EIR Economics

Paul Volcker leaves the sinking ship

by David Goldman

For two years, Federal Reserve officials point out, Fed chairman Paul Volcker issued regular warnings that the United States could not continue to live on the foreign capital inflows that have made the United States the world's biggest debtor nation. Instead, he demanded, Congress and the administration would have to take draconian austerity measures to reduce federal spending. In the few days before his June 2 decision to refuse a third term in office, Volcker apparently determined that this President would not take such draconian measures—least of all in an election year. He decided not to be on hand for the recriminations, when the foreign credit of the United States collapsed.

At the International Monetary Fund, the Federal Reserve, and leading Wall Street investment firms, Volcker's departure left senior officials thunderstruck; Volcker himself had told friends only days earlier that he fully intended to accept a third term. In effect, the on-the-ground commander had announced that the battle was lost before it was joined.

The true turning point came May 29, when the New York Federal Reserve Bank's foreign exchange chief Sam Cross told a press conference that the volume of central banks' foreign exchange intervention—roughly $34 billion during the three months to April 30—equalled the U.S. trade deficit for that period. Foreign private lending to the United States shrank during the second half of 1986, and disappeared during 1987. America's entire foreign deficit, and two-thirds of the federal budget deficit, were financed this year to date by the printing-presses of foreign central banks, as they purchased with their own currency, unwanted dollars in the foreign-exchange market, and reinvested those dollars in U.S. Treasury securities. "That is the point where you have to stop extrapolating," warned a senior Federal Reserve staffer. "That is obviously not sustainable for the long haul."

Since the retirement last year of Federal Reserve Governor Henry Wallich, Paul Volcker has been America's connection to the Bank for International Settlements group of central banks, which now provide the *only* source of external financing for the United States. In effect, he solicited the foreign loans which propped up the fading credit of the U.S. government, and, at the point at which he could do no more, he left office.

The two governments

Whatever his personal motives for leaving, Volcker remains the casualty of the civil war among two governments in Washington. Having usurped the Congress's power to create currency, the major American banks have constituted a second government. That is true not merely in the technical sense, i.e., that their combined offshore operations *create money at will,* a privilege reserved for governments; they also built the *parallel intelligence community,* whose machinations have come to the surface in the Iranian arms affair.

Both governments face bankruptcy, as a result of this usurpation. America's industrial and agricultural tax base has declined such that the federal government can neither tax nor borrow its minimum spending requirements at home, largely thanks to the monetary policy Volcker introduced after taking office in 1979. The offshore operations of the major banks, meanwhile, typified by (but hardly limited to) the Third World's $1 trillion debt, have left them insolvent as well.

Now, one government will become the other's receiver in bankruptcy. Volcker sought a mandate from the White House to become this receiver, and did not get it. Doubtless, the White House had preferred to keep Volcker in office, to "reassure a nervous financial world," as a *New York Times* editorial wrote—but on condition that he not do to the Re-

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publicans in 1988, what he did to the Democrats in 1980: plunge the economy into depression on the eve of presidential elections. It was this lukewarm invitation to limited authority that Volcker snubbed, in favor of whatever position in the high six figures he takes at a Wall Street investment house.

Citibank's $3 billion addition to loan loss reserves, forced the question of who bankrupts whom. The writing-down of Third World loans would force the elected government to bail out the parallel government, either directly, or by guaranteeing the repayment of Third World debt traded in a projected "secondary market." To assume the bad debts of the banks, the elected government would have to sacrifice its own credit. That is what Volcker demanded: drastic reductions in both defense and social spending, at the direction of America's creditors. As *EIR* reported ("President Reagan dives into the budget trap," May 22, 1987), a faction in Congress now wants the equivalent of a bankruptcy trustee for the federal government: automatic sequestration of spending above the Gramm-Rudman-Hollings targets, and the appointment of a special commission to determine long-term budget cuts.

The creditors' committee would consist of America's foreign creditors, represented by the International Monetary Fund, and the investment-banking cartel which markets the debt-paper of the U.S. Treasury. Lazard Frères' Felix Rohatyn, who set the precedent for such trusteeship with the "Municipal Assistance Corporation" which ruled New York after its 1974 bankruptcy, set forth the terms of such trusteeship in a recent speech.

"The U.S. today is headed for a financial and economic crisis just as New York City was 15 years ago," Rohatyn said. "What appeared to be only a possibility five or six years ago became a probability more recently, and has now become a virtual certainty. The only real questions are when and how. In addition, when the crisis occurs, it will entail, quite possibly, a worldwide recession. The facts are that the U.S. has been guilty of the most irresponsible fiscal behavior in its history for the last seven years. American fiscal folly, coupled with our inability to coordinate economic policies with Europe and Japan, have created an ever-increasing worldwide pyramid of debt that cannot withstand a major recession."

What should be done? Rohatyn protests that we "have committed $2 trillion for a defense program of dubious values . . . been unwilling to limit . . . Social Security and Medicare . . . and that, in an act of ultimate financial cowardice, we have attempted to pass on to our children the cost of this behavior by borrowing from tomorrow instead of taxing today."

His recommendations are identical to those of the International Monetary Fund staff, namely, spending cuts and tax increases in the United States, combined with monetary and fiscal expansion abroad, to continue financing a reduced American deficit.

But Volcker determined, Washington sources emphasize, that Treasury Secretary James Baker III had failed to obtain the required commitments from the Europeans and Japanese to maintain support for the dollar after the Venice summit. As Rohatyn had warned in the same speech, "There is no purely American solution to any of our major economic problems. The U.S. cannot afford a recession that would drive our deficits to more than $300 billion and possibly cause a crash in the value of the dollar as well as in the stock and bond markets. The result could be massive domestic and international banking defaults, a world recession and political instability in large parts of the globe. Avoiding such a scenario, if possible, would involve a delicate combination of coordinated domestic and international efforts: The U.S. would cut its deficit with new taxes and expenditure reductions . . . [while] to avoid a collapse of the dollar, Japan and Europe would stimulate growth, cut taxes, increase spending."

In summary, Volcker could neither force the administration to take the bitter medicine before presidential elections, nor could he count on America's allies continuing to extend the exposure of their banking systems, in the face of a global financial disaster.

Why Greenspan?

Federal Reserve chairman-designate Alan Greenspan got the job from a White House which wanted a free-market ideologue who is also a loyal Republican. A well-informed Washington source adds that Greenspan accepted the position, which the more astute Volcker spurned, only because he is power-hungry enough to ignore the danger he is walking into. Since his tenure as President Gerald Ford's economic adviser, Greenspan has been a favorite position-paper-drafter and committee chairman, tending toward the Henry Kissinger wing of the party. His principal qualification has been that he is a clever man with no strong views about anything. He has a sharp tongue, however; at a private Swiss monetary conference last year, he ridiculed the administration's so-called economic recovery. He has also gone on record recommending a level of 120 yen to the dollar as a supposed cure for the trade deficit.

There is no point in speculating what Greenspan might do in office; he is there, precisely because he may be caused to do almost anything. The White House has neither the intellectual nor moral courage to do what is necessary, namely, to put the parallel government into receivership, through a general banking reorganization. In principle, President Reagan wants a constitutional amendment for a balanced budget, and Treasury Secretary Baker wants increased International Monetary Fund surveillance of the American and other economies. In practice, the President and his circle do not wish to throw the election 18 months in advance. That left only the choice of a mediocrity for Federal Reserve chairman, who will act on behalf of whatever forces prevail.