President Reagan dives into the budget trap

by David Goldman

The federal budget trap is yawning wide, and President Reagan has dived into it head-first. Whether the U.S. Treasury will default upon outstanding debt by the time subscribers read this, due to the Senate's reluctance to approve an extension of the federal debt ceiling, or whether the Senate will view the threat as mightier than the execution, and postpone the crisis until July, remains unclear at deadline. Whether the trap springs now or later, i.e., whether the dollar and government bond markets suffer their worst crash to date before or after the June 6 industrial nations' summit in Venice, the outlines of the plan are unmistakable.

"Things have not been so bad in Washington since that clown Bill Miller was Treasury Secretary" in 1978, commented an adviser to the International Monetary Fund, and the remark is not out of place: The financial institutions which first put in place the Carter administration, associated generally with the Trilateral Commission, are steering the Reagan administration into a horrible replay of the 1978-79 events that led to the present world economic catastrophe.

The differences between today and 1979, however, mean that the dollar and bond-market crash now in preparation, which is supposed to compel the United States to adopt Third-World-style budgetary austerity, will destroy America's strategic position for all time.

The pre-programmed failure of the Venice economic summit will trigger a flight from the dollar, at the same time that the U.S. administration concludes that a further drop of the dollar, by perhaps 30%, is required to bring down the U.S. trade deficit, still running (as of the $13.63 billion March deficit) in the $160-170 billion annual range. The bankers' pack will howl that "fundamental solutions" to "structural problems" must be carved out of federal defense and entitlements spending; and Federal Reserve chairman Paul Volcker will play the only trick he knows, and repeat the credit-crunch of late 1979, in order to blackmail Congress into accepting such a policy. Sen. Phil Gramm (R-Texas) will play the role of the drunken deacon blessing a lynch mob, threatening, or perhaps even forcing, default by the U.S. Treasury, perhaps as early as May 25, in order to batter the White House into acceptance. And President Reagan, mumbling the magic formula "108 in '88!" is attacking congressional Democrats for moving with insufficient speed against the deficit!

The deficit-reduction hoax

It must be assumed that the Goldman Sachs, Salomon Brothers, Merrill Lynch cabal of government securities-dealers playing out this scenario are not so stupid as to imagine that this program will actually reduce the federal deficit, and that their intent is broader, strategic in content: to knock the United States out as a world power. Brazilian-style austerity will massively *increase* the budget deficit, rather than reduce it.

The federal government's off-budget guarantees of the financial system include a trillion dollars' worth of home mortgages, a trillion dollars' worth of savings deposits, two trillion dollars' worth of commercial-bank deposits, half a trillion dollars' worth of pension obligations, and the assorted Exim Bank, shipbuilding, student, and similar loans.

The insurance funds behind the $1 trillion in savings deposits are exhausted, and the insurer, the Federal Savings and Loan Insurance Corporation (FSLIC), requires $45 billion to sort out the problems now at hand; it will probably end up usurping the $18 billion now insuring the $2 trillion in commercial-bank deposits, leaving those unbacked. The Pension Benefit Guarantee Board is similarly out of funds.

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The agencies which guarantee the trillion dollars' worth of home mortgages have funds amounting to barely 1% of exposure, and a modest rise from the present home-mortgage default rate will send them running to the Treasury.

The federal deficit will balloon uncontrollably as these guarantees are brought to be honored at the Treasury. The self-feeding collapse of U.S. government finance, triggered by a collapsing dollar and rising interest rates, will wipe out America's already shaky commitment to spend money to defend itself and its allies.

A 30% dollar decline

"The implication" of European views at the just-concluded ministerial meeting of the Organization for Economic Cooperation and Development (OECD) in Paris, wrote *Washington Post* columnist Hobart Rowen on May 14, "is that Baker and Co. quit too early in their effort to force the dollar lower—a judgment in which many financial analysts concur." Among these are Rudiger Dornbusch of MIT, one of the Trilateral Commission's stable since the Carter days. "Why the Dollar Must Fall Another 30%" was the headline of Dornbusch's commentary in the May 10 *New York Times*. "The dollar continues to be overvalued. In fact, it will have to decline as much as 30% to eliminate the remaining trade deficit, create the conditions for cutting the federal budget deficit, and force Europe and Japan into more reasonable economic policies." Dornbusch takes Treasury Secretary James Baker III's discredited logic and pushes it to extreme conclusions: If bashing the dollar is the way to cut the deficit, it has another 30% to go, since, with the dollar collapse so far, "the deficit by 1991 will be moving once again toward 1986 levels."

