If The Economy's So Great, Then Why's Everyone So Worried?

Over the last week the President's Council of Economic Advisors, outgoing Federal Reserve Chairman Arthur Burns, pro-capital formation Republicans in the Congress, and virtually everyone who has said anything about the economy have all registered hysterical reactions over inflation. These responses are incapacitating to the point of making it impossible for anyone in the U.S. to think rationally about economic policy, a situation akin to France where Gaullist economics writer Paul Fabra just attacked the call by French employers union economist Robert Pelletier for stepped-up investment in productivity-boosting modernization and new technologies like nuclear power. Fabra rebutted that French industry already has enough debt. However, the hysteria is a response to something real — the fact that the U.S. credit system is heading deeper into terminal crisis.

BUSINESS OUTLOOK

In his January Economic Report, Manufacturers Hanover Trust economist Tilford Gaines warned that inflation could at any moment wreck the U.S. banking system, causing savings to bypass commercial banks, thrift institutions, life insurance companies, and pension funds, seeking out high-yielding, short-term speculative investments. His bank also revealed this week that U.S. banks' spreads on international loans (the difference between what they pay for money and the rate they lend it out at) have been reduced to an intolerably low three-fourths of one percent because of rising U.S. interest rates. The Federal Reserve has to keep pumping money into the banking system, despite the potentially inflationary consequences, or the whole "intricate system of intermediation system" goes bust.

Inflation Scare

In the U.S., conservatives of the Chamber of Commerce-type have been put in a "controlled psychological environment" by pronouncements of various "experts." The 365-page report released by Carter's Council of Economic Advisors Jan. 30 paid lip service to the need to spur business investment, but principally concerned itself with the threat of inflation. "When higher rates of inflation become built into the expectations of the public...the process of unwinding the inflationary momentum is a slow and arduous task."

The real solution to the inflation, actual and potential, plaguing the U.S. economy is a policy of targeted investment in export-oriented, high-technology production — which will boost productivity and reduce the costs of production — in tandem with a deliberate policy of drying up speculative investment in the areas such as pure debt refinancing and the real estate bubble. But this is hardly what the CEA, under the direction of former Brookings economist Charles Schultze, advises. "Next year will pose a critical test for the new program (of voluntary wage and price restraint — ed.) because of the heavy calendar of collective bargaining and the fact that utilization rates for both labor and capital will have risen substantially." The report calls for "larger moderation" in labor costs to produce a 0.5 percent "deceleration" in inflation a year between now and the end of 1979.

Adding to the scare about inflation, Arthur Burns, in his farewell appearance as Fed chief before the National Press Club Jan. 30, termed inflation "the mortal enemy of economic progress and freedom." "The need to fight inflation is widely recognized in our country," intoned Chairman Burns, "but the will to do so isn't yet strong enough."

Expounding on the same theme, Manufacturers Hanover's Tilford Gaines writes with approbation of the systems of forced savings employed in the Soviet Union, China, and Brazil — what maleducated Gaines calls Marx's theory of surplus value!

> In the case of the Soviet Union, the People's Republic of China, and the other authoritarian socialist states, saving is mandated through a system that pegs workers' pay at a level less than the value of their contributions. The increment, which Karl Marx called "surplus value" in reference to the capitalist system, is the saving to be made for investments in industry...Even the modern "economic miracle" in Brazil has been made possible by a system of government controls that systematically increase workers' pay by less than the rate of price inflation.

Gaines went on to warn about the threat to the banking system of rising interest rates. Last week the average Federal funds rate, the determinant of all interest rates, hit a three-year high of 6.80 percent. Commercial banks are being forced to pay more for money, but they have to keep the rates they charge on loans down if they want to stay in business.

The fact that consumer price inflation slowed to an average monthly rate of increase of only 4.4 percent in the second half of 1977, compared to 9 percent in the first half of the year, is no solace. The current freak-out about inflation stems from the realization that the built-in potential for inflation is huge. Economists of the Friedmanite stripe point out the monetary base has been growing at a very rapid clip — by 17.4 percent over the last two years or slightly more than during the 1972-73 "boom," and it has accelerated to a more than 10 percent annual rate of change since the end of November.

This expansion of the monetary base represents straight banking reserve creation by the Federal Reserve to keep the banking system liquid — to forestall the collapse of spreads mentioned above — and to keep the debt bubble (mortage debt, consumer debt, Third World debt, etc.) going. Reserves supplied to the banking system by the Fed have, potentially, a multiplier effect on the supply of credit to the economy. Since early November, however, loans to commerce and industry have been essentially flat, reflecting a lull in economic activity. Should industrial production grow any faster than the current languid rate, the potential liquidity will be realized in enormous money supply growth, higher prices, and all the evils of run away inflation.

