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Group of Seven hands over policy to the central banks

by David Goldman

Exactly those issues which the Ottawa summit should have resolved were taken in hand by the central banks of the summit countries before the final communiqué was distributed, to such an extent that the events at Montebello lodge *distracted* world attention from the real exercise of economic power in the West. The American, West German, and Italian central banks instituted *qualitatively new* measures which further tie the arms of elected governments, and open a direct path to the worst-case economic scenario the summit was to have avoided.

West German Chancellor Helmut Schmidt, with characteristic bluntness, was the only world leader to tell the press the important story: that the governments would have to step back from the markets, reducing their outlays, "in order to give the central banks more maneuvering room."

Apart from this, the noteworthy developments came from Washington, Frankfurt, and Rome.

That American interest rates moved upward toward *possible new record levels* at the same moment that the economy was perceived to have fallen into recession should have been the big financial story of the year, at least by the standards of the American financial press. This conjuncture overthrows the banal game of perceptions that projected a fall in interest-rate levels once economic activity "cooled off," that is, a repeat of the events of the second quarter of 1980. Now the "expectations" of interest-rate declines have evaporated—witness the miserable performance of the stock and bond markets—as rapidly as "expectations" of economic recovery or even benign stagnation. The fall in real final sales during the second quarter combined with heavy, involuntary inventory accumulation means that an even steeper fall is preprogrammed for the third quarter (see Domestic Credit).

Despite admissions from a variety of established financial pundits that continued high interest rates will bring about major bankruptcies by the end of the year, Federal Reserve Chairman Paul Volcker informed the House Banking Commitee July 21 that the Federal Reserve will not only stick to its present course setting, but reduce by another half-percentage point its monetary growth targets for the last quarter of 1981 through the last quarter of 1982. Federal funds, the most important indicator of short-term interest rates, were trading solidly above 20 percent as of July 23, or about two percentage points higher than the mid-July levels.

The S&L question

By this action, Volcker has thrown the United States into an unpredictable period of crisis. Real trouble will emerge by the end of the third quarter, as Federal Home Loan Bank Board Chairman Richard Pratt indicated in a July 16 request to the Federal Reserve for an

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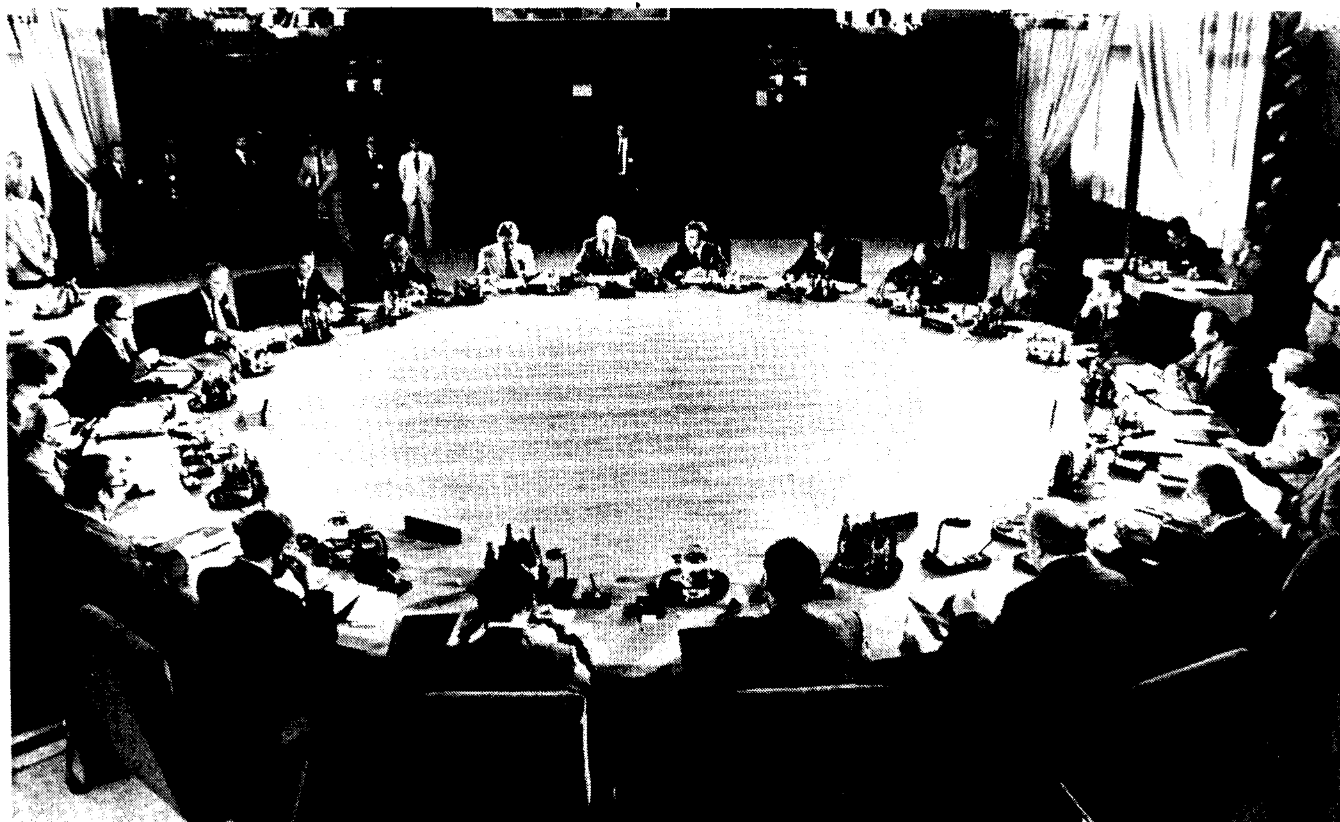
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The heads of state gather at Montebello, Quebec.

