Why the Federal Reserve cannot print its way to a recovery

by David Goldman

To our knowledge, the following is the only published forecast which predicts a continued downturn during 1983, of between 3 and 10 percent, depending on monetary factors which may not be pre-specified. In November 1979, *EIR*'s LaRouche-Riemann economic analysis was the only published warning of a major downturn during the first half of 1980; in late 1980 and early 1981, *EIR* published the only computer-assisted forecast of a major new downturn beginning in the second half of 1981.

Not so much *EIR*'s past record, however, as the extraordinary nature of the present situation should persuade government officials and businessmen to look askance at the standard "mild recovery" forecast. Fundamental shifts in the American labor force and capital stock have occurred during the past three years of Federal Reserve-dictated austerity which have impeded the economy's capacity to recover.

In financial terms, it seems that a recovery is more expensive than previously; the cost of rebuilding inventories and rehiring labor alone suggest demands for private bank credit well in excess of those during the fourth quarter, even to maintain the fourth quarter's rate of decline! These cannot be met at the same time the federal government must finance over a quarter trillion dollars in new debt (budget deficit, off-budget financing, and "guaranteed" and "sponsored" items). On the strength of this alone, the International Monetary Fund's North America division has unofficially abandoned its prediction of recovery for 1983.

But these financial considerations reflect two basic paths of deterioration of the underlying real economic structure. First, *the proportion of economic output devoted to production of wealth* is shrinking in a self-aggravated spiral, as larger sections of the goods-producing workforce are eliminated; in real terms, the overhead burden per employed worker has risen. At the same time, the disastrous *decline of capital spending in new technologies* during the past 10 years, exacerbated by the past three years' depression, has reduced the economy's productivity. These two conditions lock the economy into a spiral of negative growth, and are mirrored in the financial impasse represented by the Treasury deficit.

Here, we present two scenarios for the U.S. economy during 1983 and 1984. As in the past, we caution that all such forecasts are based upon the predictable impact of economic policies which have been pre-specified and analyzed with the aid of the LaRouche-Riemann model. No attempt is made to predict the future, but to accurately analyze the results of identified policy decisions. The present forecast is, therefore, doubly complicated.

First, the Federal Reserve has currently abandoned the monetary policy which dominated the American economy since October 1979, but cannot maintain its present monetary largesse indefinitely. Secondly, the relationship between the intentions of policy makers and the outcome of specific decisions has been severed by the immediacy of world financial crisis.

At present, the short-term actions of the U.S. Federal Reserve and other central banks are admittedly dictated by the contingencies of the world banking crisis, although not in such a way as to eliminate the danger of crisis. As stated in the Introduction to this report, we do not expect that the central banks will postpone such a crisis much longer than the first quarter of 1983. Perhaps the last opportunity to avoid such a crisis is the conjuncture of events around the early March 1983 meeting of the Non-Aligned developing nations;

The complete LaRouche-Riemann forecast for 1983-84 from which this article was adapted is available from EIR. Call or write to Special Services Director Peter Ennis. Subscriptions to EIR's quarterly econometrics services, one of whose available components is a $15,000 global survey, may also be discussed with the Special Services department at (212) 247-8820.

© 1983 EIR News Service Inc. All Rights Reserved. Reproduction in whole or in part without permission strictly prohibited.

should the developing countries or any sub-group thereof make a unified demand to the industrial countries for long-term debt rescheduling on such terms that world trade might be revived, prospects for avoiding a crash would be improved. Short of such international agreement, we do not expect the present banking system to endure through 1983 in its present form.

The Federal Reserve strategy

The Federal Reserve has been pumping money into the economy at a rapid rate for the entirety of the fourth quarter of 1982: bank reserves have grown at an almost 18 percent rate since October and money supply at a 20 percent rate. The Fed's basic policy-making body, the Federal Open Market Committee (FOMC) decided, at its November meeting, that in the near future it will abandon the regulation of money supply.

This strategy cannot work. The U.S. economy's basic productive infrastructure has been so ravaged by 20 years of technological obsolesence and the last three years of the Volcker depression, and the U.S. skilled labor force has been so destroyed by real unemployment in excess of 23 percent, that the U.S. economy, in its given technological mode, could not recover, short of a comprehensive financial reorganization aimed specifically at restoring American technological strength. That fundamental problem is reflected in the financial system in a special, but parallel fashion: the tremendous weight of the debt overhang of the productive sector, government sector, and total economy. This debt burden, already massive, will explode further in 1983, as we will show below.

