Foreign Exchange by David Goldman

The wreck of the EMS

The European Monetary System may be disbanded—or transformed into a vehicle for austerity.

Unless President Ronald Reagan quickly calls a halt to Federal Reserve Chairman Paul Volcker's upward spiraling of world interest rates, the European Monetary System will most likely be disbanded by early summer.

French President François Mitterrand of the Socialist International is expected by many Paris and New York bankers to "pull the French franç right out of the EMS snake within days," Bankers Trust Foreign Exchange Advisory Service's John Van Belle reported this week, adding that soaring U.S. interest rates will pull flight capital out of Europe for months.

West German Chancellor Helmut Schmidt is "politically committed" to maintain the French franc in the EMS, bankers say, and thus for the last several weeks has directed the Bundesbank not to raise its interest rates. The West German Lombard rate has been held at 12 percent, compared to an 18 percent effective U.S. discount rate, in spite of the fact that this allows a run out of German marks into dollars. It is only the 5 percent differential between the Banque de France discount rate, now at 18 percent, and German rates that prevents a total collapse of the franc against the mark.

Instead of raising German rates, the Schmidt government this week organized a massive attempted "bear raid" in support of all European currencies against the dollar. On May 20 alone, the West German, Swiss, French, and Italian central banks spent an estimated $1.5 billion in sudden intervention. "It was an attempt at an offensive move," said Bankers Trust's Van Belle, "to show the resolve of the central banks." European intervention during the week that François Mitterrand took office is estimated at more than $2 billion.

Schmidt's initiative failed, however, in the face of massive capital flight into the dollar.

"The central banks were simply overwhelmed," said Van Belle, "and the day after the attempted 'bear squeeze' the franc collapsed by 3 percent and the mark by 2 percent against the dollar.

"Our expectation is that the French franc will be withdrawn from the EMS within days of Mitterrand's investiture."

"The bottom line is that the cost of staying in the EMS, given the size of the speculation against the franc, is too high," said another New York banking source. "It will run France over $5 billion by the time of the June French parliamentary elections alone."

There are other possible scenarios, however, under which Mitterrand and the British government of Margaret Thatcher would attempt to maintain the appearance of life in the corpse of the EMS. By keeping the snake together, advisers such as Chancellor of the Exchequer Sir Geoffrey Howe hope to use the EMS as a vehicle through which central banks will impose "postindustrial" programs upon Europe.

Howe made the surprising announcement following the Mitterrand election that it was now time for Britain to consider joining the EMS. Sources in London say the British believe that with former French President Giscard out of the picture, Helmut Schmidt is now politically weakened in Europe to the point that Britain may be able to "capture" the EMS.

The British would use the EMS as a "currency bloc" against the U.S. European anger at the Volcker high interest-rate policy would be turned against the Reagan administration, whose new policy of not intervening to support European currencies "looks like giving 'monetarism' the same sort of reputation that Attila gave to the Huns," wrote David Marsh in the *Financial Times* of London this week. Undersecretary of the Treasury Beryl Sprinkel, "who makes foreign exchange pronouncements for the administration," is "displaying gross insensitivity about the effects of the marauding dollar on the rest of the world."

If Britain were to capture the EMS, Mitterrand would stay in according to this scenario, and the EMS central banks would move to take policy away from national governments. They would implement a somewhat "looser" credit policy, such as Socialist Mitterrand might desire, but the central banks would seek to ensure that available credit is turned from nuclear and other high-technology industries, as it now will be in France, and into labor-intensive industries.

That would spell the end of the European economic miracle.