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Latest Stage In Pound-Dollar Battle:

Central Bank Support Operation For Dollar?

Next week's meeting of the Bank for International Settlements, the central bank for central banks, in Basle, Switzerland, might be the occasion for a massive central-bank support operation for the U.S. dollar. Word of this possibility, which seemed to originate with the Japanese but more likely comes from the Federal Reserve and the West German Bundesbank, was the major factor in the dollar's recovery at the end of this week, according to foreign exchange traders at the big New York commercial banks.

In addition, some of the biggest banking and corporate muscle in the United States has decided that the only way to break the fundamental problems underlying the dollar's recent weakness is to organize a massive drive to correct the U.S. trade deficit from the export side. Apparently, this decision will be reflected in the proceedings of the National Convention on Foreign Trade in New York City Nov. 14-15.

With these and related actions, the world monetary system has eased back slightly from the brink of a catastrophe which earlier threatened to take the form of an uncontrollable run against the U.S. dollar. At deadline on Friday, Nov. 4, the foreign exchange markets were relatively quiet, and the U.S. dollar stood at about 2.26 to the deutschemark and $1.8060 to the pound sterling, not substantially different from the week's opening, and a strong recovery from the record lows registered against major currencies earlier in the week. Perhaps more significantly, key short-term interest rates also ended the week where they began, with the Federal funds rate at a shade over 6.5 percent, and the six-month Eurodollar rate steady at 7 and five-eighths. The steadying of interest rates seems to have accounted for the last-minute recovery of the New York stock exchange, which rose 7.28 on the Dow-Jones Industrial index to 809 in trading Friday, after threatening to close the week below the 800 level.

The converse of the dollar's steadying occurred in London. Sterling fell back sharply from the Wednesday, Nov. 2, high of $1.86, and massive foreign profit-taking hit the stock and bond markets. The *Financial Times* industrials were down 31 points on the week to 476; gilt-edged stock were down, on average, almost 3 points on the week; and the flash-in-the-pan British financial recovery suddenly appeared to be in short-term danger.

These events are the result of several layers of political action from New York to Tokyo, but the week's leading performers are probably Fed Chairman Arthur Bruns and his New York City banker constituents, and the Western European monetary authorities.

Burns's Bluff

Developments on the interest rate front earlier this week baffled money market participants. But now that the dust has cleared, word is out that Arthur Burns has hoisted up fighting colors. Burns let the Fed funds rate drift up to 7 percent on Monday afternoon, leading to panicky speculation that the Fed's target for the central Fed funds rate had moved as high as 6 and three-quarters. Dispelling these fears, the Fed's trading desk injected liquidity to bring rates within a shave to where they had been on Friday. Eurodollar rates, which had earlier led the domestic rates upward, followed an identical pattern, indicating that the Fed was in close control of events.

Under pressure from the Fabian gang at the Council of Economic Advisors and the Treasury, Burns had earlier avoided striking action on the money markets. But Monday's action was a direct warning that the Fed would stick to a strong dollar policy at all costs. In particular, the move was a strong signal to the Western Europeans, who had held back from heavy intervention during Monday and Tuesday's foreign exchange trading. But Burns was also sending a clear signal to the White House that he would resist efforts to unseat him as Fed Chairman when his four-year term expires on Jan. 1, 1978.

By Thursday, expectations were so strong in the foreign exchange market that the United States and West Germany would announce a joint intervention policy to prevent a further fall in the dollar, that the U.S. fund rose sharply in anticipation of the joint press conference that afternoon between U.S. Treasury Secretary W. Michael Blumenthal and Bundesbank President Otmar Emminger. When Blumenthal said that the countries' central banks would intervene to smooth out day-to-day fluctuations, but not to support the dollar's parity, the dollar immediately fell. But on Friday, word of the Bank for International Settlements meeting was a major factor in the dollar's recovery.

Sterling Floats — On Its Belly

Top Western European bankers qualified the Bank of England's decision Monday to let the pound sterling float upwards as a "disaster," which will "provoke a backlash." These predictions bore out over the week. Most press commentary ascribes Britain's sudden financial problems to the threat of major strikes by coal and electricity workers. Although the coal union's rejection of a compromise contract offer Wednesday,

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and the go-slow by electricity workers, represented a significant factor in the market, the story is much more interesting. Dresdner Bank foreign exchange traders report a rumor that the New York Fed itself was in the market selling pounds. Although this cannot be corroborated, there is no question that the entire New York banking community *wanted* to sell sterling, and top-level Fed officials were passing out recommendations that short positions against sterling would not be a bad idea. "A run against the pound is definitely possible," one said, "and it would be in the U.S. national interest."