This defines a fairly clear situation: the only means by which the White House-Federal Reserve collaborative team could finance the huge federal budget deficit and financing needs projected for fiscal year 1983, in addition to the huge debt service refinancings of the corporate and agricultural sectors, plus provide a margin of funds for the prospective recovery, is for the Federal Reserve to *monetize $50 to $80 billion of Treasury debt*. If the Fed implements such a policy course, and it appears that it will, the dollar will collapse on foreign exchange markets, and interest rates will rise. A further rise in interest rates would, of course, frustrate the effort to reflate the economy; debt-service costs on existing debts will rise faster than the banking system could successively compensate through the issuance of new credits.

The two scenarios we present have the following conclusions and assumptions:

1) Continued decline of the U.S. economy at a 10 percent annual rate in terms of output of tangible goods, assuming continued lack of credit availability to the productive sector, and inability and unwillingness on the part of goods-producing corporations to rebuild inventories, re-hire employees, skilled workers, and production line workers, and replace plant and equipment. This projection is considered "most likely," with the obvious provision that it may be complicated by a sharp deterioration of the world monetary situation.

2) Continued decline of the U.S. economy at a 3 to 4 percent annual rate in terms of output of tangible goods, under conditions of a general reflation which would revive auto and housing, but leave basic industry and capital-goods industries unaffected. This scenario is not considered probable, and is included less as a forecast than as a demonstration that conventional reflation mechanisms will not work under prevailing circumstances.

The user of these forecasts is advised to consider them as points of orientation in a rapidly shifting political and economic climate. Depending on the unpredictable course of political events, actual economic trends will show elements of more than one projection. For example, the small upturn of the auto and housing sectors during the last quarter of 1982 belongs to the geometry of the "reflation" forecast, although the impulse of the economy remains in the realm described by the basic forecast of continued rapid economic deterioration.

Scenario one: continued credit attrition

The first scenario is substantially unchanged from the forecast presented in our last published report, which was summarized in *EIR* Nov. 2, 1982. It assumes:

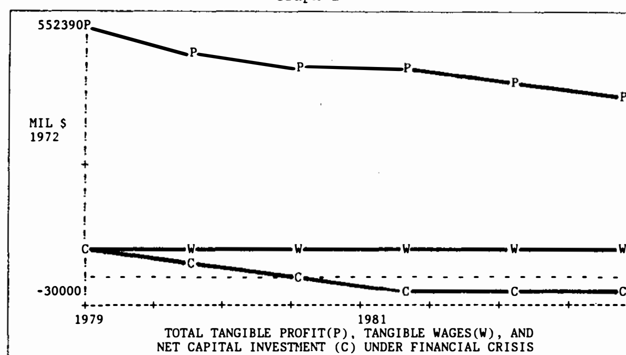
1) That the availability of credit to the goods-producing sector will remain at the levels registered during the third quarter of 1982 and, judging from preliminary data available, during the fourth quarter of 1982, rather than the relatively higher levels of availability of credit during the first and second quarters of 1982. This worsening of credit usage by the productive sector indicates a deterioration in the economy such that the rate of decline of tangible-goods output would fall from the 7 percent per annum average registered during the first three quarters of 1982 to the 10 percent per annum rate of decline shown in October 1982.

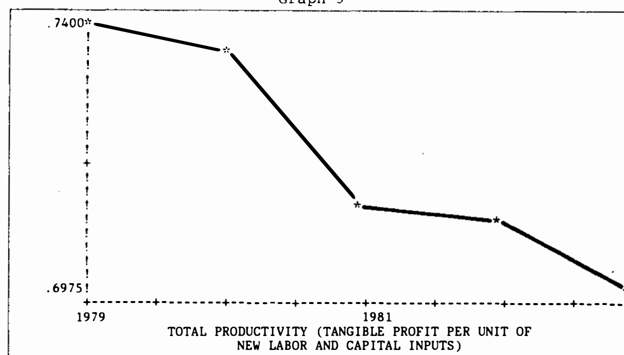
2) That real interest rates (the effective prime lending rate minus the Gross National Product deflator) will remain in the range of 6 percent, against a 1970s average real interest rate of about 2 percent, continuing the pressure against corporate balance sheets, and forcing further diversion of corporate deployment of revenues towards debt service, at the expense of purchase of inventories and hiring of labor.

