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EIR Economics

The next phase of Volcker's austerity

by David Goldman

Next week, *EIR* will release our aggregate economic forecast for the second half of 1980 and 1981. The premise of the forecast is that the economic track prescribed by both Carter and Reagan's leading economic advisers will prevail, namely, the attempt to shift the American economy into lower consumption patterns through the 1980s.

The argument presented by the American Council of Life Insurance in a book-length report to be reviewed in our next issue, and subscribed to by most Fortune 500 corporate economists, is that too large a portion of America's capital resources has been devoted to consumer durables, and a greater portion must be shifted into investment at the expense of the consumer durables sector.

Since all production is, in a basic sense, a multiple of the volume of consumer goods production—the means of sustenance of the goods-producing labor force—it stands to reason that a reduction in the volume of consumer goods production, freeing real and financial resources for other purposes, provides a certain kind of boost to productivity, providing that the number of manhours spread over this volume of consumables remains the same. That is an artificial and temporary boost to productivity, since lower living standards tend to depress demographic conditions which enhance productivity.

Assuming that the current 13.5 percent per annum rate of fall of personal income prevails throughout 1980, we programmed the LaRouche-Riemann model to project a higher productivity through 1981. However, the model tells us that the current burden of non-productive overhead costs is so oppressive that the one-shot boost in productivity so obtained does not bring about lasting recovery. On the contrary: the economy barely regains half the ground lost since Jan. 1, 1980, before turning down again in mid-1981.

We will demonstrate at some length in next week's economic survey that the economic scenario propounded by the Council of Life Insurance and others is foredoomed to fail, and that the United States faces the gravest economic crisis in its history if policy remains fixed in this direction. In a May 6 survey, *EIR* warned that the United States had little time left to reverse course before reaching a "point of no return," after which the American economy would not be physically capable of making sufficient investments to even maintain its capital and labor stock at existing levels of efficiency.

In fairness to Mr. Reagan, he has objected in many public statements to the notion that a fall in living standards is any form of solution to our economic dilemma. Many of his advisers, including Jack Kemp, Prof. Arthur Laffer, and Jude Wanniski, are committed to a tax cut plan that would increase available personal income. However, it is our current estimate of the Reagan camp, and the overwhelming expectation in the business

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community, that the policies represented by Paul Volcker will continue, with Volcker at the helm at the Federal Reserve, and austerity proponents such as William Simon, Alan Greenspan, and George Schultze will take major positions with a Reagan administration. Far greater political convulsions than the straitjacketed convulsions of the Democratic Party in New York this week will be required to unseat this latter group from the commanding position in the Reagan camp, no matter how much Reagan prefers the electoral appeal of the Kemp approach between now and November.

Credit conditions

Between now and November, we are headed for an interest-rate disaster. It is not merely that, as various bank economists forecast, the pressure on securities markets will continue to push rates up during the next two months. The external side of the American fixed-income securities markets may push matters much further than domestic conditions, as such, would ever warrant.

Long-term rates and also short-term Treasury securities rates have crept up during the past two weeks. What Fidelity Bank economist Lacey Hunt said in his July 30 forecast appears entirely accurate. Hunt wrote: "Several factors could lead to a setback in intermediate and long-term bond prices in August and perhaps September. First, a large corporate bond calendar of approximately $4 billion will be issued in both July and August. Second, about $5 billion of intermediate and long-term Treasury securities are to be offered in the July refunding. Also, we expect a worsening increase in the producer price index and continued gain in retail sales for July to be reported in early August. According to our projections, the yield on long-term Treasuries might rise from a monthly average of 9.9 percent in June to 10.44 percent in September."

The prognosis for output during the second half is negative; as the United League of Savings and Loan Associations points out, this level of interest rate increase will draw $17 billion of deposits away from the thrift institutions, aborting what little recovery potential remains in the housing markets. Particularly since banking "deregulation" has ended the differentials favoring savings over commercial bank time deposits, the housing markets have nowhere to go but down.

In the case of industrial output, the continued rise of the inventory-to-sales ratio through the June inventory period, to 1.52 months' worth of stocks, will mean a further slide in production.

All this is fairly well reported in the financial press. However, there are two situations that bear special concern, because they will tend to adversely affect total economic conditions in a way not anticipated by most American businessmen or economists.

The Interstate Commerce Commission has jumped the gun on the compromise deregulation bill signed into law by President Carter earlier this year, breaking up the motor carriers' rate bureaus, and throwing open routes to any comers. Because the old route certificates held by trucking companies made up a fair portion of their capital, worth hundreds of millions in aggregate resale value, the ICC's illegal aggressiveness in this field has wiped out a great deal of the motor carriers' capital, and, in many cases collateral for bank loans. Several major bankruptcies in the industry have resulted, including the 2400-employee Johnson Motor Co. in North Carolina. The ICC action has coincided with the industry's worst year since regulation came into effect, when freight volume between May 1979 and May 1980 dropped 22 percent nationally and 36 percent in the industrial Midwest.