Only two weeks before, the financial press crucified Baker for bashing the dollar in order to reduce the trade deficit. (At the OECD meeting, Baker actually argued that the policy had shown success, because the volume of U.S. imports had declined—i.e., the United States is consuming less, but paying more for it!) Precisely when Japanese and European investors are considering whether to cut their massive losses in the dollar—which has lost 45% of its value in two years against their currencies, and particularly in U.S. government bonds, which have lost 13% of their value since April 1—Baker is now being urged to knock the dollar down again.

The consensus in the London and other European financial centers says that the lack of agreement at the Venice summit will provoke a much worse crash of the dollar than ever before. But after testing the waters in Venice, Baker told reporters on May 13 that nothing should be expected from the summit. After all, he shrugged, you can't expect a major agreement among industrial nations every three weeks. That goes especially when the last several rounds of "major agreements" have been demolished on the financial markets. For all the talk of pushing the West Germans into a reflationary course, Economics Minister Martin Bangemann promised an unspecified reflationary program, if West German economic growth were to fall short of 2% this year. He promised as little as Japanese Prime Minister Yasuhiro Nakasone promised to President Reagan during his Washington visit two weeks earlier.

The debt ceiling cliffhanger

On the same *New York Times* page as Dornbusch's demand for an additional 30% dollar devaluation, former Carter economic official Robert Hormats, a Trilateral Commission member now at Goldman Sachs, argued that a huge reduction in the federal deficit was the only solution. New currency agreements between industrial nations can't "break the logjam," and "credible revenue increases and federal spending cuts would make a larger portion of domestic savings available to finance new investment. . . . United States budget action should induce the Germans and Japanese, among others, to stimulate domestic demand."

The conclusion was cited by the *Washington Post*'s Hobart Rowen, from a paper presented recently at the Center for Strategic and International Studies (CSIS): "Little that the principal Western partners can do in the short term will break the effect of the very serious imbalances that have been allowed to emerge over the last few years. . . . What most needs to be done will require not only time, but political perserverance of an exceptional order. . . . We would suggest that there is no short-term panacea for the current ills of the Western world."

This translates into a federal budget crisis, designed to break the back of any resistance to banana-republic economic prescriptions for the United States. A three-level national default crisis is in preparation for either May 25, mid-July, or September. Despite House approval of a 60-day extension of the federal debt ceiling May 13, and maneuvers for a "unanimous consent agreement" in the Senate for the same extension, it is still doubtful that the Senate will act in time to prevent the Treasury from defaulting upon maturing Treasury bills May 25. The last expansion of the federal debt ceiling contained a time-bomb, under which the ceiling reverts back to $2.1 trillion from the "temporary" $2.3 trillion level this month. Since the debt now stands at about $2.25 trillion, the Treasury must, by law, pay back all maturing debt.

The scenario on Capitol Hill runs as follows: Sen. Phil Gramm is will introduce an amendment to the debt-ceiling extension, "strengthening" Gramm-Rudman-Hollings, by reintroducing automatic sequestration of funds, struck down last year by the Supreme Court. Then the House will strip the Gramm amendment. Gramm will either hold up approval of the extension in committee until the Senate recesses May 22, making default inevitable; or he will withdraw his amendment, and strengthen his hand for the July re-emergence of the default crisis. Whether the showdown occurs in May or July, depends entirely upon the tactical decisions of the forces that want to put the administration against the wall.

The House and Senate have already proposed a "deficit

reduction" program linking any increased defense spending to tax increases, putting the White House in a bind. Under the Senate version, a $7 billion increase in defense spending, already less than the rate of inflation, would be paid for by $7 billion of a total of $18.3 billion in new taxes.

