I. ECONOMIC DIPLOMACY

Volcker's interest-rate war to set the international stage?

by David Goldman

Ronald Reagan began his presidential campaign at the Republican convention last July with a speech that included a pledge of currency stability and a preference for a "monetary standard," a coded reference to get gold backing for the U.S. dollar. But if the U.S. Federal Reserve continues its actions of the past several weeks, the new President will step into a major foreign economic crisis—coincident with a probable renewed downturn of the national economy.

In an effort to "discipline" Western Europe, in the words of a senior Federal Reserve official, the Federal Reserve began what the French call bluntly "interest-rate warfare" against the European Monetary System. The object, as detailed by Fed officials in background discussions with *EIR*, is to force Eurodollar interest rates up to the point that funds would flow out of the German mark—the pivot currency of the two-year-old European Monetary System—and into the dollar.

Although freely described by Fed officials, the content of the foreign side of Federal Reserve Chairman Paul Volcker's interest-rate policy is little discussed in the American press. It is a virtually daily topic of commentary in *Handelsblatt*, *Le Monde*, and other European journals, however.

A pre-emptive move

In effect, Paul Volcker has set out to pick a fight between the United States and Europe which neither Ronald Reagan, nor French President Giscard and West German Chancellor Schmidt, want. The action is more political than monetary. Paul Volcker, former strategic planning chief at Chase Manhattan Bank and (until he became Fed chairman) a board member of the elite Anglo-American Ditchley Foundation, is profoundly committed to the postwar special relationship with Great Britain.

Reagan's own philosophy would point, instead, to what has been mooted to be a "Washington-Bonn-Paris" axis, bypassing London, and also leaving behind the intensely anglophile international financial institutions, such as the International Monetary Fund, the World Bank, the Organization for Economic Cooperation and Development, and the General Agreement on Trade and Tariffs.

As former British ambassador to Washington Peter Jay put it in a recent *Economist* commentary, the issue is the resurgent nationalism expressed in Reagan's landslide electoral victory against the postwar "internationalism" of the IMF and similar institutions. A committed internationalist, a public advocate of "controlled disintegration of the world monetary system [as] a legitimate objective for the 1980s," Paul Volcker is conducting a pre-emptive strike against what he and his faction in the U.S. and Britain expect to come from a Reagan administration.

In the beginning of November, following a spectacular rise of Eurodollar rates into the 15 percent and higher range, the West German mark fell from about DM 1.9 to the dollar to DM 1.96 at the worst. However, the mark suddenly recovered with help that the Fed had not anticipated—massive purchases of marks by the Saudi Arabian Monetary Agency. On Nov. 12 the SAMA made its first *daily* purchase of about DM 3 billion, effectively establishing a "floor" under the German mark, in the estimation of surprised Fed staffers. The West Germans also began negotiations with the Saudis for a special credit facility of about DM 9 billion, in addition to the planned borrowing of ECU 10 billion projected by the European Community for next year. West German Bundesbank chief Karl-Otto Poehl went to Saudi Arabia last week, and the West German finance ministry played the foreign exchange market rumor mill brilliantly, alternately feeding background out to the German media and demurring that anything unusual was in the works.

The announcement that West Germany would play hardball on the foreign exchange markets came early in November from the dean of West German finance, Deutsche Bank Chairman Emeritus Hermann Abs. "Anyone who says that the German mark is undervalued," Abs told the press, "is both stupid and irresponsible."

At a London press conference Nov. 17 with British Prime Minister Margaret Thatcher, the German chancellor himself told reporters that the British pound was overvalued against the German mark, immediately provoking a slide of that currency to below $2.40. The British pound is largely sustained by short-term capital inflows seeking high interest rates for short periods of time, and is continuously subject to runs on the part of speculators who might, simultaneously, decide to cash in their winnings. "Helmut Schmidt is not above trying to provoke that scenario," said an American monetary official.

The dollar and the Euromarkets

But the bigger danger is that the same scenario could hit the American dollar. Unlike Britain, the American dollar has merits as an investment currency in the long term, and domestic U.S. financial and tangible investment is attractive to investors who hold strong European currencies. But the United States, after six quarters of uninterrupted falling industrial productivity, is now sliding into a worse trade-deficit position. Despite the severe recession, which would have in the past implied lower import demand, the U.S. will show the third $30 billion trade deficit in a row during 1980. The deficit in 1981 could be worse. If the Federal Reserve's monetary policy keeps interest rates at around their 1980 peaks for any significant length of time, the American economy will turn down again sharply, and the dollar will be in very bad shape.

However, a fall of the dollar to DM 1.70 or even lower does not, by itself, imply a fundamental crisis in the dollar sector. What is much more dangerous is the consequences for the world payments system of the Fed's high interest-rate policy.

Next year's payments deficits of non-oil-producing less-developed countries and weaker industrial nations (e.g., the Mediterranean countries) will exceed $120 billion, even presuming that there is no increase in the price of oil. The financing of these deficits, the majority of which are the debt service on $350 billion of commercial loans, depends on the interest-rate situation. Every 1 percent rise in the London Eurodollar six-month rate adds $3.5 billion to the deficit figure. If the Federal Reserve maintains dollar interest rates at a plateau above 15 percent or so for several months, the resulting increment to the world payments imbalance may be sufficient to provoke defaults or reschedulings on too broad a scale for comfort.

Ultimately, the parity of the dollar against other major currencies depends on the rate of profit of dollar investments compared to the rate of profit available in competing currencies. Dollar-sector investments in the Eurodollar market are principally *arbitrage*, that is, borrowing short term and lending short term at some interest-rate differential. A very large portion of the $1.2 trillion Eurodollar market, or about $400 billion, represents interbank loans, whose profitability depends on fine gradations of interest charges between different borrowers.

A portion almost as large is an arbitrage operation disguised as international lending: Eurodollar banks borrow at the London interbank offering rate (LIBOR), and lend to their developing-sector debtors the sum these countries owe by way of principal and interest on preceding loans. The loan is made at LIBOR plus a "spread," usually between 1 and 2 percent in the case of LDC borrowers.

The borrowing country immediately "repays" its previous debts with the proceeds of the new loan. The Eurodollar bank then makes a fictional profit based on the "spread" net of administrative costs.

Once the viability of this paper is questioned, the entire fraudulent game collapses, and the imputed "profit" due to the spread between the banks' own cost of funds and charges to borrowers is greatly outweighed by the prospect of involuntary moratoria or defaults on loans. At this point the bookkeeping rate of profit on Eurodollar lending will collapse.

Two options

There is no firm basis for predicting the likelihood of such a development. However, the Federal Reserve is playing a brinksmanship game, partly to persuade the Europeans to abandon what is still an ambitious loan program to finance their exports to the LDC's. If the Fed takes the credit system over the brink, the consequences for the dollar are incalculable. The result may be exchange controls of a type more drastic than Britain maintained until recently.

Whether the Federal Reserve and banks who share its views have evaluated this possibility, and would rather see a "Fortress America" fall-back position than a Washington-Bonn-Paris axis, is difficult to say.

However, these are the two paths that lead out of the present situation. The President-elect has the choice of working with the European Monetary System to restabilize the dollar, which means ultimately working off American foreign liabilities through *net exports*, or accepting the worst consequences of "controlled disintegration." Mr. Reagan faces an oil slick put down by the Carter Federal Reserve chairman. He will have to think fast to avoid the worst consequences of his predecessors' mistakes.