Thus, Manufacturers Hanover weekly *Financial Digest* (Jan. 30) says slow economic growth is fine. The economic recovery is about to enter its fourth year; don't spoil it with overly stimulative policies. "...a tax increase is precisely what is needed." Worries about a takeoff of inflation are overshadowing the recent wave of layoffs in the auto industry, the decision by automakers to scale down their first quarter production levels by 6.8 percent, the fact that American Motors Corp. is looking for a merger partner, and U.S. Steel's decision to cut its dividend. In fact, the report that factory orders climbed 4 percent in December from the previous month was interpreted either as a fluke or as a danger sign!

The warnings about inflation are having a predictable effect on Republicans in Congress. An aide to Sen. Henry Bellmon, ranking Republican on the Senate Budget Committee, which is now reviewing Carter's FY 1979 budget, said that all the Republicans on the committee agree that inflation is the number one problem; worry over the size of the projected budget deficit is one of the constraints that is forcing them to alter their thinking. A number of supporters of the Kemp-Roth "bigger tax cuts for business" tax legislation are now likely to desert it.

Feeding this kind of thinking, the Congressional Budget Committee, under the direction of former Brookings economist Alice Rivlin, is now circulating a report to Congressional offices which demonstrates that many of the assumptions of the Carter budget are overly optimistic — the projected unemployment and inflation rates — and that the tax package works out to be a small tax increase in FY 1979 and a greater one in 1980. Her arithmetic is likely to impell some Republicans to support another Republican tax bill now in the making. Sources reveal that Sens. Danforth and Javits will put a second tax bill on the table in a week's time, which includes Javits' long-standing plan for "anti-inflationary" tax incentives to businesses for rehabilitating old plants in the northeast and midwest.

—Lydia Dittler

Europeans, Saudis, Japanese Keep Pressuring For Stable Dollar

On the eve of the Jan. 31 expiration of the Rambouillet Agreement — whereby central banks agreed for two years not to trade gold among themselves — the leading U.S. trade daily, the *Journal of Commerce*, warned its readers that if the dollar was not stabilized beyond the short-term, the rest of the world would move to gold-linked currency systems without the United States.

GOLD

The editorial, titled "Gold — Gone Today, Here Tomorrow," noted that efforts to "banish gold from the monetary system" had proved futile in the past, and that if this lesson was not heeded, "the rest of the world will begin to look for alternatives, however limited." In particular, the editorial mooted that, given the right circumstances, the Arabs might move into gold bullion.

A related warning was given by the head of Petromin, the Saudi Arabian oil corporation, in an important address to 500 mainly Western European business leaders at a meeting in Davos, Switzerland sponsored by the European Management Forum. The Petromin head, according to reports in the Feb. 1 *Wall Street Journal*, stated that Saudi Arabia "would like to invest a much larger proportion of its reserves in currencies other than the U.S. dollar," and indeed, that "it would be 'desirable' to diversify Saudi reserve holdings so that the dollar share might go as low as 50 percent." Although the Petromin governor was careful to qualify his threat — essentially indicating that the Saudis would prefer to remain with the dollar, given the size of the U.S. economy and the dollar's central role in world trade — his warning was clear. Underlining the Saudis' motivation explicitly, the Petromin head stated, "Our interest doesn't lie in speculation or quick gains, but in the assurance of a stable financial market....instability in the international financial system...(can only be) detrimental to our interests." Interestingly, as the *Wall Street Journal* noted, the Petromin head only made part of his speech public to the journalists present at Davos, for "sensitive political considerations."

More Pressure

Other clear-cut pressures on the U.S. to shape up its economy and give the dollar some much-needed commodity and export backing are:

*The head of Mitsubishi, speaking in San Francisco, suggested that Americans work with the Japanese in joint development projects in Southeast Asia, as a means of relieving pressure on the dollar.

*Otmar Emminger, president of West Germany's central bank, the Bundesbank, in a widely publicized statement in Saarbrücken, West Germany on Feb. 1, "declared that the surplus of dollars in world markets had become not only the key problem of the international monetary system but also a possible obstacle to world economic recovery and to an upswing in the German economy this year," according to the *New York Times* on Feb. 2. As a solution, however, Emminger has been proposing to merely "paper over" the dollar glut — by soaking up the excess dollar liquidity into long-term U.S. Treasury bills or related Government notes to be sold on