Why is the Fed supporting the franc?

Volcker's officials fear that the Germans may cut Mitterrand loose in order to strengthen the mark.

West German Bundesbank President Karl-Otto Poehl has been insisting since the beginning of the year that the German obligation to aid in the support of other currencies in the European Monetary System has been a source of weakness for the German mark. As such, the European Monetary System has been a convenient channel for a political subsidy from Helmut Schmidt's government in Bonn to his erstwhile political allies, the French government of Valéry Giscard d'Estaing and the Christian Democrats in Italy. Now that those governments are out, Schmidt may well let the subsidy go.

After falling from about 5.00 French francs to the dollar to less than 5.60 after Mitterrand's May election, the franc fell to 6.18 by Aug. 12. The French finance minister Jacques Delors, hastened to assure the financial press that no devaluation of the French franc was contemplated, praising the EMS as an "island of stabiliity in a sea upset by the dollar." Some commentary attributed the franc's subsequent modest recovery to the Delors statement. But well-placed West German banking sources reveal that the Federal Reserve began substantial intervention on behalf of the French currency that week, at the same time that the Bundesbank reduced its scope of intervention in the Paris market. This extraordinary action on the part of the Federal Reserve is doubly strange in the context of Treasury Undersecretary Beryl Sprinkel's revival of the old "benign neglect" policy toward the currency markets.

Apparently, the West German bankers conclude, Washington has a greater interest in supporting France's new Socialist President François Mitterrand than Bonn does. State Department chief Haig and CIA director Casey began a campaign on behalf of the French Socialist president soon after he was elected.

With an inflation rate already at 13 percent, double the West German rate, Mitterrand's hold on the French body politic was shaky to begin with, despite the strength of his vote in both the national and the parliamentary elections. French investors are putting funds into hard assets, and into Switzerland, as quickly as possible. Were the franc to drop, the rate of inflation would rise by roughly half the amount of the devaluation due to higher import prices, throwing France from the verge of an economic crisis into the thick of it. The French are hoping for a German revaluation inside the European Monetary System, a fixed-parity agreement among the European currencies excluding the British pound. German sources say that Bonn has rejected this proposal out of hand.

The remaining possibility is a devaluation of the French franc, along with the Italian lira and the Danish kroner, at least, against the German mark. Mitterrand wants to keep such a devaluation to a minimum, but the new tough line out of Bonn suggests that a devaluation would be major. Joining the franc would be the Italian lira which, according to some Italian press accounts last week, nearly left the European Monetary System altogether in mid-August.

Surprisingly, the British have joined the act. The London *Financial Times* Aug. 18 revived long-dormant discussion of possible sterling entry into the EMS in an editorial entitled, "Why Sterling Needs the EMS."

That the same institutions, e.g. the British cabinet and the U.S. Federal Reserve, which looked on the EMS with such hostility a few months ago, should now turn into its most fervent supporters is not surprising. They opposed a German political subsidy for Giscard and deposed Italian Prime Minister Arnaldo Forlani, and support such a subsidy for Mitterrand and for Italy's current prime minister, Giovanni Spadolini.

Turnabout, however, is fair play, and the Germans may cut the dead weight loose.

Schmidt fought his Bundesbank president bitterly on the subject of the European Monetary System, which he hoped would evolve from a mere currency area to a fully developed European Monetary Fund. Now he can let Karl-Otto Poehl take the blame for having wrecked the fund.

German bankers predict a "tactical shock" to the foreign exchange markets, in which the Bonn government would suddenly stop intervention on behalf of the French franc.