Who prearranged the U.S. budget-deficit blowout?

by Kathy Burdman and David Goldman

A full-scale crisis of confidence in Ronald Reagan's economic program hit the U.S. credit markets Aug. 24, when the Dow Jones industrial average began what became a 22-point slide to 900, and the bond markets "ceased to exist," as Luis Mendez, chief trader at Dillon, Read, put it.

"Investors have simply decided that Reagan's budget deficit is out of control, that the Reagan program is a total failure," Mendez told *EIR*. "This is a political crisis of confidence of first magnitude in the competence of this administration." The Wall Street investment banks voiced their no-confidence vote openly, demanding two-year Treasury bill yields of a historic 17 percent.

What caused the sudden crisis? William Griggs, the much-quoted economist at Schroder Bank in New York, referred to a front page Aug. 16 *New York Times* leak titled, "Budget Gap to Top $60 Billion," which reported a study by the Congressional Budget Office that the 1982 deficit would be 50 percent higher than the Office of Management and Budget's $42.5 billion estimate. "A shift in market psychology took place over the weekend," Griggs concluded.

In fact, Reagan adviser Alan Greenspan had surfaced the $60 billion figure through Leonard Silk of the *New York Times* in early June, and Wall Street economists have been working with a budget-deficit range between $60 and $80 billion for fiscal 1982 for at least the last three months. Morgan Guaranty's current estimate is $68 billion, although Morgan economists expect the figure to go higher. A "Black Monday" of some sort, as *EIR* has emphasized since May, was inevitable at some point. The bond houses merely chose to spring it after Reagan had stepped out on a political limb, mortgaging his political capital to force his economic package through. "We've got the Reagan administration where we want them," Griggs concluded. "The Treasury will have to pay the piper."

In fact, the Federal Reserve is now expecting an $80 billion deficit for the next fiscal year, which means the other shoe will drop on the bond markets within the next several weeks—judging from past performance, in the midst of the International Monetary Fund's annual conclave in Washington, D.C. at the end of September.

According to Ernesto Fernandez-Cata, deputy director for North America at the Fund's Washington headquarters, the Reagan administration will now have to take dictation from the IMF and its central banking sister institution, the Basel-based Bank for International Settlements. The extent of IMF dictates to the White House includes insistence that the Defense Department drop the costly MX missile program in favor of the cheaper cruise missile approach. Working with the BIS and IMF from the beginning, he said, have been Bechtel Corporation Chairman George Shultz, chairman of the President's private Economic Advisory Board, former Fed Chairman Arthur Burns, now ambassador to Bonn, and former Council of Economic Advisers chief Alan Greenspan, the Wall Street economist. These "cooler heads" have "warned the administration" since the inauguration that Reagan's policies would lead to a budget blowout and crisis, Fernandez said.

The script for the late August developments was released on June 15 in the Bank for International Settlements' annual report, which warned that excessive budget deficits in the United States and other industrial nations made necessary an impossible credit market regime, raising the possibility of a depression "comparable to the economic decline during the interwar years."

Arthur Burns, the Fed chairman during the August 1971 debacle, and George Shultz, then in the administration, are in effect celebrating the 10th anniversary of the worst mistake in postwar economic policy by dragging President Reagan into the same trap they prepared for Richard Nixon. As economic advisers to the White House, they urged the President to tolerate the Federal Reserve's monetary policy, which had the entirely predictable result of increasing the Treasury's debt-service bill by about $20 billion per annum.

A Young Plan for America?

Judging from recent private pronouncements at the IMF and Federal Reserve, these institutions have in mind a sort of "Young Plan" for the United States, comparable to the Bank for International Settlements' receivership role in the German banking system after 1931. The BIS, founded to administer Young Plan payments, stepped in to reorganize German finances after the 1931 banking crisis, imposing their representative Hjalmar Schacht—later the "economic wizard" of the Nazi war economy—as head of the Reichsbank.

A senior Federal Reserve official said, "Reagan's stuck his neck out, and now he's got a market crisis on his hands. This is hardball. We're not kidding around. Paul Volcker wants a recession and, by God he's going to get it. A social price has to be paid—I mean putting a lot of people out of work."

Following the recommendations of the BIS June report, Volcker has already told the White House that an additional $40 billion in budget cuts (or tax increases) are the minimum required to stabilize the financial markets—a demand for social and political chaos in the United States.

The BIS program extends even to the point of gutting of any competent U.S. military budget. The BIS June annual report specifically demands a cut in the U.S. defense expenditures, and according to our IMF source, the debate in the press over whether the United States can "afford" to rebuild its defense is coming straight from the BIS, the Fed, and the Shultz/Greenspan crowd.

