

## EIR Special Report

# Volcker's clamp on the economy: past and future results

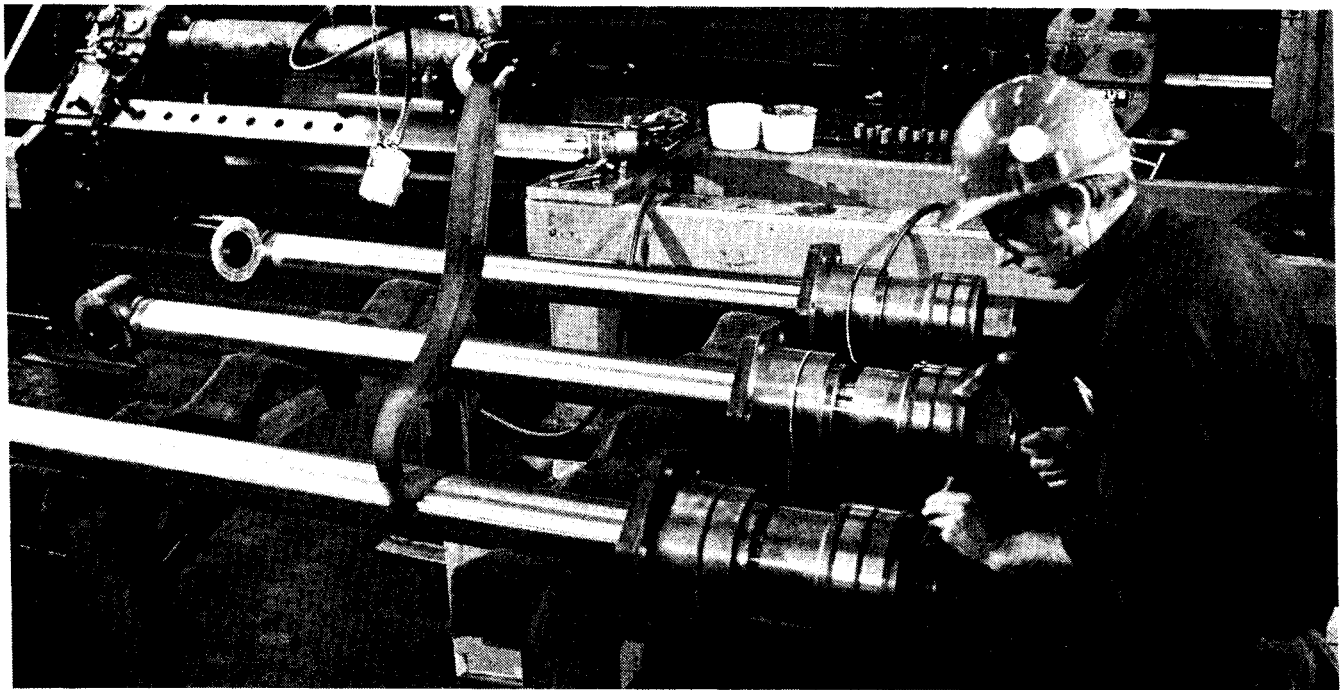
by David Goldman, Economics Editor

Last Sept. 2, *EIR* forecast a modest recovery from the depths of the 1980 industrial downslide, motivated immediately by the halving of interest rates that summer from their February 1980 highs, followed by a new downturn during the second half of 1981, or earlier, should Jimmy Carter remain in office. This forecast for the aggregate economy was elaborated, in January and again in May 1981, as a highly differentiated change in the structure of the American economy, within the same overall parameters.

Now the evidence is accumulating, to the point that the "consensus" of forecasters is finally that the United States economy will be in recession during the second half of 1981. If the "consensus," at last, cannot manage to be wrong, at least they are succeeding in being thoroughly misleading.

Short-term "business cycle" fluctuations have very little to do with what is at issue. *EIR's* success in such forecasting stems from an approach which begins with the LaRouche-Riemann model's unique capabilities for "long-wave" forecasting. The computer model provides the only accurate quantitative analysis of the underlying crisis of the American economy. As an afterthought, short-term forecasts are possible from this unique vantage point, given a competent financial model and the political-intelligence capability to "outguess" the predictably stupid moves of both the monetary authorities and market participants.

However, the United States, and therefore the world economy, have entered a period where the political choices that must be made are so fundamental that it is not possible to forecast more than the appearance of a crisis sometime during the fourth quarter of this year. What form the crisis will take, and what might lie beyond it, are not yet decided. To the extent that the computer-based forecast presented in this Special Report accurately portrays the declining path defined by the *present momentum* of the U.S. economy, it does not tell us at what point this trajectory will intersect a monetary and political crisis. Since among the readers of *EIR* there are a number of participants in the decisions to these questions, it is sufficient that we all be clear as to the nature of what faces us.



Courtesy of Bucyrus-Erie Co.

*Assembling hydraulic cylinders: capital goods are not flowing into the requisite industries.*

First, let us agree with the Federal Reserve's cheerful confession that its supposed program of monetary control is a hoax, i.e. that narrowly defined money supply no longer has anything to do with other measures of monetary expansion, bank lending, or the economy in general. The first eight months have not been a period of monetary restraint, but monetary explosion, as the Federal Reserve staff will admit to any caller. What Salomon Brothers' oracle Henry Kaufman calls the "credit proxy," or simply business borrowing, has risen at a 35 percent annual rate. Economist Alan Reynolds of Polyconomics Inc. in Morristown, New Jersey, has constructed a monetary aggregate "M1-X," by "adding to M1-B the increase in money market funds, overnight Eurodollars and repurchase agreements," etc. His measure rose at a 22 percent annual rate in July, on the same path that this measure began at the start of the year.

