

A new battle over the Federal Reserve's policy

by David Goldman, Economics Editor

Federal Reserve Chairman Paul Volcker is under full-dress siege, to the point that his best defenders in the financial press have acknowledged the danger of his position, as in Lindley Clarke's warning in the Jan. 11 *Wall Street Journal* that the Fed Chairman has been told by the White House that he is dispensable. Yet the motives of Volcker's antagonists are so disparate and contradictory that the fallings-out among the besiegers are as important as the assault against the Federal Reserve itself, and the likely direction of policy evolution in Washington is far from clear.

Rep. Jack Kemp told a nationwide television audience the morning of Sunday, Jan. 10, that at very least the Federal Reserve should return to its pre-October 1979 policy profile, before Volcker—who returned by special plane from the International Monetary Fund meeting in Zagreb in the midst of one of the worst postwar dollar crises—announced the present regime of tight money. Volcker's formula, per the "Saturday Night Massacre" of Oct. 6, 1979, and the basis for Federal Reserve policy since, was to control the monetary aggregates no matter what the cost for interest rates; Kemp proposed the opposite formula, "targetting interest rates rather than monetary aggregates," or, in the vernacular, printing money to bring interest rates down.

'Something has to give'

From Kemp, the congressional White Knight of the "supply-siders," rhetoric of this sort is predictable. But Kemp's statements over national television coincide with equally vigorous, if private, recommendations to the same effect by a variety of Wall Street economists,

including Volcker's friend and former colleague at the elite Ditchley Foundation, James O'Leary of U.S. Trust, and William Griggs, the money-market economist at Schroeders' Bank. Their reasoning was summed up by the chief of bond operations at Arnhold S. Bleichroeder in New York, Erwin Shubert: "The administration is in a box. They have a \$150 billion borrowing requirement, they can't cut spending, and they can't raise taxes. The numbers don't add up. So something has to give—and that thing will be monetary policy."

U.S. Trust's O'Leary, the Wall Street economist closest to the current Fed chairman, as well as Chase Manhattan Bank economist Philip Braverman and others, argue that the Federal Reserve has ruined its own effort by creating "such fear and uncertainty," in Braverman's words, "that it's realistic for markets to run for cover once they see the opportunity for the Fed to ease is over." O'Leary and Braverman believe—with the staff of the Swiss-based Bank for International Settlements—that some form of direct controls on credit issuance, rather than interest rates as such, will ultimately replace Volcker's form of monetary management.

However, the critique of Volcker opened by Bank for International Settlements President Jelle Zijlstra at the October meeting of the International Monetary Fund, and conceded in large measure by New York Fed President Anthony Solomon during the Christmas meeting of the American Economics Association, only promised an even tighter monetary regime. Zijlstra et al. pointed out, correctly, that Volcker's use of the interest rate bludgeon had produced *uncontrolled* expansion of credit, principally to finance debt service costs



Stuart Lewis/NSIPS

Paul Volcker

driven up by higher interest rates, in a self-feeding spiral. The most recent banking numbers show that the spiral is, indeed, still rising (see article page 6). This is the reason that interest rates continue to rise despite the still-worsening collapse of economic activity. The BIS approach was to use administrative fiat to stop credit expansion, which meant, as BIS chief economist Alexandre de Lamfalussy said point-blank in a variety of speeches in the last two months, getting the messy job of bankruptcies over with quickly.

Now, no one is so sure that this was a good idea.

The bond market's whip-like reaction to any White House resistance against Volcker's demand that the country pay the additional interest costs on the federal debt by cutting necessary federal spending has so far kept the President in growling submission. But each austerity measure, taken against the President's own best instincts, has only led the Federal budget further into the morass, to the point that a Federal budget deficit now estimated at \$150 to \$200 billion for each of the next three fiscal years leaves the President no way out. The reward-punishment game that Volcker and the bond market have played with the President has run to the point that there are no more rewards.

Regrettably, the White House has shown little initiative, or even understanding, of its own position as of yet. A measure of this is the White House announcement Jan. 12 of the appointment of Sears, Roebuck executive Preston Martin as the new Vice-Chairman of the Federal Reserve (see Banking). Contrary to press reports portraying Martin as a "California savings banker" with ties to Reagan's California apparatus,

Martin spent his career as a monetarist agent in the ranks of the savings industry, and was hand-picked by the Fed to join its ranks.

Printing money won't work

No matter how disastrous, the monetary policy of a ruling financial elite has never been overthrown except when a crisis has emerged within the ranks of the financial elite itself. On its own terms the present debate is almost silly. As a senior Federal Reserve official argued to *EIR* (see below), merely printing money represents no guarantee that a crisis will not emerge, and to suggest it is only to display panic.