Shultz, Burns, and Greenspan, in particular, have been recently advising the President that "pragmatism" dictates the United States shave between $10 and $20 billion from its defense budget as part of Volcker's budget-cut demands, IMF sources say. Defense Secretary Weinberger, who is supposed to be running the big buildup, is, however, the appointee of Shultz, his former boss at Bechtel. In fact, Weinberger was Shultz's deputy director of the budget during the 1970-1972 period when Shultz and Weinberger gutted the NASA program in the name of austerity. "Weinberger was put in there to cut the fat in the defense program,' " said our IMF source.

Controls in the works?

What is not made public in this financial crisis, however, is perhaps the feature most resembling the 1930s situation in Germany: the U.S. economy has already been put under limited credit controls, and more may be in the works.

According to high-level Fed sources in Washington, the Fed has established a secret "bank credit target" on credit to nonbank corporations which is being inexorably lowered to deliberately cut industry off from credit. This is modeled on Arthur Burns's 1974 letter to the commercial banks, "asking" them not to extend industrial loans, the official said. The United States has been under such "creeping" controls since the March 1980 Volcker credit control measures, he added. Volcker does not believe in the free market.

James J. O'Leary, chief economist of U.S. Trust in New York, told *EIR* in August that if the Reagan budget continues out of control, which he believes will occur, there will be "no alternative" to Volcker's moving a step further and enacting actual credit controls. Volcker himself in an Aug. 20 broadcast of the "McNeil-Lehrer Report" hinted that to control unwanted loans for large corporate takeovers he seeks "additional mechanisms" to those currently in use.

More is afoot. Studies are being done for Defense Secretary Weinberger's proposed Emergency Mobilization Board (see National) for a top-down militarization of the economy, which could lead to direct controls and even a return to the gold standard. "U.S. instigation of a major military action" could lead to the proposed board's imposition of foreign-exchange controls, and the limitation of the use of the U.S. dollar as "military scrip," pegged to gold at "$1,000 per ounce," sources close to the Defense Department told *EIR*.

A source close to the National Security Council (interviewed below) denied that militarization is on the immediate agenda, but confirmed that the NSC is in fact conducting a study of the need to move to the gold standard should the Reagan budget continue to collapse. The NSC study is being conducted by allies of Budget Director David Stockman, notably NSC Director of Research Norman Bailey, who would like to use the "discipline" of gold to force a severe deflation.

We have told them, however, since last spring that we would like the deficit to be cut.

Q: David Stockman and the National Security Council are talking about a different plan, about continuing to finance a big military spending deficit by a return to gold, or by exchange or capital controls.
A: Gold standard, that's ridiculous. The Stockman boy is profoundly insane. The NSC knows nothing about economics; they don't have one economist there. Cooler heads will prevail.

Q: Who do you mean?
A: George Shultz, Alan Greenspan, Arthur Burns.

Q: Who is their spokseman in the administration?
A: Donald Regan.

Q: I noticed the CBO's projections were based on Greenspan's econometric model. What are they telling Reagan?
A: They're telling him to cut the deficit, and to cut the military budget to do so if necessary. They've been warning of this trouble on the credit markets for many months.

Q: Are you sure they don't want credit or exchange controls?
A: No, I met with Volcker this week, he's dead set against it. Credit controls in any case won't help them finance the deficit, because if they put controlled rates on Treasury bills, people would refuse to buy them, and just go out into the Eurodollar market instead.

Q: Are you sure they don't need emergency measures to get the military budget program through?
A: No. All they have to do is what [Deputy Defense Secretary] Frank Carlucci said: cut back wasteful expenditures.

Q: The CBO says about $10 billion in defense cuts is needed for 1982 out of the $20 billion budget deficit rise.
A: That's about right. There are a lot of military bases you can close. I'm sure there is a lot of waste there. There is also a wide range of programs to choose from which are less expensive than others.. Did you know that a cruise missile only costs $1 million? Build a thousand of them and that's only a billion dollars. They should go with the cruise missile and dump the MX program.

Q: But Weinberger favors the MX land-based. . . .
A: No he doesn't, I'm sure Weinberger is thinking in my terms; that's why he was put in there, to cut the fat in the defense program. He's with us. They haven't decided to build the MX, and they won't, believe me.

IMF: 'We made the leak'

Ernesto Fernandez-Cata, deputy director of the International Monetary Fund North American Division, told one of EIR*'s banking sources Aug. 26 how the Reagan administration's budget was set up for a "crisis of confidence."*

Q: The Congressional Budget Office reported this week that the U.S. deficit for 1982 will be $60 billion, not $42.5 billion as the President projects.
A: Naturally; we've been telling the Reagan administration since May that we don't agree with their economic projections, and that their deficit would be too big.

Q: Do you mean you forecast the debacle for the administration this week on the credit markets?
A: Certainly. We have our own internal econometric forecast of the U.S. budget, and we came up with the same deficit projections months ago—we always told them the 1982 deficit would be more like $50 or $60 billion. But we didn't want to publish it because we're a supranational institution. We are reluctant to risk a confrontation with the U.S. government.

