The Federal Reserve takes aim at the White House

by Kathy Burdman

The war between the central banks that speak for the old European oligarchy and the President of the United States has come out into the open. To the cheers of Bank of England Governor Gordon Richardson and the Bank for International Settlements, Federal Reserve Board Chairman Paul Volcker strongly tightened U.S. credit this week, in direct opposition to the expressed desire of President Reagan. Earlier in the week, Reagan had blasted Wall Street for raising interest rates in opposition to his economic program.

Recent claims by Volcker ally Treasury Secretary Donald Regan that interest rates have peaked were exposed as only a public relations maneuver by Volcker's action. Volcker drained funds from the credit markets this week, bringing the federal funds rate up over an average of 20 percent, from recent levels of 17 percent and under. "This is a strategic reversal in interest rates," said Bankers Trust. While the prime rate had slipped from 20.5 to 20 percent last week, "Twenty percent is now the floor, not the ceiling, for fed funds. The prime is headed right back up."

As Volcker acted, Bank of England Governor Gordon Richardson summoned the international bankers resident in London to a luncheon to deliver a strong endorsement of Volcker's policy. The Federal Reserve's determination to "fight inflation by tight money" is a "necessary program," said the British official. "A failure by the United States to bring inflation under control would cause great damage to the rest of the world."

Richardson particularly endorsed the international effects of the Volcker credit squeeze, singling out West German Chancellor Helmut Schmidt, President Reagan's main ally in Western Europe, for attack. Richardson sharply criticized Chancellor Schmidt's demands that U.S. interest rates be lowered. "However great the discomfort for other countries of having to live with high American interest rates," he said, "firm monetary policies should be pursued."

For his part, Schmidt, in direct support of President Reagan, pressed his attack on U.S. interest rates in debate before the West German parliament. "High interest rates will at best slow down economic recovery, at worst will lead to a world economic depression," he said. "You cannot have high interest rates without unemployment going up sharply."

Schmidt announced that he was "committed" to bringing the Fed's interest-rate policy up as a major topic at the July Ottawa heads of state economic summit. The Bank of England's Richardson stated, however, that Britain would urge the United States to rebuff the West German call for easier credit at the summit.

As European currencies were driven to frightening lows, Volcker himself toured Europe this week to seek support for his credit squeeze, visiting bankers in Paris and London, and addressing the International Monetary Conference of the American Bankers Association at Lausanne, Switzerland. There, Swiss National Bank President Fritz Leutwiler joined the Bank of England in strong backing for Volcker, as did British, Swiss, and Italian bankers in general. Leutwiler stated that U.S. real interest rates would, and should, remain at current high levels for the foreseeable future. "Most people feel that high interest rates are appropriate to the United States position," seconded Sir Jeremy Morse, chairman of Lloyds Bank of London.

More ominously, Leutwiler and New York Federal Reserve Bank President Anthony Solomon also asserted at the Lausanne meeting that Volcker's policy is part of a top-down tight-money program being "jointly coordinated" by all the central bank members of the Basel-based Bank for International Settlements. It is the central banks, Solomon said, not the national governments, who at this point control monetary policy and therefore the destiny of nations. Leutwiler cited the recent U.S. Treasury decision to abdicate responsibility for foreign-exchange market intervention as a healthy removal of "government interference" from the money markets.

President Reagan has the few remaining weeks before the July 19 Ottawa summit to prove the Swiss oligarch wrong. Unless the U.S. President takes decisive action to reverse the Volcker interest-rate policy, Chancellor Schmidt could be toppled by the recession Volcker is causing in Germany. This week, Schmidt's opposition in the Christian Democratic Party called upon the chancellor to resign and proclaim the state bankrupt, as German industrial production grinds to a halt and unemployment rises under the historic 12 percent interest rates imposed by Volcker's program (see Special Report).

First steps

President Reagan this week took a first step in that direction, upending a plan by Volcker to sell off the nation's ailing savings and loans. The cabinet action came after weeks of intense lobbying by the U.S. League of Savings Associations and the National Association of Homebuilders, who are demanding the ouster of the Fed chairman and the immediate reversal of his credit squeeze.

"The pressure on the Fed to lower interest rates not only exists—it's getting a bit personal," a Treasury official who backs Volcker worried this week. "The U.S. League is after Volcker's head. The homebuilders are after it, too. The political pressure on the administration to do something is immense, and pressure is getting very strong on Volcker to leave. It's going to be unusually hot in Washington this summer."

The mood of the country has been felt at the White House, and President Reagan and his closest advisers, such as White House counselor Edwin Meese, are aware that Volcker is wrecking the Reagan presidency. U.S. League sources told *EIR* this week, "They're out to get rid of him." The time frame is the problem. The White House has told its constituencies that it cannot move on the Volcker Fed within the next 30 days, or even ask for a lowering of interest rates before that time. "Reagan is afraid to dump Volcker in the middle of a major fight on tax legislation," has been the rationale.

The President's fear is based on an overt threat by Wall Street and London bankers this week to create a U.S. dollar crisis if Reagan ousts the Fed chief. Bankers argue that the Reagan tax plan is too inflationary, and the President cannot afford it without tight money. In effect, Wall Street is threatening to create an uproar around the tax package as a "protection racket" for Volcker.

