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EIR Special Report

Will the American economy survive a new credit crunch?

by Richard Freeman

Federal Reserve Board Chairman Paul Adolph Volcker's decision to boost the Fed Board's discount rate to 14 percent May 4—18 percent for large money center banks—puts the U.S. economy on a collision course. The Wall Street money-center banks pushed the prime to 19 percent within hours of Volcker's announcement; a prime of 21 to 25 percent within weeks is clearly possible.

Volcker's latest assault will wreck the U.S. economy, and the Reagan administration, if it continues. Crocker National
son commented May 1, "If the prime rate stays at that level over the next three weeks, the economy will not be able to withstand the shocks." President Reagan will face a new depression and a ballooning budget deficit fed by high interest rates and economic collapse. The stage will then be set for "social convulsions" in major American cities directed against Reagan.

Budget trap

Volcker began pushing hard for higher interest rates during the last several weeks, because, as he realizes, there is a tremendous vacuum in economic policy-making in Washington, D.C.

Inside the Reagan administration, the President is held hostage to the high interest-rate policy, not only by supermonetarists like Beryl Sprinkel, but by the President's foolish support for the simplistic and highly destructive budget-cutting approach advocated by quack economist Milton Friedman and budget director David Stockman. Volcker and his City of London controllers plan to use Reagan's commitment to this budget-cutting approach to trap the President.

Many Wall Street economists have already commented that the 1982 fiscal year program may produce another outbreak of inflation. They say the administration understates the cost of financing the public debt; the budget contains heavy expenditures for nonproductive but necessary military hardware; and an untargeted 30 percent Kemp-Roth tax-cutting plan that will further reduce revenues without any necessary growth in industrial output.

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Federal Reserve Chairman Paul Volcker: "an arsonist."

"This is a Lyndon Johnson liberal Democratic guns-and-butter program," Goldman Sachs chief economist Gary Winglowski went so far as to claim on April 30, predicting that the Stockman budget deficit will be $50 billion in 1981 and another $50 billion in 1982. By 1984, the budget deficits may be up to $100 billion a year, wrote *New York Times* editor Tom Wicker May 1. "President Reagan may have set himself up for a fall."

At the quarterly closed door meeting of the Treasury Department Refinancing Group—which the heads of top U.S. investment and commercial banks attend by invitation only—the bankers told the Treasury point-blank they thought the federal budget deficits were too large. On April 30, Stockman, on the advice of these Wall Street bankers, announced that this year's federal deficit—not the 1982 budget now being debated—would be cut an additional $5 to $6 billion.

Backlash scenario

This stringent approach to budget-cutting is bound to fail if interest rates climb higher and the economy collapses. Under such circumstances, the budget would go even more sharply into deficit because the interest on the public debt would go up another $2 to $3 billion. As one banker put it, "Government revenue would fall while the expenditures would rise, due to inflation."

This would put Reagan in a dilemma—either he rushes to implement antirecession countercyclical spending programs for increased unemployment benefits, more food stamps, more public works, etc., in which case his restrictive budget approach is entirely discredited along with Reagan himself, or else he refuses to undertake such an antirecession program, and the economy slides out from under him while the Socialist International uses its current assets in the labor, minorities, and environmentalist movements to organize anti-Reagan riots in the streets.

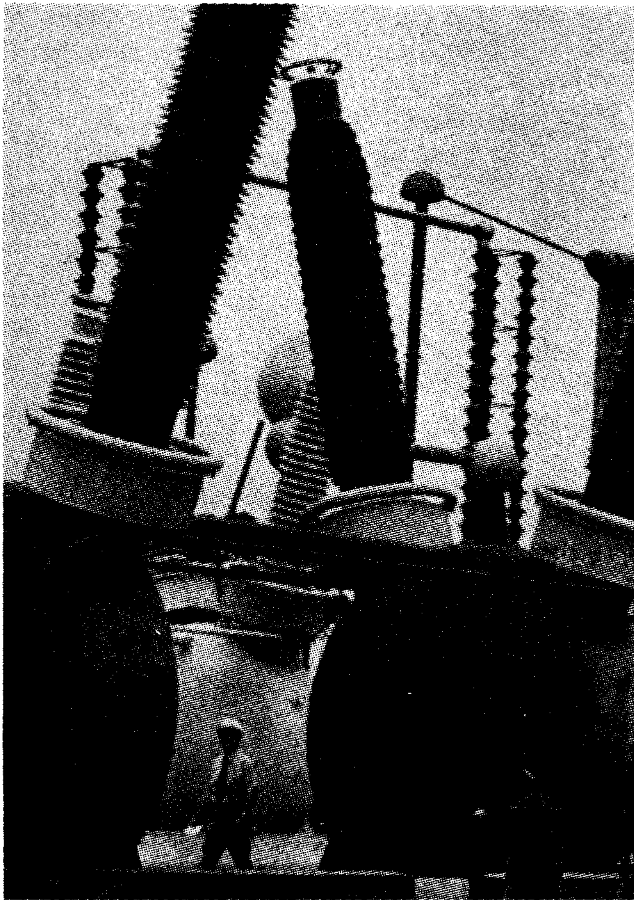
Laying out this scenario, Harrison Raines, a columnist for the New York *Daily News,* wrote May 1, "There will come a time when Ronald Reagan is no longer the beneficiary of good fortune and cannot act to improve himself." Raines added, "The interest rates created by the Federal Reserve Board have the strength to undo any of the stimulation to the economy that a tax cut might bring."