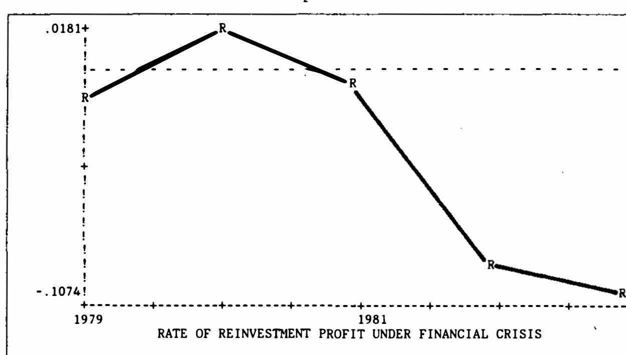
3) That changes in tax policy during 1983 will not affect the flow of funds into productive or non-productive categories. According to our analysis of the flow of funds, an attempt to reduce the budget deficit through increased taxation will merely substitute a taxation pressure upon corporate and household incomes for a credit pressure arising from the extraordinary nature of the federal budget deficit.

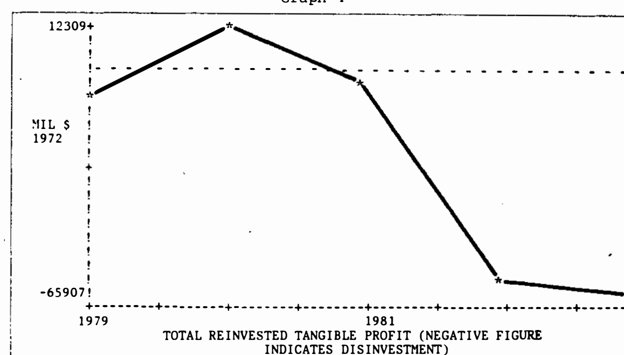
4) That the President's military spending plans such as adopted by Congress during 1982 will remain in place; the impact of the military spending plans have been programmed into the 30-sector model, using Defense Department esti-

The quarterly forecast results









mates of sectoral impact of defense procurement of tangible goods.

Graphic analysis

The consequences of these assumptions, as generated by the LaRouche-Riemann model, are summarized in the following excerpts from the computer-generated analysis.

Graph 1 shows, on the same scale, the Total Tangible Profit, Tangible Wages, and Net Capital Investment. Capital investment will be negative, at -27 billion 1972 dollars in 1983, and -15 billion 1982 dollars in 1984. Surplus falls by 28 billion 1972 dollars during 1983, at a 7 percent annual rate; tangible wages fall at the same rate.

Graph 2 shows the rate of reinvested profit ($S'/C1 + C2 + V$), also the potential growth rate of the economy. At -10.7 percent during 1983, this measures the rate of economic decline.

Graph 3 shows the gradual decline of the economy's total productivity, as measured by amount of surplus per unit of capital input. In terms of economic potential, the economy undergoes a 6 percent productivity decline by this measure over the 1979-84 period.

Graph 4 shows the total reinvested tangible profit (S'), falling from a barely positive figure during 1980 to net disinvestment during 1981, and a $66 billion 1972 dollar rate of disinvestment during 1982 and 1983.

The 'attempted reflation' scenario

The second scenario is prompted by the change in Federal Reserve policy since last October, when the Federal Reserve noted the likelihood of economic and monetary breakdown and shifted towards what is widely advertised as an attempt to bring about an economic recovery at all costs. It assumes:

1) That the Federal Reserve will succeed in reducing real interest rates to the 2 to 3 percent level, an assumption which, as noted, we do not consider realistic, but have included in order to give the monetary authorities the "benefit of the doubt" in the matter of whether "demand-management" economics may bring about even a short-term secular recovery.

2) That credit is widely available for users of short-term credit, but that long-term credit either for capital investment or for consolidation of debt remains in short supply due to the extraordinary demands of Treasury financing during the next two fiscal years.