There are nonetheless two overriding features of the debate which have little to do with the terms in which it has been presented. Both stem from the strategic consequences of the Polish events. The financial leadership centered at the Bank for International Settlements and the Bank of England, as well as the Federal Reserve Board of Governors, is perfectly willing to steer directly into a major financial catastrophe if it feels secure in its ability to manage the political consequences. A financial crash only means, after all, managing society's affairs through the intervention of the courts and the powers that stand behind them, rather than through the insistent tug of "market forces." But a financial crisis also creates the risk of losing political control. Doubtless there are individuals in the Bank of England who have not forgotten that the great crisis of 1773—which the Bank manipulated in order to cement the East India Company's hold on the Hanoverian monarchy—opened the political space in which the American Revolution could succeed.

When it became clear, over the past two weeks, that the British Foreign Office mishandling of the Polish events had put NATO at its worst potential disadvantage since its founding, a sudden feeling gripped London and New York that the present was a very bad time for a financial crisis. Only more slowly has it begun to dawn on a few British policy-makers that the Western nations may have to abandon monetarism in favor of a dirigistic policy aimed toward rebuilding the in-depth capabilities of the West to match Soviet arms.

Fed: 'The past two years have been wonderful'

A senior staff official, who asked not to be identified by name, had the following discussion with EIR on Jan. 11.

Q: Not just Jack Kemp, but a number of Wall Street economists are saying that the Fed will have to go back

to the pre-October 1979 policy of keeping down interest rates. There are even some people on the bond market predicting a rally on this basis. Will you do this?

A: The whole scenario is completely overblown. I haven't heard a single thing said to that effect in this institution. Absolutely no one is on that track. And, as you may have noticed, we have not done anything to prevent a rise in interest rates.

Q: Are you concerned about political pressure from the White House?

A: If interest rates go up, political pressures will become serious. That is what we expect. But no one is going to turn around and walk away from something that has worked so well for the last two years.

Q: Isn't that like the guy who jumped off the Empire State Building and said when he passed the 23rd floor, "So far, so good?"

A: If you mean the risk of disaster in this approach, yes indeed, there is a risk of disaster. But monetary policy has been better in the past two years than in any previous period, in the sense that we've hit our basic objectives, by the skin of our bleeding teeth, but we've done it, and that's more that we've been able to do before. It means that the Federal Reserve is committed to some definable, understandable objective, and you don't just give this up. Paul Volcker didn't invent this policy on the plane back from the [October 1979 IMF meeting at] Zagreb. I was writing studies on it for this institution in 1971. We've spent more money running computer regression analyses on the monetary aggregates than Poland spends for national defense!

Q: In Western Europe, most people agree with Helmut Schmidt that interest rates have been the problem, and that the NATO alliance will collapse if the economic situation continues into depression.

A: That whole scenario rests on the proposition that to loosen up on monetary policy will help. What makes these people think that printing money will *avoid* a crisis? We hear this from the U.S. administration all the time.

Q: From whom exactly?

A: From the supply-siders, from the people who are running the place. But among the cognoscenti, among the elite, whatever you want to call them in this country, we have gotten unanimity on the proposition that you can't print money.

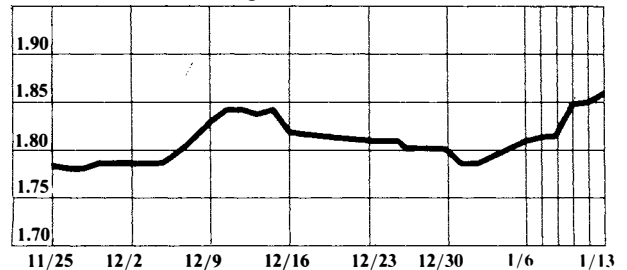
Q: But the Poland situation may change all this. In a strategic crisis, the old rules may have to go.

A: The strategic pressures are more real than they were, say, two months ago. Whether they're determinant or not, I don't know.

Currency Rates

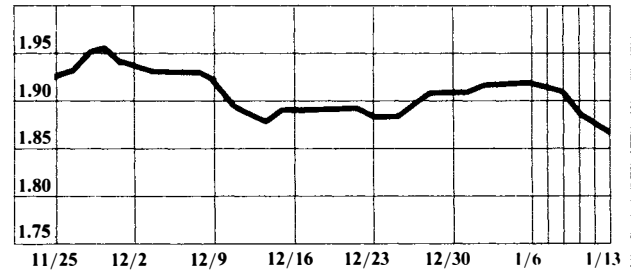
The dollar in Swiss francs

New York late afternoon fixing



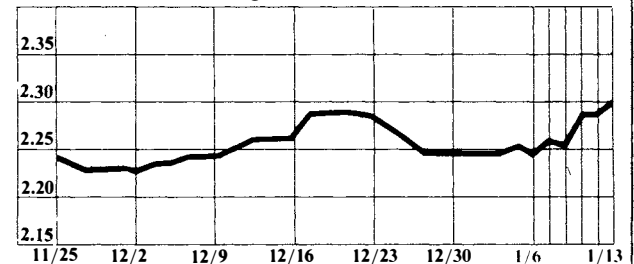
The British pound in dollars

New York late afternoon fixing



The dollar in deutschemarks

New York late afternoon fixing



The dollar in yen

New York late afternoon fixing