Volcker's blackmail

To hasten this scenario, Volcker began raising interest rates to precipitate the crash. On April 18, the federal funds rate, at which banks trade excess reserves overnight and which sets the basis for the prime rate, was 15.67. By May 1, Volcker, by withdrawing funds from the banking system, had put it up to 19.5 percent, a fantastic jump of 4 percentage points in 4 days.

Volcker said that he tightened interest rates because the money supply (M1B) is exploding at a 13.5 percent rate for the last three months, twice the Fed's target range of 5 to 6 percent.

While the deposit and remittance of the Treasury Department's tax and loan account had something to do with the recent runup of money supply, *it is Volcker's incompetence and the complete bankruptcy of monetarism as a strategy, overlaid onto the heavy indebtedness level of the U.S. economy, that explains why money supply is*



Debt service is draining funds from capital investment.

out of control. Here is the proof.

First, to set aside the problem of the Treasury's tax deposits at banks. In early March and then again in early April and into the middle of that month, the U.S. Treasury deposited tax receipts garnered from the federal tax April 15 filing date at commercial banks around the nation. Because these deposits require compensating reserve requirements, but banks have to set aside reserves only two weeks after they have taken in deposits, a crunch developed in late April. At this point, banks were forced to increase their reserve requirements two weeks after the fact at the very time that these same banks had been remitting these deposits back to the Treasury Department and thus could not draw on these extra deposits as part of their reserve balance. This squeeze forced the banks into a desperate need for cash. In the midst of this process, Volcker began playing games with the banking system. Volcker actually *drained* funds from the banking system on Friday, April 24, promising to replenish these funds the following Monday, April 27. But that Monday came, and Volcker lied about his promise. Volcker did not return funds to the banking system until Wednesday, April 29. At that point, the federal funds market was stretched tight as a drum and Volcker had succeeded in manipulating the federal funds rate to above 18 percent.

Yet the tax deposits, which eventually wash out of the credit system, only created the basis for the federal funds rate increase; *they do not account for or explain the increase in the money supply.* The answer is to be found in the obvious: Volcker and Milton Friedman's (as well as Beryl Sprinkel's) brand of monetarism is outright failure.

Consider for a moment what Volcker is doing. He has abandoned attempts to influence money policy by interest rates per se and has resorted to the "management of bank reserves," the strictest form of monetarism possible. The idea behind this approach is that the Fed manages the amount of reserves that banks put aside to cover reserve requirements. Since money supply is simply reserves times some multiplier, the reserve management theory holds, if reserves are held constant and the multiplier is held constant, money supply should remain the same. If reserves are made scarce, then money supply should fall.

This theory is blown to bits by what actually happened in the U.S. economy. On Jan. 1, adjusted bank reserves were almost $47 billion, according to figures supplied by the St. Louis Federal Reserve Bank; on April 1, they were $46.5 billion: that is they didn't rise (and even fell slightly) during this period. Yet, during the first quarter M1B grew by nearly 9 percent. Even more startling, in the month ending April 22, M1B, which includes currency and interest-bearing and non-interest-bearing checking accounts, expanded at an annual rate of 18.8 percent, even though reserves in the banking system declined at 6.7 percent annual rate!

