture, and consequent smaller leverage against his own domestic opponents, Schmidt's own program is in doubt at home. But he can, at least, point a way out of the crisis facing the U.S. President—something that Mr. Reagan is seeking urgently at this time.