The budget-cutting faction ridicules these proposals as inadequate in any event. The Committee for a Responsible Federal Budget wants much more. Susan Joy, executive director of the group, notes that a large portion of the cuts, too small in any case, is to be derived from asset sales and similar one-shot devices, including changes in accounting, which "will not take the budget off its long-term glide." She predicts that the budget debate next September may "roll the debt ceiling, Gramm-Rudman, and deficit reduction all into one," in a final showdown with the White House.

An internal White House analysis surfaced in press accounts, showing that the Fiscal Year 1988 deficit will be $135 billion, up $37 billion from previous projections. Neither this nor previous projections have much to do with the real world, since the standard private estimate puts the FY 1988 deficit at $170 billion—without counting, say, $100 billion to bail out FSLIC and other bankrupt agencies. Nonetheless, "Disclosure of the analysis also will embarrass the administration," notes the May 14 *Wall Street Journal*. "President Reagan has been criticizing Democratic lawmakers for drafting budgets that fail to adhere to Gramm-Rudman, and Democrats have fired back by contending that the President's own budget—which purports to hit the law's deficit target on the nose—actually misses it by billions of dollars."

The consequences

"Most people were able to take Peru's partial default in stride, and even Brazil's, but how would the world feel about a U.S. default?" asked the May 8 *Wall Street Journal*. "The [federal debt] ceiling will be raised ultimately. The only question is whether some temporary delay will further damage the world's confidence in the ability of the U.S. Congress to manage its affairs. In other words, how much will Congress cost the country in higher interest rates and a further flight from the dollar?"

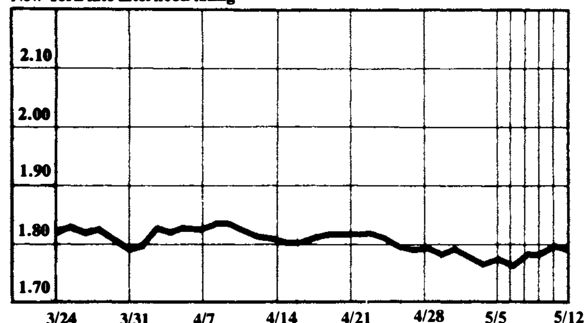
Recall that the dollar and the bond market survived the May 6 Treasury debt auction, only because Japan's government virtually assigned quotas to major Japanese institutions purchasing U.S. government securities. City of London observers believe that a Treasury default would explode the government securities market.

At the point that the flight from the dollar runs out of control, Paul Volcker will step into the breach, as he did in October 1979, and conduct a new "Columbus Day massacre." Wall Street wants a sharp rise in interest rates, not merely to stabilize the dollar, but to force the administration and Congress to adopt banana-republic measures. A sharp rise in U.S. interest rates following the Venice summit will coincide with either the aftermath, or preparations for, Treasury default.

Currency Rates

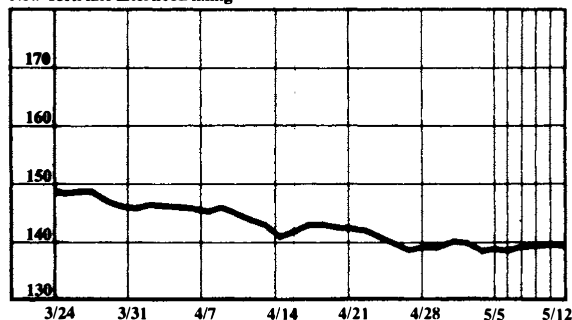
The dollar in deutschemarks

New York late afternoon fixing



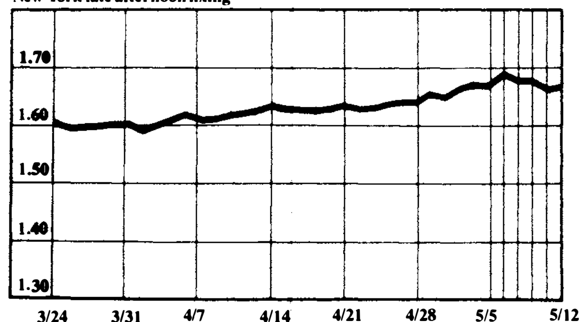
The dollar in yen

New York late afternoon fixing



The British pound in dollars

New York late afternoon fixing



The dollar in Swiss francs

New York late afternoon fixing