Interviews with foreign exchange traders at the leading New York commercial banks show a consensus that sterling is in trouble. In retrospect, this should not be surprising. As W. German press sources (see below) explained, the Bank of England let the pound float under conditions they did not choose. The Bank's problem is that the entire market in sterling investment instruments has been swamped by the incredible $16 billion in capital inflows so far this year. The rate of sterling inflows has actually managed to exceed the Public Sector Borrowing Requirement. With reserves at $20.3 billion as of Oct. 31, Britain also had interest rates below U.S. rates, with double the rate of inflation, an unsustainable situation. Sales of British government stock could no longer stop the inflows from flooding the banking system with liquidity, and the narrowly-defined money supply rose at a 27 percent annual rate during September.

The City of London installations who planned the boom in the first place intended to move on to a major international investment program, making the pound sterling a world investment vehicle for the first time in 40 years. Under present exchange controls, resident holders of sterling may only invest in foreign securities by purchasing, at a premium of roughly 25 percent, investment dollars from a limited pool controlled by the Bank of England. In addition, such securities may only be cashed back into sterling if the seller surrenders an additional 25 percent of the sale value.

In unison, the British press argued for the lifting of these controls. But British trade unions exercised their clout inside the Labour Government and prevented it. The Trades Union Congress has argued that permitting sterling to flow out of the country would interfere with availability of investment capital for British industry. (Proponents of lifting controls, e.g. the daily *Guardian* newspaper, did not dispute this, but argued that foreign investment "at the highest possible rate of return" would be better than domestic investment).

Apart from philosophical objections, the TUC had a more down-to-earth reason for opposing the lifting of controls. A significant portion of their pension funds are invested in foreign securities bought at premium. Were the controls abolished, the re-sale value of these foreign securities would also drop by the current investment dollar premium.

This line-up of forces was consolidated at Wednesday's meeting of the National Economic Development Council, the tri-partite body of British government, unions, and labor. Representatives of the Confederation of British Industry demanded that the Government haul the sterling rate back down, fearing for the competitiveness of British exports. But the trade unions — forcing Chancellor of the Exchequer Denis Healey to support them — vetoed the lifting of controls. The CBI, which has reason to worry, probably has little reason to worry about a sterling rise in any case.

New Rules of the Game

Britain's attempt to re-emerge as a world financial power has been forgotten in the scramble for new positions, now that the rules of the game have changed. A bellwether is the Swiss banking community, most of which had followed British thinking closely until this week. (A good public indication was the performance of the Swiss Bank Corporation's Alfred Matter and Credite Suisse-White Weld's Michael von Clemm at the *Financial Times*' Bahrein Conference Oct. 21-22). According to very good European sources, Swiss banks liquidated between £250 and £300 million on Thursday, including £100m for Arab customers. A large part of these funds went into dollars and thence into gold, which rose sharply to $165.90 at the Friday London fixing. Strong Swiss profit-taking is a good sign that the smart money is playing the short side of the London market.

What follows? The French are pursuing negotiations with the Soviets which could have surpassingly important consequences for the shape of the monetary system (see *Economics*). Top West German banking sources report that they are planning to squeeze London dry, and use the outflow to fund a new Euromarket center in Luxembourg to rival London, along with a major gold market center. The Luxembourg proposal was a major ambition of the assassinated chairman of the Dresdner Bank, Juergen Ponto. A senior official of Commerzbank says that the major difference between London and Luxembourg will be tight enforcement of a "hard commodity" credit policy — trade and investment rather than speculation — through a "gentleman's agreement" of participating West German and French banks. Dresdner Bank officials say that centralizing Eurocurrency funds in Luxembourg could create up to DM 150 billion of credits to finance West German nuclear exports to developing countries.

Dollar Fundamentals

But the most important question is still to be settled, namely, the correction of the $30 billion a year U.S. trade deficit — which the Administration continues to predict will be sustained again during 1978. Leading U.S. bankers believe that this is unacceptable, and are planning a major export drive and new credit arrangements to finance it. "No matter how much central banks intervene, it will do no good unless action is taken to correct the U.S. trade deficit," commented the West German daily *Die Welt* Nov. 3.