open discount window for the savings and loan associations.

Pratt estimates their cash needs, assuming continued high interest rates, at between $45 and $50 billion, while Commerce Department Deputy Secretary Joseph Wright, a former Citibank executive, spoke earlier the same week of a $75 to $80 billion "bailout." Volcker's first choice, like Joseph Wright's, would be to open the S&Ls to interstate and interindustry takeovers, i.e., buyouts by the commercial banks, in the manner of Chase Manhattan's $125 million "option to buy" the near-defunct Equibank of Pittsburgh, should banking regulations change to permit this.

Short of such takeovers, Federal Reserve officials report, Volcker has already told the Federal Home Loan Bank Board (FHLBB) that the discount window will, in fact, be open to the S&Ls, which opens the way to a monetary inflation such as the United States has never seen.

It is futile to attempt to guess what the Federal Reserve chairman will actually do. People to whom he looks for advice, like the "Group of 30" (the organization chaired by former IMF Managing Director Johannes Witteveen), have been debating the manageability of a classical credit squeeze for more than a year without reaching a conclusion. Better put, the individuals responsible for the irresponsible policies of the Federal Reserve and other central banks do not have the qualities of judgment required to manage a crisis of the magnitude that Volcker has set in motion, or they never would have advocated the actions that brought us this far.

Concludes Princeton University economist Peter Kenen, chairman of the Group of 30's academic panel, "Someone's going to have to print a lot of money."

Bank of Italy moves

In Europe, the Italian central bank took actions considerably more gruesome than anything the Fed has yet attempted. Starting July 20, the Bank of Italy shut its discount window to Treasury paper, which undermines the basic operations of the Italian banking system. Bank loans already cost an effective 30 percent. Now the banks' own cost of funds is certain to rise sharply, because their only recourse for refinancing is to sell their holdings of Treasury bills on the open market, instead of to the central bank.

The Bank of Italy's maneuver came a week after the Italian stock exchange underwent a "Black Thursday" type of crash, and the first government-directed closure of the stock exchange since 1917. With the accession of the first non-Christian Democratic government in Italy since the World War II under Prime Minister Giovanni Spadolini, the central bank's action demonstrates what

a new and ugly set of rules of the game are in force.