What remains of the industry is being turned over either to the railroads, which are building up their own road haulage subsidiaries, and to the independent truckers, who will work at a comparative wage scale of roughly half that of unionized Teamsters, with many times the accident rate. Large trucking companies are leasing their rigs to independents, and bankrupts like Johnson are likely to come back only as leasing services for independents. The industry, which was one of America's best functioning, is in ruins.

Since transportation time is a productivity-determining feature of any economy, this is a disaster. An *EIR* survey published in November 1979 estimated that trucking deregulation would cost the American economy 1 percent of productivity per year over four years. That is a time bomb for the economy as a whole.

Food prices

When the July producer price index becomes available on Aug. 15, we will see to what extent the spectacular rise in food prices on the wholesale market has filtered down to official indices. Between April and the end of July, wholesale spot market prices for food commodities rose 21 percent. The prospect over the next several months is for continued such increases. As *EIR* has reported, the sharp dropoff in grain availability this year is not merely a function of adverse weather conditions, but also one of the most immediate results of the Volcker monetary policy, which has wiped out substantial portions of farm credit. The entire array of administration policies has been a disaster for the farm sector. Beef prices will show the most spectacular rise, due to slaughter of herds.

Since the improvement of the inflation rate from the near-20 percent levels scored in the first months of the year is almost entirely due to the mitigation of the rate

of food price increase, the resurgence of food prices threatens to bring the economy right back up to the inflation levels that caused near financial panic.

Most threatening, however, is the foreign side of the securities markets. It has been clear for some months that the rest of the industrial world viewed the electoral choice of Carter, Reagan and Anderson as the worst disaster that had befallen the Atlantic Alliance in the decade.

There is no confidence whatsoever in either the Carter or Reagan economic strategies, for one overriding reason: both approaches are founded on a Malthusian attitude toward the developing sector. Europe believes, and its leaders have stated publicly at every available pretext, that the industrialization of the developing sector is not merely the key to the industrial world's future economic growth, but a precondition for world security. Combined with European judgment of the quality of American economic management, justified foreign repugnance toward the American government's Malthusianism has brought confidence in the United States to a postwar low.

Fed to crunch again?

Various European institutions (see Foreign Exchange) are poised to act on the conviction that the United States headed towards the sinkhole, liquidating large volumes of fixed-income dollar securities. This is not merely a short-side play on the market, but a decision to reduce exposure for the indefinite future. The results for the dollar and American interests rates are potentially disastrous.

The probable response of the Federal Reserve to all this will be to further tighten the monetary situation, partly to draw short-term funds back into the United States, partly to further reduce American consumption. This will only worsen the vicious circle that brought us here in the first place.

Little noticed in the American press, but splashed over the front page of the London *Financial Times* Aug. 11, was a report issued by Sen. William Proxmire's Senate Banking Committee. The Proxmire report 1) commended Volcker for his policy actions thus far, and 2) demanded stricter monetary targets to be set for the next several years. This is a page from the book of Reagan campaign guru Milton Friedman, from the pen of one of the most liberal Democratic senators. With this political encouragement there is not much room for Volcker to choose courses alternate to the one he apparently prefers.

With these pitfalls in view, we consider our econometric forecast a *best-case scenario*, because credit market disruptions could make matters a great deal worse very quickly.

Who's behind the world oil glut?

by Judith Wyer

Following the December 1979 OPEC cartel price-setting meeting, Saudi Arabian Oil Minister Ahmed Zaki Yamani vowed that his country would reverse the tide of anarchic oil price increases by flooding the world markets with Saudi crude and outstripping demand. Eight months later, the Saudis have succeeded in this objective.

"There's an unbelievable oversupply of oil out there," observed a Wall Street oil analyst, "and yet the Saudis just keep pumping their 9.5 million barrels a day of crude. . . . The basements of the corporate headquarters of the major oil companies must be full of crude now, I don't know where else they could put the stuff."

Saudi Arabia's record-high production level, coupled with a marked decline in world consumption, has forced a number of OPEC price hawks, most notably Iran, to begin to shave their prices. In the industrialized countries refiners have imposed cuts in the market price of petroleum products, including gasoline during the summer months when gasoline is normally in peak demand.

Riyadh's goal is to force the pricing militants in OPEC to reunify the OPEC price at the upcoming heads of state OPEC summit in Baghdad in November. This will require a number of OPEC producers to lower the price tag for their crude, which goes as high as $37 a barrel, down to the Saudi benchmark price, now at $28 a barrel.

Riyadh hopes to then force the cartel to accept a plan worked out by the Long Range Planning Committee headed by Yamani to stabilize world oil prices by imposing small quarterly oil price adjustments pegged to the rate of world inflation.

Last week, Saudi Arabian Foreign Minister Saud al Faisal gave a press statement affirming that Saudi Arabia would continue its present oil producing and price policy through 1980. A well-informed Mideast observer remarked that the Saudis are "regaining the upper hand in OPEC and they are going to play very nasty to renew pricing discipline."

Saudi Arabia is not acting independently in this effort but has the support of the nations of Western