Q: Does the Federal Reserve have similar projections?
A: Certainly, the Fed has a confidential model of the U.S. budget too, but they're very concerned that their forecasts not be leaked. They also project a much higher deficit, on the order of $60 billion. But they can't afford to battle the administration on this right now.

Q: It's generally believed the leak of the CBO deficit forecast caused the market crisis this week. Are you saying that the CBO published your results for you?
A: Well, we couldn't publish them. I have many personal friends at the CBO, and they're not afraid of confrontation with the administration; a lot of them are Democrats.

Q: What policy do you want Reagan to implement?
A: We want them to cut the deficit, period. Now the Reagan administration has been telling us, as they are telling Wall Street, that they will be able to finance the deficit by raising interest rates high enough to attract capital, which means that neither industry nor anyone else gets capital. If they want to do this, it can be done, and that is fine with us, as long as the Fed doesn't print money to monetize the deficit. But it means that they will have to maintain high interest rates indefinitely. Doing this is very uncomfortable—it could mean a dangerous bankruptcy among savings and loans, say.

Fed: 'No more fat to cut'

Federal Reserve Chairman Paul Volcker is demanding that President Reagan make an additional $40 billion budget cut during fiscal 1982 to "squeeze the fat from the economy," a Fed source close to Volcker told EIR.

EIR: What does Volcker think of Reagan's budget crisis?
A: Reagan's certainly stuck his neck out, and now he's got a market crisis on his hands. But Volcker won't change direction. We warned the administration six months ago that if they balloon the deficit they'll get higher rates, and that's just what we're going to give them. The Treasury will have to pay a lot more for financing, and crowding out has only started to raise its ugly head. There won't be any credit for industry, S&Ls will go bankrupt, airlines will start to go under.

The Reagan program is only starting to come unraveled. It's going to snowball. The 1982 budget deficit won't be $42 billion or $60 billion, but $80 billion, because the economy will weaken rapidly as interest rates rise more sharply and bankruptcies start. That will really cut into budget revenues, especially corporate revenues. . . .

There's only one possible resolution: much more substantial cuts in government expenditures, I mean $30 or $40 billion more new cuts in fiscal 82—or a major new tax increase. This is hardball, we're not kidding around. A social price has to be paid to fight inflation, I mean putting a hell of a lot of people out of work for a long time. It means hard times and a long recession. Volcker wants the Congress and the people to decide to pay the price. He's telling the President, "You guys have to cut the budget now, and raise taxes."

And poor old Caspar can squeak and squawk but the defense budget will have to be trimmed, too.

EIR: What if President Reagan and Congress refuse?
A: Volcker is going to take this as far as it can possibly go. He's calling the question. If they don't cut, we just keep raising interest rates until there is real pain out there. And it's going to get a lot rougher from here on in, because we've got the fat squeezed out now. Every uptick in interest rates at this point really hurts, the corporations are screaming out there. We're no longer cutting fat.

EIR: Do you think you can get away with this?
A: We'll try, but at some point, push comes to shove. Congress either agrees to cuts in the fall, or it goes the other way. If the administration doesn't listen to us, and switches over to side with Congress against us, then there is nothing the Fed can do about it. Congress can threaten to change the Federal Reserve Act, and the administration would support them. We're a creature of the political structure, and if the people of this country will not pay the price of sacrifice to kill inflation, then there's that risk.
tightening the belt and cutting deep. But Americans aren't the Swiss. If Congress and the administration get together, we'll have to print money.

NSC: 'Gold or controls'

The National Security Council is studying the possibliity that a crisis of confidence in the Reagan budget may necessitate a return to the gold standard. This interview with an NSC source was obtained from banking sources.

Q: Can you confirm Washington reports that the NSC is studying a possible return to the gold standard?
A: Yes. There is a great deal of soul-searching going on here with reference to the monetarist assumption that exchange rates must float free and gold has no role, as well as respecting the Keynesian assumption that we can run huge budget deficits. If things continue to look strange, if the budget deficit stays high, if interest rates continue to rise, foreign-exchange rates continue to fluctuate wildly, and the decaptialization of the economy continues—in short, if things don't go as we've expected—then a return to the gold standard might become necessary. We're doing the necessary studies to determine what conditions might be to trigger it.

Q: NSC studies? Or with the Reagan gold commission?
A: NSC internal studies, because such a deterioration of the U.S. economy would be a national security risk. It would jeopardize other things we might want to do at home and abroad, like our defense program.

Q: What likelihood do you estimate this gold scenario has?
A: Well, we're not happy with the current situation. Things aren't going as the administration had planned. We're questioning a lot of the assumptions, now, that had been made earlier by the budget projections.

Q: What about if a military emergency triggered a mobilization?
A: We of course have other studies of this going on, not related to gold necessarily. First, we would put the entire economy under controls, foreign-exchange controls. We would put controls on the dollar, in which case we might not need gold, because the dollar would be very strong since there would be very tight credit demand here.