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Foreign Exchange by Richard Katz

For the EMS, small breathing room

Given the way London is manipulating OPEC and driving up interest rates internationally, the European Monetary System's "phase two" will never happen—unless it happens soon...

A private, in-house meeting of the Dresdner Bank's foreign exchange experts last week concluded that U.S. inflation would continue at a 15-20 percent rate despite a predicted serious recession in 1980. In that context, said the experts, gold would rise to over $1000 per ounce within two years.

Similar meetings have occurred throughout West Germany warning that the European Monetary System (EMS)—originally set up as a dollar-stabilizing device—was incapable of stemming the new round of flight from the dollar unleashed by the latest rise in oil prices and interest rate hikes.

Even more worrisome, some proponents of the EMS have joined its opponents in predicting that the combined oil, dollar and interest rate stresses are building up centrifugal forces among the EMS countries which threaten to break apart the EMS as an institution.

The planners of the EMS had envisioned a two-phase process. The first, limited phase consists primarily in using the foreign reserves of the EMS members to intervene in the currency markets. This would stabilize the value of the dollar against the EMS currencies as a whole while maintaining stable relationships among those currencies. These reserves are now simply being overwhelmed by the oil, dollar and interest rate crises.

The opponents of the EMS don't intend to give it the breathing space to implement the second phase—using the EMS as a nucleus for wholesale international monetary reform. "The EMS will blow apart in the first quarter," gloated a top currency trader from one of London's most famous banks. "The mark will rise 5 percent while the French franc will rise not more than 1-1.5 percent. This will force yet another realignment of internal EMS currency rates—making a sham out of its pretense of being able to stabilize currencies."

With the EMS's stabilizing capacities on the defensive, London and New York bankers are gambling that the latest round of OPEC price hikes will send funds streaming out of dollars and into marks, yen and Swiss francs.

A disunited OPEC is to be the bludgeon forcing other currencies to share reserve status with the dollar. At the OPEC meeting Venezuelan oil minister Humberto Calderon proposed the so-called Geneva 1 formula, i.e., oil be priced in a basket of currencies but each nation be allowed to demand payment in the currency of its choosing. Calderon's proposal was referred to the long-range planning committee.

In the past, the Saudis have used this referal tactic to effectively kill the proposal, but observers believe the breakdown of OPEC internal discipline means that the policy will be implemented, on a country by country basis.

Already, Mideast and other countries have begun placing significant chunks of their foreign reserves in non-dollar currencies. In fact, even staunch dollar supporter Saudi Arabia provoked a 10-point rise in the yen two weeks ago when it purchased $200-300 million worth of Japanese Treasury notes. Some London banking sources predict that, beginning with oil, 20 percent of world trade will be denominated in deutschemarks by the end of 1980, compared to 12 percent now.

A top New York analyst added an interesting twist to the currency-diversification scenario. If the English courts rule against the U.S. attempt to freeze Iranian assets, he said, then developing country dollars will leave the U.S. for London—certified as a safe haven—and a significant portion of dollars will be converted into other currencies. On the other hand, if the British courts rule in favor of the U.S., there will be no safe non-U.S. haven. The OPEC countries would fear to flee the dollar so quickly as to rapidly send it—and their own reserve value—plummeting.

At this point no technical measures short of wholesale international monetary revamping can prevent dollar depreciation, fluctuations among all major currencies, increased reserve status for non-dollar currencies and a general flight from currencies into gold and other commodities. Whether this predicament leads to a de facto breakup of the EMS, or provokes France and Germany into a faster implementation of Phase II, remains to be seen.

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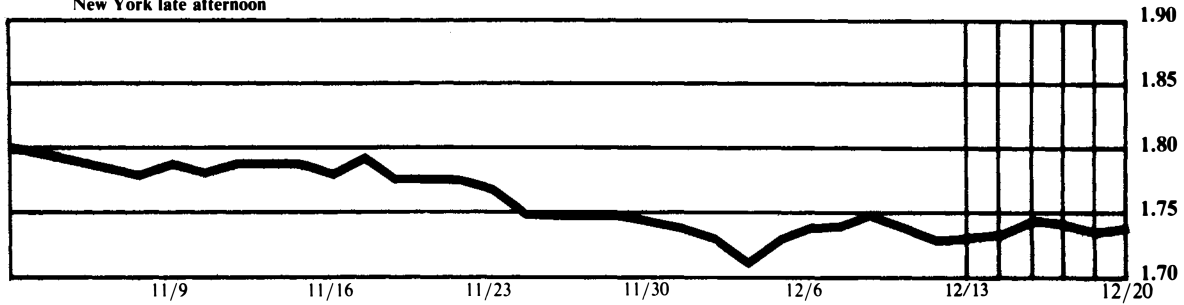
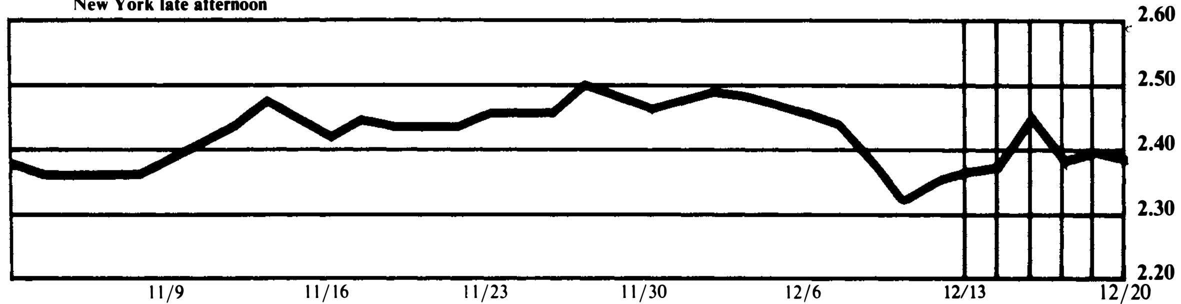
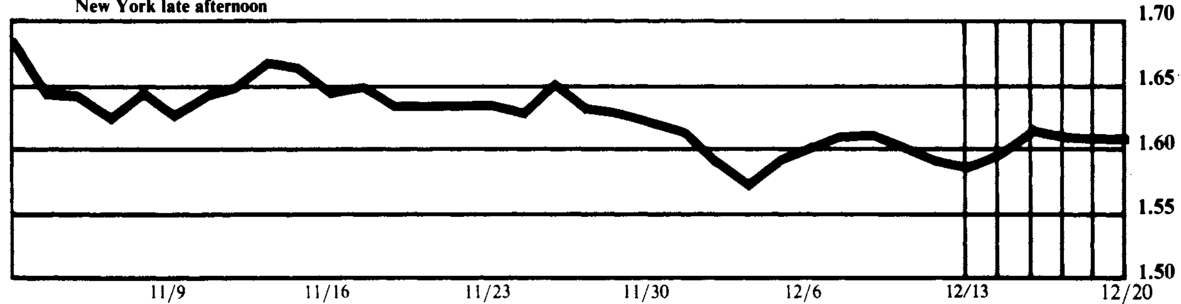
The dollar in deutschmarks
New York late afternoon



The dollar in yen
New York late afternoon



The dollar in Swiss francs
New York late afternoon



The British pound in dollars
New York late afternoon