EIR Economics

Paul Volcker's tantrum and Japan's strategic leverage

by David Goldman

Federal Reserve Chairman Paul Volcker told Congress on July 23: "The substantial depreciation of the dollar has placed our industry in a decidedly better competitive position vis-à-vis other industrial countries . . . [but] history demonstrates all too clearly that a kind of self-reinforcing, cascading depreciation of a nation's currency, undermining confidence and carrying values below equilibrium levels, is not in that nation's interest or that of its trading partners."

The United States is heading toward the position of the Callaghan government in Britain during 1977-78, when Britain was compelled to raise interest rates to the 18% mark in order to persuade foreign depositors to keep funds in sterling. Volcker appended that remark, widely quoted in newspaper and wire-service accounts, to a straightforward announcement that the Federal Reserve would not better its 1/2-point reduction of the discount rate earlier in July. To reduce interest rates further, he warned, would bring on precisely such a "cascading depreciation" of the dollar, with the fatal consequences *EIR* reports elsewhere in this issue, and has elaborated in the past. In any event, Volcker added, it is beyond the Federal Reserve's power to boost economic activity by lowering interest rates, since the collapse of the nation's trade account has undermined the industrial sector.

Volcker demanded that West Germany and Japan reflate instead; the West German Bundesbank issued a curt rebuke on July 25, to the effect that it had no intention whatever of changing its interest-rate policies. Yasuhiro Nakason'e newly-strengthened government in Tokyo, for somewhat different reasons, has no intention of throwing bad money after good, i.e., adding printing-press money to the $60 billion of its trade surplus it lends to the U.S. government each year.

Volcker's demand is, after all, not much better than Adolf Hitler complaining about air pollution from the smokestacks at Buchenwald. From the Columbus Day weekend of October 1979, when Volcker staged a dramatic early return from the International Monetary Fund's annual meeting then in progress in Yugoslavia, to announce a tight-credit program which quickly brought U.S. interest rates up to the 20% range, the destruction of the nation's trade account has been the underlying content of Federal Reserve policy. Volcker engineered a global dollar shortage, at a time when the dollar traded at less than DM 2.00, and threatened to disappear as a world reserve currency. The first fruit of the dollar shortage was the collapse of developing-sector finances in 1981-82.

The 1979-82 events destroyed the industrial sector, with a twofold consequence: First, the Federal government's tax base began to contract (after taking into account inflation; second, the U.S. became dependent on foreign sources for a rising margin of its physical consumption. The U.S. trade deficit of $170 billion per annum represents goods that would cost $300 million to produce at home, once currency differentials (including the enormous undervaluation of Third World currencies) are figured in. On only $1.640 trillion of goods-producing Gross National Product, net imports now constitute about 18% of total physical consumption.

By no other means could the Federal Reserve bring off the perception of "post-industrial recovery," a term that should make the skin of any sane person crawl. The 10-million expansion of service-industry employment rolls since the Reagan administration took office in 1981, depended on the availability of "free goods," paid for by pushing the United States into the world's worst net-indebtedness position.

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Political arrangements

The following political arrangements were required to maintain these arrangements:

1) Financial institutions had to generate hundreds of billions of dollars worth of unsecured paper each year, to generate apparent profits on speculative real estate, securities market,
industry, agriculture, transportation, mining, or other productive activity. To a growing extent, the banks and brokerage houses accomplished this by mediating dubious offshore funds, including flight capital, narcotics revenue, tax evasion, and so forth that had to be available to finance portions of the U.S. deficit;

2) The U.S. government had to underwrite these apparent profits of speculators, by granting substantial tax concessions to real-estate developers, insurance companies, and other financial institutions, as well as emitting over $100 billion of government-sponsored securities annually to support the mortgage markets;

3) Japan and Western Europe had to be willing to absorb an additional margin of U.S. paper in return for their trade surpluses with the United States;

4) Ibero-America in particular, and other developing-sector exporters, had to accept prices for their manufactured goods at 70% below comparable U.S. cost of production, at the expense of 10-20% reductions in living standards each year.

All of these arrangements have since broken down. The financial establishment behind Volcker has panicked, in particular, over West Germany's and Japan's refusal to inflate on behalf of the Fed's efforts to bail out the U.S. banking system. Despite Volcker's encomium to Congress, the Federal Reserve is pumping whatever money into banks that banks require. With 1,200 U.S. banks on the Treasury's warning-list, numerous large banks, particularly
patch, have serious funding troubles. The giveaway is that Wall Street analysts are now looking at discount window borrowings—the Fed's lender-of-last-resort funding of banks—as the principal indicator of Fed money creation.

Although overnight money-market rates are at the lowest level in 11 years, discount loans from the Fed are at an unusually high level of $413 million. Banks are going to the Fed, because they cannot purchase overnight funds on the money market. "The Fed still is following a very accommodative policy," Discount Corp. analyst Edward Sawicz told UPI July 24. "You have to look at discount window borrowings over several weeks to see if a policy change has been made."

The banking crisis, barely out of the cage, has turned into an automatic money-printing mechanism for the Fed. If banks can't get funds from other banks who fear for the safety of their money, they will go to the Fed discount window, and the Fed will create money on the spot. That is why Volcker fears a currency collapse.

West Germany and Japan refuse to play this game in tandem with the Fed. Here is the *Wall Street Journal*'s full-tilt on-the-floor tantrum, in its July 25 editorial:

"Now the Japanese, and especially the Germans, are refusing international coordination in bullheaded pursuit of the narrowest kind of domestic goals. They have slowed their economies in the face of mammoth trade surpluses—if not indeed *in order* to generate mercantilist surpluses at the expense of their own citizens' living standards. The lack of international demand from Germany and Japan is now slowing the U.S. economy; if we slip into an outright recession, it will come labeled Made in Japan and Germany. . . .

"The Great Depression, indeed, arose from a failure of international coordination; in the 1920s the Banque de France played much the same mercantilist role the Bundesbank plays today. To head off that danger in an even more interdependent world, we need to evolve a greater measure of coordination than has been evident since the Plaza meeting [of the Group of 5]."

That is all ridiculous. Japan has subsidized the decimated American physical economy, and accepted $60 billion of our paper in return each year. To ask the Japanese to mortgage their currency to help bail out our bankrupt banks, is an act of tragicomic arrogance. Why should not the Japanese, instead, lend their trade surpluses to the developing sector, and shift their exports toward capital goods for Korean-style development of the Third World? A recent Japanese private-sector study writes:

"The other option open to Japan is to build on the strength of its international position, to take an initiative to coordinate economic policies for the mutual benefit of nations engaged in world trade, which other surplus countries, notably West Germany, could be encouraged to join. The purpose would be to maintain the export growth of the world economy, and adopt measures to allow Japan's current account surplus to finance the deficits of other growing economies. This could be done by evolving mechanisms for the intermediation of the Japanese surplus." (Report by the Study Group of the World Institute for Development Economics Research, quoted in *Far East Economic Review*, July 17, 1986.)

At the risk of oversimplifying, we may identify the two forces in contention for control of the present world financial crisis: the two principal sources of financing for America's $150 billion annual payments deficit, Japan's $60 billion, and the $80 billion from sources unknown, most of which, Fed officials admit privately, derives from narcotics traffic. The Donald Regan-George Shultz faction in the administration (Merrill Lynch and Morgan Guaranty) represents precisely those financial interests which mediate dirty money into U.S. foreign debt. The collapse of these institutions now in progress will fundamentally weaken the latter's power; Japan emerges as the potential leader of world economic affairs. An international monetary reorganization to benefit world trade and development, as Japan has long proposed, represents the West's only hope.