The President's request to Congress for a three-year tax bill is "too inflationary," William Griggs, chief economist of Schroeder Bank in New York said. "That's why Volcker tightened interest rates this week. Wall Street doesn't like the President's tax policy, and we're backing Volcker. The bigger the tax cut the President wants, the more we will complain, and the more impossible it will be for the President to demand that Volcker lower interest rates."

In this market environment, should the President "dare" to dump Volcker, "Reagan has more to lose than to win," said Michael T. Sherman, director of research for Lehman Brothers Kuhn, Loeb this week. "His tax package is an inflationary mess, and if he dares to fire the chairman of the Federal Reserve with this kind of inflationary environment, he will lose the public's confidence.

"Reagan would be raising the issue of who protects the national currency," the banker continued. "People locate their confidence in the currency within the independence of the Fed. What Wall Street is saying is that people will start dumping dollars. Forcing out Volcker at this point creates incalculable risks for Reagan."

"British and other foreign bankers would be very unhappy if Reagan got rid of Volcker, including especially the Bank of England and the West German Bundesbank," Mr. Griggs of Schroeder's added. "The dollar may look strong at the moment, but they would certainly sell dollars if Volcker were undermined."

In Washington, awareness is growing that Volcker is in fact working hand-in-glove with the Socialist International to topple the Reagan administration and turn the country over to House Speaker Tip O'Neill's social democratic wing of the Democratic Party.

Lehman Brothers' Michael Sherman was open about the alliance between Volcker's sponsors on Wall Street and "socialist" O'Neill to fight the President's tax program, not with a better alternative, but with the deliberate aim of paralyzing the President. "Wall Street and the Democratic leadership under Speaker O'Neill have the same view of the Reagan tax package," said Sherman. "They both think it's inflationary because big tax cuts mean a huge budget deficit. The Democrats have been using Wall Street's fears as their weapon in the debate against Reagan's program."

Interview

Galbraith on the blackmail strategy

From a June 2 interview with Harvard Economics Professor John Kenneth Galbraith, a liberal Democrat, provided to EIR.

Q: What are Reagan's political prospects?
A: It's been nice up to now, because he focused on the larger vision of cutting big government, but now comes the time for the consequences, when all constituencies have to take cuts. The honeymoon is over for Reagan. The leading Democrats like Tip O'Neill for example, are not going for his tax bill. Tip is going to flatly oppose any tax cut. The Democrats are the biggest fiscal conservatives in town.

Q: That's what Wall Street is saying.
A: The Democrats think just like Wall Street. I advise them to represent their people, and their people don't want more inflation.

Q: There will be no compromise with the Reagan administration?
A: No. They're going for confrontation. Tip intends to represent his people who elected him, and I'd urge Rostenkowski to represent his people as well. And they didn't vote for a tax cut for the rich.

Furthermore, as the cuts hit the constituencies, people are going to ask why the defense expenditures are so huge. It's incredible that they're exempt from cuts. I'm advising the Democrats to forego the tax cut, to question military expenditures, and also to start moving on demanding arms control negotiations.

This is partly for strategic survival, and partly for the economy's sake. I also advise direct restraints on wages and prices.

Q: Why aren't the Democrats attacking Volcker's interest rates?
A: Look, these rates are going to be politically disastrous for Reagan. They're disastrous, and that is the strongest single reason for resisting tax reduction. If you have tax cuts, you must keep money tight or you get real inflation. You can only lower rates if you do not cut taxes.

Q: Does that mean you're agreeing with the supply-siders in theory?
A: Yes, they're right. You have to choose between tax cuts and lower interest rates. If you call for lower interest rates, you're making the best case for rejecting Reagan's tax program altogether.

Q: But Reagan can't go back on his tax program.
A: That's right, he would have to reverse himself on his major policy, which he won't do, so that's a problem.

Q: You mean he's stuck with high interest rates?
A: Yes.

Q: Will people be blaming Volcker's actions on President Reagan?
A: His interest rates are going to be hung on the President. Reagan is responsible for the Fed's actions, it always gets hung on the President. It's going to be the basis for disenchantment with Reagan.

Q: Are you saying Reagan will be Hooverized?
A: There's a good chance Reagan will be Hooverized. His program reminds me of the story they told about Hoover, the horses and the sparrows argument. Hoover's economic theory was that if you give a lot of oats to the horses, eventually small bits of it will fall down to where the sparrows can get at them.

Reagan's programs have already been put on trial by Margaret Thatcher and failed in Britain. So Reagan could be Thatcherized.

Q: Won't a confrontation on tax policy paralyze Washington?
A: Yes. I say the Democrats are elected to do what's right, what their people want, and not to do what Ronald Reagan wants. They can't move over to his position. So the administration could be paralyzed. Then the liberal Democrats will be the winners.

This will also bring labor into an alliance with the liberal Democrats.

Q: What will Arthur Burns be telling Europe?
A: He'll be telling them they will have to stand for higher rates. They don't like that. Reagan's high interest rates are having a severe effect on Europe. And the Europeans are beginning to question his huge military budget as well.

Q: Reagan won't listen to them?
A: He hasn't so far. It's creating a distinctly unfavorable opinion of the United States in Europe.