3) That the result of this unusual mix of available short-term credit and unavailable long-term credit will follow a pattern already discernable during the fourth quarter of 1982: while certain sections of consumer credit, e.g. auto loans and mortgages for single-family homes, will be encouraged, capital investment will continue to decline, and goods-producing corporations will be unable or unwilling to amass large amounts of short-term credits in order to rebuild depleted inventories.

4) That the overhead costs of the economy, defined by both the military budget and the additional cost of unemployment compensation and other social welfare programs, will remain high as a result of depression. This is a critical, but highly justifiable assumption.

In real terms, this implies continued diversion of tangible output away from re-employment of labor, in favor of maintenance of a population made unproductive by the depression. In financial terms, it takes the form of a federal deficit borrowing requirement perhaps 50 percent in excess of total domestic savings, which will absorb that credit fund that might otherwise be available to finance a recovery. The implication of this assumption is that nothing short of a thorough-going reorganization of the financial system would break the vicious cycle, and that such a reorganization would have to be directed towards restoring the depleted productivity of the goods-producing sector of the economy. In terms of the LaRouche-Riemann model, this means that the labor productivity ratio S/V must be higher than the overhead ratio of d (non-productive expenditures) over V; if the latter is larger than the former, economic growth cannot take place.

No demand-management program is capable of restoring the imbalance between the productivity and the overhead ratios. On the contrary, the austerity demand-management program exercised by the Federal Reserve during the past three years merely damaged the productive sector, while permitting non-productive employment to growth (until May 1982, when non-productive employment also began to fall). Under present circumstances neither the Federal Reserve nor the administration has the tools to correct this trend towards self-feeding decline; the economy is now in a mode of structural decline. What the solution to this dilemma might look like is discussed in the following section.

Graphic analysis: the 'reflation' scenario

Graph 5 compares the tangible profit of the total economy under the first scenario, indicated by the numeral 1, and the reflation scenario, denoted by numeral 2. The economy declines in both cases, although the rate of decline is much lower in the second case, at about 3 percent p.a. during 1983 and 4 percent p.a. during 1984.

Graph 6 compares the rate of reinvested profit (S'/C1 + C2 + V) under the two scenarios; both are clearly negative, although the first scenario (as noted above) shows a nearly 11 percent rate of decline during 1983 against a 3 percent rate of decline.

Graph 7 shows the growth rate of tangible profit of the total economy under the two scenarios.

Graph 8 shows the effects of the reflation attempt in the Construction sector, which registers 15 percent growth during 1983, largely due to a calculated rise in the level of housing starts from the present level of about 1.1 million per year to about 1.5 million.

Graph 9 shows the Steel sector under conditions of total reflation, falling gradually rather than catastrophically.

Graph 10 shows a marked recovery of auto output, from the range of less than 5 million units per year to about 7 million units per year (although still well below 1979 levels), assuming widespread availability of low-interest auto loans; scenario 1, shown in the same graph, assumes continued decline.

Graph 11 shows practically no effect in the Nonelectrical Machinery sector, which is predominantly a capital-goods category, as investment continues to decline.

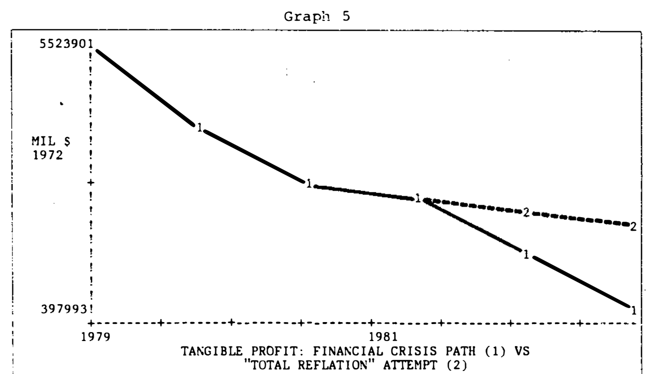
Graph 12, however, shows a small recovery in the Electrical Machinery sector, which, as noted earlier, is otherwise less depressed than the industrial average.

Graph 13 shows a 3 percent decline in the Fabricated Metals sector's tangible profit during 1983, rather than the 14 percent rate of decline anticipated under Scenario 1, shown in the same graph.