Meanwhile, the first action of the Spadolini government will apparently be to cut the rate of Italian government spending back to its target range of slightly over $31 billion per year, after monthly averages this year ranged upward toward $42 billion, which implies a staggering cut in social services and support for municipalities beyond anything that U.S. Budget Director David Stockman has imagined.

Finally, Spadolini has scheduled negotiations with the employers and the trade unions for the purpose of dealing with what the government calls "the second central problem in fighting inflation, the reduction of labor costs."

Pressing an incomes policy

A reduction in labor costs is also the subject of the recent pronouncements of the West German Bundesbank. Its central council attacked the results of the most recent round of wage negotiations, "which endanger price stability," as well as "the unexpected expansionary effects of the public budgets." These remarks, whose political weight is evident from Chancellor Schmidt's aggrieved statement after the Ottawa meetings, came in the context of an announcement that the Bundesbank would steer its monetary course toward the extreme lower limit of its targets for money-supply expansion.

A handful of commentators hope that a more straightforward approach toward the suppression of incomes (through reduced wages and transfer payments) might take the edge off the crisis which the central banks have unleashed.

In the back of the central bankers' minds, there appears to be a witting intent to force a crisis to achieve precisely this result. In its annual *World Economic Outlook,* dated July 19, the International Monetary Fund has the following to say:

> Another aspect of the solution lies in the use of incomes policy to support, or complement, sound fiscal and monetary policies. Incomes policy is now frequently identified with the setting of wages and prices through controls or other administrative means, often without a supporting program of restraint on aggregate demand. Several experiences along these lines in the mid-1970s failed, bringing incomes policy into a certain disrepute. There are, however, more flexible forms of incomes policy—varying among countries according to their political and social environment—that may contribute to the fight against stagflation. In a few European countries, for example, the authorities have been directly involved with industry and labor in a process of negotiation in which efforts are made to relate the growth of real wages to the average economy-wide gain in productivity.

Although a few pundits, e.g. the editors of the *New York Times* in a July 19 editorial, seem to believe that this sort of game will avert an interest rate-induced credit crisis, the appropriate reference for "incomes policy" of this sort is the Thatcher disaster in Great Britain. The most important economic action of the government following last month's rioting in major cities was to announce a cut in unemployment benefits for laid-off workers to $71 per week from over $100 per week, effective Jan. 1, 1982.

No such action has been taken by any British government since William Pitt the Younger commissioned Malthus's *Essay on Population* in 1798 as a justification for eliminating poor relief.

Thatcher, of course, wants to save about $600 million in a budget that has grown by 50 percent over the Treasury's projections, due to loss of revenues and higher unemployment payments. Unemployment has doubled in Great Britain since Thatcher took office to 3 million, or 11.8 percent of the workforce. The magnitudes of income reductions required in Great Britain now, and other countries subject to a monetarist regime momentarily, is past what could merge from the type of negotiations the Internaional Monetary Fund alludes to. Those who propose to take the edge off the crisis through officially sponsored reduction of incomes are in fact proposing to force such income reductions by springing a crisis.

Crisis of competence

No one is more aware than the central banks themselves of the unpredictability of the consequences of their actions. A source close to the New York Federal Reserve Bank's top management says, "At the Board of Governors in Washington, the staff are fighting the last war—they know what to do if there's another Herstatt [the West German bank that folded in July 1974] but not how to handle what's coming up. At the New York Fed bank the staff is a lot smarter—and they're just sitting there chewing their fingernails."

Below we discuss in more detail the lacunae in the crisis-management procedures of the central banks (see International Credit). What is especially telling, however, about the confidence with which the managers of the present international monetary system are entering a period of crisis is reported by *EIR*'s gold columnist, Montresor, in this issue. The statistical evidence demonstrates overwhelmingly that old European money is hoarding as much gold as it can get hold of, to the extent of shaking out the gold hoards of the developing sector for reimport and melting down into bullion in Europe. The supposed crisis managers have already voted "no confidence" with their own money.