### **The money-supply explosion**

Other such approaches are possible. What stands out is the simple fact that U.S. corporations opened \$36 billion of Eurodollar market credit lines in the single month of July, partly to obtain quick funds for merger negotiations, but also to prepare for direct controls on lending in the United States. The one area central banks cannot control—merely because they have not yet demanded of the banks sufficient information to do so—is loans from the Eurodollar market to domestic corporations.

Of course, the market still reacts to weekly changes

in the silly M1-B measure, not because anyone except University of Chicago cultists believe it means anything, but because the Fed has the market trained through classical punishment-reward techniques. Because the Fed has conditioned the market to expect higher interest rates when the nonsense-measure M1-B rises, it responds appropriately, except to the extent that reality pokes up through the floorboards.

The side of the monetary process that has become "objective" is that over 65 percent of the gross internal funds of nonfinancial corporations must now be applied to interest on existing debt, against an average historical value for this ratio of about 25 percent. About 40 percent of all lending this year, *EIR* economist Richard Freeman calculated, merely refinanced old debt service, while a further 20 percent financed debt service indirectly, by keeping unsold inventories on retailers' and wholesalers' shelves rather than winding down production.

To the extent the Federal Reserve intervenes to slow the rate of liquidity expansion, itself due to the extreme illiquidity the Fed created through its initial high-interest policy, one of two things may happen. Either corporations will liquidate inventories and production, leading to a severe downturn, or they will cease to pay debt service, and enter bankruptcy proceedings.

That the Federal Reserve would do again what Arthur Burns did in October 1974, or Paul Volcker in March 1980, i.e. advise the banks to stop lending, has been predictable all along. Whether this takes the form of outright credit controls, or the more discreet appli-

cation of a "bank credit target," is of secondary interest. "Paul Volcker wants a recession, and, by God, he's going to get one," said a senior economist at the Federal Reserve Board of Governors. The only problem is, Volcker may get considerably more than that.

### Investment areas

The second, and more important, point of agreement is more elusive, if only because the most basic criteria of competent economics have been overwashed in the gush of "supply-side" economics and so forth. What the LaRouche-Riemann model permits is a rigorous examination of how the physical economy functions. To be specific, it immediately dampens the enthusiasm for so-called "sunrise industries" or "information society" devices.

As we indicated in our last general forecast, which took into account the combination then proposed of tight money, across-the-board tax cuts, and an expanded military budget, every dollar of sales in the economy is not equally important, particularly with respect to the prospects for getting the economy through to next year. If investment shifts to oil and electronics from steel and auto, but the product of electronics is consumed mainly in the form of home video games, office equipment, and military procurement, the shift represents a *net loss* to the economy. It does not matter, except in the very short run, that the electronics industry is much more productive (e.g. value added per unit of labor cost in the office equipment sector, such as computers, is about two and a half times as high as in the steel industry). So much more of the electronics industry's product is consumed as "overhead," rather than ploughed back into the stream of production that the shift actually lowers *real productivity*, measured by the key ratio of reinvestable surplus product divided by the sum of capital and labor costs in tangible-product terms.

Even more obvious, if more difficult to accept, is the fact that the present oil-drilling boom is a case of the economy collectively banging its head against the wall. It represents the substitution of American labor, raw materials, and capital goods to the extent of \$15 to \$20 per barrel in extraction costs, if not higher, to save the purchase of Saudi oil, at a per barrel extraction cost of less than \$1. Of course, the Saudis extract payments from us of \$34 per barrel, and a complicated financial mechanism is required to obtain, once again, use of Saudi revenues. But the underlying point is that American energy "independence" at the higher end of the production-cost spectrum represents a massive charge against the future potential of the American economy.

Together, all forms of energy-related investment, including oil and gas drilling, down-sizing of automobiles and aircraft, energy conservation, conversion of

refineries to heavier crude oil, amount to 45 percent of all capital investment in the United States. Since the one form of energy investment that is best justified by state-of-the-art technological standards, nuclear power-plant construction, is practically nonexistent, the entire remaining mass of investment—except for a few obvious improvements—represents a form of economic retrogression. In other words, the differential between the cost of solving the energy-supply problem through construction of nuclear power plants and between solving it through investments of the sort America is now conducting represents a straight addition to "overhead."

### The basis for downturn

For this reason, as *EIR* has emphasized, the internal content of the last year's industrial behavior is much more significant than the absolute volume of output. To the extent the economy has actually recovered, auto, housing, steel, and a handful of other industries have marginally revived above the 1980 trough point, but remain far below the 1970s' production average. To the extent that the industrial production of the nation has stabilized (most of the increases registered this year in the Federal Reserve's industrial production index reflect more statistical fluke than real output), this has occurred in a disturbing way. The sectors leading the increase are petroleum, electronics, machinery, and so forth, the so-called sunrise sectors who produce mainly for consumption as overhead. In other words, the division of the economy into a "losing" and a "gaining" stream of production, the characteristic of the economy's behavior since Volcker began his monetarist turn in October 1979, reflects a worsening of the actual problem, not a solution.

Built into the present computerization of the extent to which the *unproductive consumption* of the industrial product will lead to a future downturn. The projections we present below show the *structural* tendency of the economy toward decline according to these criteria. No other economic model is oriented toward such fundamental distinctions; the standard Wharton-variety econometric procedure treats gambling casinos and McDonald's hamburger stands indifferently from steel mills. The subtler distinctions, e.g. between energy savings due to expenditures on computer control of factory heating equipment and energy savings due to the provision of cheaper electrical power through the construction of nuclear generating facilities, lie entirely outside the imagination of the Wharton-variety forecaster. To the extent that such forecasts miss the fundamental structural tendency of the economy, no amount of sophistication by way of equation-fitting and financial analysis will prevent them from making devastatingly wrong predictions about even the near term of events.