It should be emphasized once more that this projection is not a forecast of the impact of a general reflation, which would otherwise encounter "perverse effects," e.g. rising interest rates, destabilizing such an effort. Rather, it is presented as a demonstration that an attempt to revive the old methods of demand-management, which bear so much responsibility for the present crisis, cannot succeed even on its own terms.

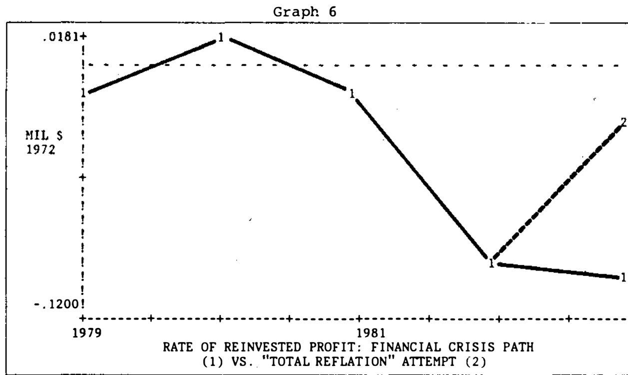
This quarterly forecast was prepared by a team under the direction of David Goldman, including Richard Freeman, Leif Johnson, Peter Rush, and Sylvia Brewda.

Graph 5



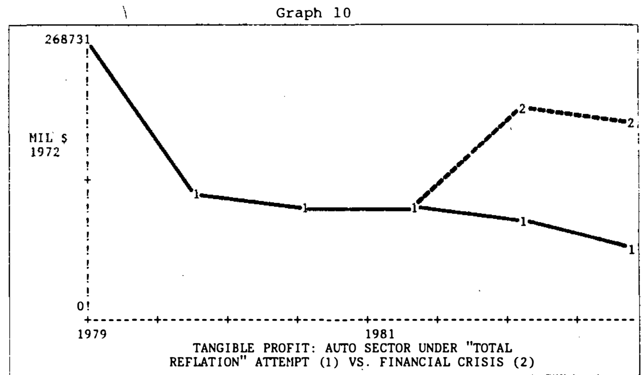
TANGIBLE PROFIT: FINANCIAL CRISIS PATH (1) VS "TOTAL REFLATION" ATTEMPT (2)

Graph 6



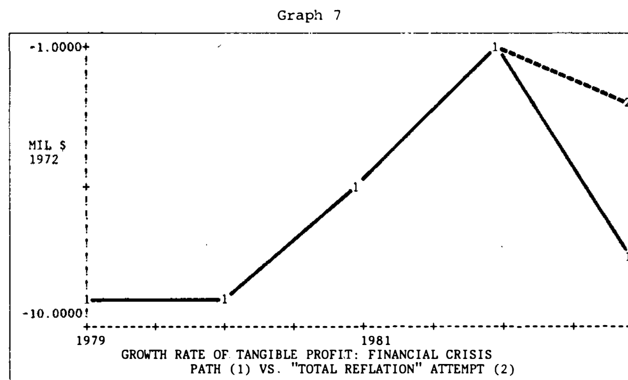
RATE OF REINVESTED PROFIT: FINANCIAL CRISIS PATH (1) VS. "TOTAL REFLATION" ATTEMPT (2)

Graph 10



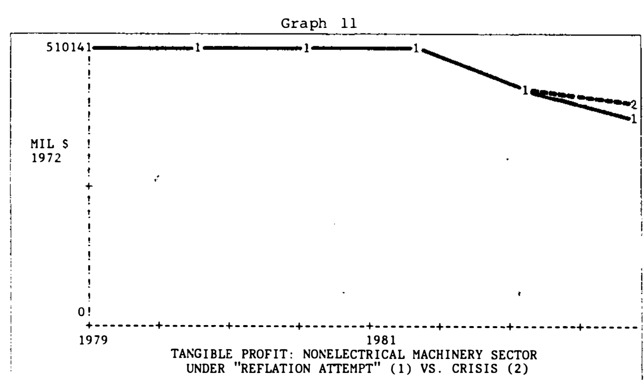
TANGIBLE PROFIT: AUTO SECTOR UNDER "TOTAL REFLATION" ATTEMPT (1) VS. FINANCIAL CRISIS (2)