Next week's annual convention of the National Convention on Foreign Trade will be a test of how far the banks will go. The conference, chaired by Bank of America's A.W. Clausen, will make the usual pitch for free trade and do its best to drum up the export spirit. Discussions with bankers indicate something bigger may be involved. One New York bank is circulating a type of "two-tier credit system" proposal. According to this plan, the Export-Import Bank would be given powers to discount trade credits at low interest rates. The impact

of such a development would be enormous. One manufacturing industry association spokesman complained, "We export mostly on medium term, and the banks have trouble with that. It's easy to understand it from their side of the argument — who wants to extend more risk to Brazil? They need the Exim Bank to hold their hands."

At least the political possibility of a major turn towards an export orientation is in the cards. Reportedly, top business leaders have "given it to Carter with both barrels" over the state of the dollar and are demanding action. Some are optimistic that the White House can be swayed in this direction.

—David Goldman

'Luxembourg Plan Will Favor Exports'

Carlos Di Arrigunaga, Senior Vice President and Economist with Bank of America, commented on the fall of the dollar in an interview last week:

Q: How is Bank of America responding to the fall of the dollar?

A: Well, everyone takes positions to avoid risk. But as far as the value of the dollar is concerned — if you compare the growth rate in the United States and any of the other economies, the dollar is very strong. Apparently this is being offset at the moment by the balance of payments. What really has to be done about the balance of payments is to increase exports. It is critical for the dollar to stabilize in 1978. The central banks should intervene to support it.

Q: If central banks mop up the excess liquidity in the international markets, won't this pose a problem in terms of availability of liquidity, say, to refinance LDC debts?

A: Liquidity can always be made available again. The Fed can put it in as rapidly as it takes it out. But the point is, this is a temporary measure, in lieu of economic expansion abroad, which is what we need for the balance of payments to register an improvement. What the West Germans and Japanese are doing should help. The mild stimulation during 1978 and 1979 should favor our exports of plant and equipment.

Q: The West German fiscal program is not expected to do much, even by the West German government. The only serious stimulation program the Germans are talking about is the plan to centralize Eurocurrency funds in Luxembourg, and finance huge amounts of exports through the private sector.

A: The Luxembourg plan is exactly what I'm talking about. There are a large number of projects and deals in the works. The Exim Bank is also beginning to introduce certain policies that will favor exports. You see these policies cropping up across the board, like getting the Exim Bank to boost exports. The United States has the potential to increase its exports massively. I think we will see a whole range of programs to encourage exports, like the DISC program, but beyond that, there are a lot of potential markets. I see a real drive for exports, teaching businessmen how to export. If this kind of drive got underway, I think everybody will be surprised to see how fast exports take off. We can't wait for West Germany to stimulate its economy. Other countries really don't have a lot of room to maneuver. We ourselves have to initiate it.

Q: It seems the best Western European thinking is that a major increase of U.S. exports — say, nuclear plants — won't drive them out of existing markets but will help open up new markets.

A: That's absolutely right. A lot of markets can be developed, and it will only mean increased output, investment, and employment at home.

Q: Most of the New York bank economists argue that we have to cut oil imports to correct the current account deficits.

A: Energy conservation is all fine and good, but we have to do it on the export side.

West German Press Looks Grimly At Pound Sterling

In an article entitled, "The Pound Stands on a Weak Foundation," West Germany's economic daily Handelsblatt *commented Nov. 3:*

"The anti-inflationary policy (of the British government) is endangered by resistance from industry and the trade unions... Profound mistrust has emerged again (towards the pound), also from abroad."

This viewpoint was repeated in an editorial in *Handelsblatt* the same day: "The trust which is being shown towards the pound these days by the market is not justified by the facts. The market, it appears, is responding ever more sensitively. For example, whenever Blumenthal coughs, this is immediately taken as a sign for the beginning of a sickness for the dollar, and provokes a minor crisis... Banks and corporations in important industrial countries are swimming in liquidity, because alongside an expansive monetary policy, too little is being invested... (British European Economic Community Commissioner) Roy Jenkins' proposal (for a unified European currency) is useless. Such a Eurocurrency would have to immediately collapse..."