What, then, is causing the blowup in the money supply? The basic illiquidity of corporations has given corporations a tremendous need for funds, which is only minimally being satisfied. These funds are needed to stay afloat. For example, corporations are currently paying 25 cents out of each new borrowed dollar just to pay off interest owing on previously built up debt. So when Volcker kept the prime rate at above 17 percent for the whole first quarter, corporations were forced to borrow at the slightly cheaper rates available to them by taking their loans at the London Interbank Offered Rate (LIBOR). Thus, commerce and industry loans at weekly reporting banks in the United States grew at negative $5 billion during the first three months of the year. But, corporations borrowed at LIBOR outside normal channels: they borrowed $5 billion from foreign banks operating in the United States and another $5 billion from the overseas offices of U.S. banks. None of this shows up in official statistics, but the $10 billion does show up in the U.S. money supply.

Likewise, U.S. corporations are effectively looting their foreign subsidiaries in order to stay afloat, and

remitting the money home. For example, Ford Motor Company's West German subsidiary may borrow from Deutsche Bank, while Ford headquarters postpones payment to its West German branch for Pinto engines turned out at Ford's plant in Cologne. On top of this, there is the flood of hot money that old European families are sending in the United States through various channels to gain higher interest rates—such as the flight capital leaving France and Germany (see Economics). All of this swells the money supply. Volcker is clamping down on a money supply that he himself has sent careening out of control.

With corporate debt service now more than 60 percent on internally generated funds, as will be documented below, the money supply is growing just to roll over a portion of this debt. By cutting back money supply, Volcker must cut back on production. Currently, plans to integrate the domestic with the international money markets, through interfacing Fedwire to the Clearing House International Payments System (see *EIR*, May 5), and with the planned introduction of international banking facilities (IBFs) sometime this fall, the central bank's ability to control money through reserve management or any other method will be reduced to minimum.

Production debacle

But the effects of the cutoff of credit to the economy are already foreshadowed by the following developments:

- On May 4, General Motors announced that it was delaying its five-year, $40 billion capital-spending program because of the crunch in auto sales. In April, when the Big Three automakers withdrew their earlier cash rebate program, auto sales occurred at a 5 million units anualized rate, far down from their nearly 10 million units per year sales rate of a few years ago.
- Mortgage rates reached 15.82 percent, the Federal Home Loan Bank Board announced May 4. The FHLB announcement a few weeks ago that it is allowing a greater increase in variable rate mortgages offered by savings and loan associations means that interest rates for housing will go up, not down, in months to come. Housing starts which dropped precipitously by 25 percent during the first quarter to a 1.2 million starts per year may fall below 1 million soon.
- The rate of bankruptcies among small and medium-sized businesses, already 50 percent higher than last year, will accelerate under the new environment Volcker has created.
- Take-home wages, corrected for inflation and taxes, have been plummeting, and will fall even further.
- The household rate of savings, down to 3.7 percent in March, the lowest level in 20 years, will perhaps go even lower.

Financial Survey

The debt time bomb Volcker has triggered

While the Federal Reserve Board has in its possession all the raw data needed to present the picture of the crushing debt level corporations and households now operate under, *EIR* assumes that the Fed has either neglected to assemble the information we display below, or has suppressed it. Any public with an awareness of the actual debt picture in the United States would not tolerate Fed Chairman Volcker's current credit tightening for another week.

Volcker's interest-rate strategy is like an arsonist reaching for a match: he has no regard for what he destroys, nor does he comprehend the staggering damage he will ultimately do.

Right now, the per capita debt load in the United States is heavier than it was during 1929—or 1974-75, when the oil hoax threw the economy into deep recession. This debt increase is built up against, and has contributed to the fall in, household income and real corporate profits.

What happens, then, when Volcker's interest rates contract production while feeding the costs of financing corporate debt? Starting with small and medium-sized firms, this signals an illiquidity panic and mass bankruptcies. At that point, it is simply a matter of lack of confidence and cash reserves—the latter are down to almost nothing—before the illiquidity problem turns into a conflagration. Companies like Chrysler, Massey-Ferguson, Braniff, Eastern Airlines, Conrail, and General Public Utility are swept into the crisis. Before long, the far from secure Fortune 500 companies, whose balance sheets show major illiquidity weaknesses, are drawn in as well.

Financially overextended families will be wiped out as Volcker's recession drives the current 7.5 million level of official unemployment to the 9 million range. The household savings rate is already at a 30-year low, and savings will not preserve many families from bankruptcy.

The illiquidity scope

The most striking feature of the overall corporate picture is the inability of liquid assets to keep up with long- or short-term debt growth, and the increasing shortening of maturities on corporate debt. Figure 1