Graph 7



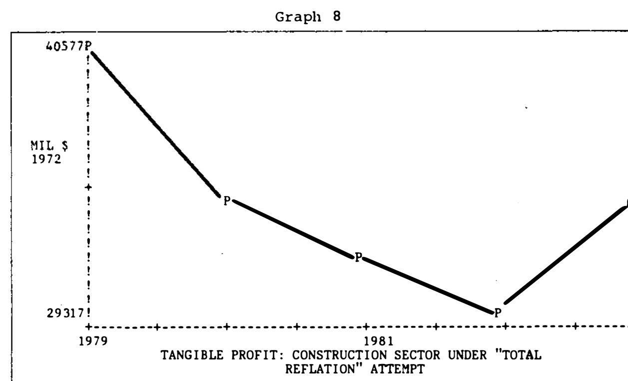
GROWTH RATE OF TANGIBLE PROFIT: FINANCIAL CRISIS PATH (1) VS. "TOTAL REFLATION" ATTEMPT (2)

Graph 11



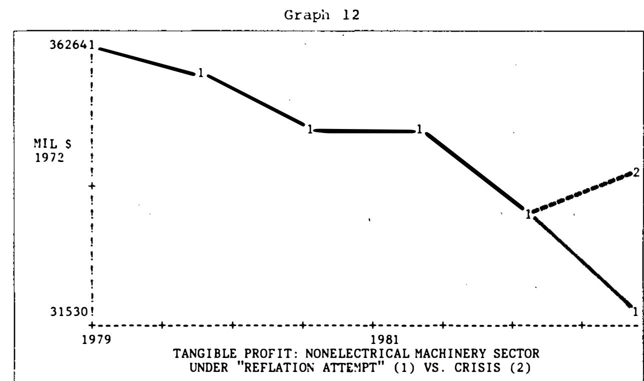
TANGIBLE PROFIT: NONELECTRICAL MACHINERY SECTOR UNDER "REFLATION ATTEMPT" (1) VS. CRISIS (2)

Graph 8



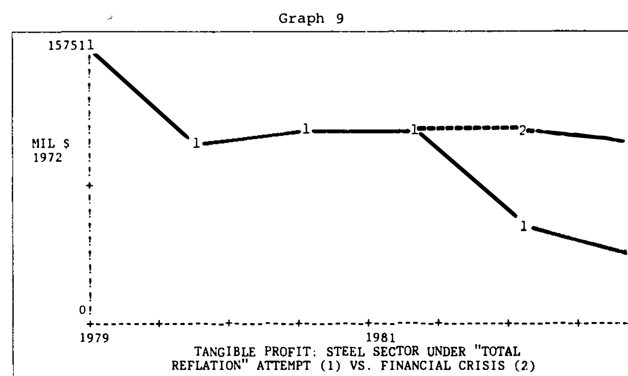
TANGIBLE PROFIT: CONSTRUCTION SECTOR UNDER "TOTAL REFLATION" ATTEMPT

Graph 12



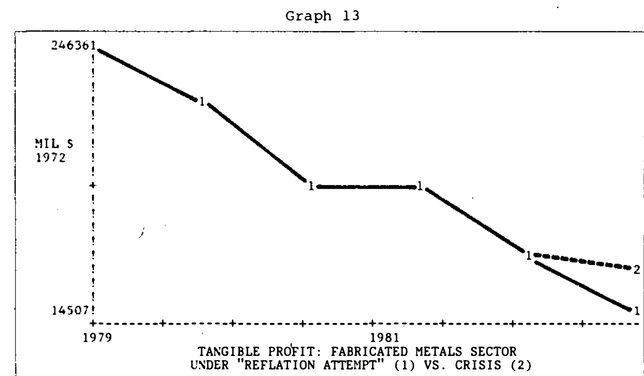
TANGIBLE PROFIT: NONELECTRICAL MACHINERY SECTOR UNDER "REFLATION ATTEMPT" (1) VS. CRISIS (2)

Graph 9



TANGIBLE PROFIT: STEEL SECTOR UNDER "TOTAL REFLATION" ATTEMPT (1) VS. FINANCIAL CRISIS (2)

Graph 13



TANGIBLE PROFIT: FABRICATED METALS SECTOR UNDER "REFLATION ATTEMPT" (1) VS. CRISIS (2)