Volcker on the way out: but what will replace him?

by David Goldman, Economics Editor

Federal Reserve Chairman Paul Volker's days in office are numbered, as Treasury Secretary Regan's June 18 announcement to the *Washington Post* of a general administration review of Federal Reserve conduct of monetary policy might suggest.

In fact, the rumors that unnerved the bond market June 22 that Volcker had submitted his resignation letter were not entirely false: the beleaguered Fed Chairman had written such a letter and left it on prominent display on his desk, but did not deliver it. In one way or another Volcker will leave, possibly as early as August; but it is far from clear whether a new and better policy direction will emerge.

Certainly the White House does not grasp the urgent need for the United States to take the lead in debt restructuring and long-term credit to the so-called Third World. Volcker himself, speaking to the Council on the Americas in Washington on June 22, said that the Latin American debt problem must be solved by cutting what he termed "rates of growth . . . that do not appear to me to be sustainable. . . . Fortunately," he added coyly, "there seems to be some tendency toward a slowdown," especially in lending to Brazil and Mexico. Acceptance of International Monetary Fund austerity regimens, he said, should be taken by private lenders as "a stamp of good housekeeping on a country."

Volcker concluded, "I hope in 1990 to be able to look back to some period of rising investment, rising productivity, and perhaps even lower interest rates."

Policy review and rumors

At least two separate policy-review efforts are at work. Publicly acknowledged is the Treasury review, in cooperation with the Council of Economic Advisers and the Office of Management and Budget. However, as the *Frankfurter Allgemeine Zeitung*, West Germany's leading business newspaper, revealed in a Zürich-datelined dispatch June 22, the Treasury is working out contingency plans for emergency action in the event of bankruptcies of "large corporations, raw-materials companies, or even large banks, as well as a possible big drop in the stock market." Swiss bankers, the German newspaper reported, concluded that Regan had given indirect confirmation to fears of a financial collapse; the article was headlined, "Fears of a Eurodollar Market Crash." Rumors of imminent American credit controls, originating in London, swept the foreign-exchange markets June 24.

Presidential Counsellor Edward Meese has made no secret of his inclination towards "other measures" than what the Fed has to offer, and Sen. Paul Laxalt's public comment that "credit allocation" might be required made public, in effect, the discussion among the President's political advisers.

According to usually reliable Washington sources, Meese recently conducted a meeting at Camp David with Treasury and other administration staff to plan a "Sunday massacre" in August, in which the White House would force Volcker's resignation on a Sunday, keep banks closed on Monday, and re-open the banking system on Tuesday under some form of controls. However, it seems unlikely that such a plan would be attempted unless the administration were to justify it on national-security grounds.

With money-supply growth now strongly in excess of targets, due to Volcker's decision last year to include savings banks' NOW accounts in the M-1 definition, the Treasury is complaining that Volcker shifted the definition in order to artificially raise money growth and obtain a pretext to keep interest rates high. The charge, which has understandable weight in the Oval Office, is true; Federal Reserve officials have emphasized to *EIR* that their policy is *not* to limit inflation by restricting money growth, which they believe is monetarist dogma, but to keep interest rates high—to "hold their feet to the fire," as one Volcker aide likes to put it.

Since the political pressure on the administration arising from persistent high interest rates is enormous, the Treasury position, as represented by arch-monetarist Beryl Sprinkel, has gained some credence in the White House for the first time. One indication of this is that Sprinkel has succeeded in forcing through a technical change long desired by the monetarists, the introduction of "contemporaneous [rather than lagged] reserve accounting" within the next six months.

The Treasury task forces are referred to internally as "Troika One" and "Troika Two." The first, on forecasting, is comprised of CEA economist Jerry Jordan (late of the St. Louis Fed); Office of Management and Budget chief economist Lawrence Kudlow, formerly of Bear, Stearns; and an unnamed Treasury representative, probably Dennis Karnowsky, a Sprinkel aide and former St. Louis Fed monetarist. The second and more important "troika," on monetry policy, is composed of Sprinkel, Kudlow, and Jordan. Overall direction of the task force is under the supervision of CEA Chairman Murray Weidenbaum, Regan, and OMB Director David Stockman. Sprinkel and his runabout Karnowsky have operational charge of the whole matter.

Nothing special is likely to emerge out of the task forces, which do not convene, much less report, during the crucial immediate period ahead; but the pressure has already begun to build. Speculation in financial and congressional circles centers on some dramatic move to impose *credit controls* in order to reduce money growth, since Volcker's rising interest rates have failed to stop the money supply from rising. That phrase is used in at least three different ways by different elements of the administration.

The credit-control question

First, as noted, Meese, Laxalt, and the "Western" group of advisers which the press used to call the Kitchen Cabinet favor some form of credit allocation, although the concept appears to still be vague in the minds of the leading participants.

Second, Kudlow, Jordan, and various monetarists are toying with what the *Wall Street Journal* favored in a June 22 editorial entitled "Bring Back Bretton Woods," that is, a formula for intervening to restrict or loosen credit should the dollar fall or rise against some "price measure," e.g. a parity relationship to foreign currencies, or perhaps gold, or the old Bretton Woods neither-fish-nor-fowl combination of the two. Without visible prospects of success, this discussion merely adds to background noise.

Third, the Federal Reserve itself, under prodding from the Treasury monetarists, may retaliate against criticisms by invoking a less drastic form of the credit controls Volcker put through in March 1980; the comparison is more to the sort of "productive loans letter" that Arthur Burns sent to the banks in his capacity as Fed Chairman in October 1974, thus triggering the bitter 1974-75 recession.

"The big question is when the banks will stop lending," said a New York bank economist, who noted that the 23 percent per annum rate of credit expansion during the year to date reflected "distress loans" to corporations gradually sinking into bankruptcy. "Banks will work with a company in trouble until it isn't worth it, and there is no way to stop the company from going under. They still have large credit lines outstanding to companies, which are a big obligation. The lending will stop when the Fed gives the banks the sort of excuse they want to stop lending."

However, as I showed in this space last issue, the collapse in profitability during the first (and presumably second) quarter left corporations with no alternative but to dramatically increase their rate of borrowing or go under; this staggering rate of borrowing, the largest credit demand on record, supported a still-declining production volume. A "productive loans letter," which does *not* mean allocation of credit to productive purposes but is simply Fed jargon for a shutdown of lending, would "kill the economy stone dead," according to one New York bank economist.

Meanwhile, an argument is under way in the White House over the status of the Credit Controls Act of 1969, which give the President authority to regulate every credit transaction any way he wants upon the declaration of a national emergency. The legislation will expire June 30, barring an extraordinary effort from both White House and Congress; however, attempts will be made to renew it in the current congressional session ending in October. CEA economist Jerry Jordan has already warned privately that the President would veto the legislation were Congress to pass it, while other presidential advisers are urging the President to do everything he can to keep it. The Republican Senate leadership opposes renewal on partisan grounds—the act gives Democrats the chance to point out that the President could take over the Fed if he wanted to—as well as for ideological reasons. How the White House will deal with the act is far from clear.