Foreign Exchange by David Goldman

Battle over the dollar exchange rate

At issue is whether the European Monetary System or the dollar becomes the world's vehicle for flight capital.

Donald Regan's blessing Aug. 16 for Salomon Brothers' plan to market packages of Treasury securities to foreigners under conditions of anonymity may or may not be torpedoed by the Senate; if it is not, it may or may not attract additional European investment capital into the United States.

The significance of Regan's remarks, viewed as a positive sign for the Treasury bond market by American institutions, is that the Treasury has based its strategy on raising funds from dubious sources, i.e., "flight capital"—mainly tax-evasion and narcotics money.

To restate a point made frequently in this space: The dollar's strength does not reflect any pronounced investment demand for dollars, but rather the collapse of dollar supply due to continuing fears of a banking crisis. American banks are shipping deposits back to the United States, rather than lending on the offshore markets; in any event, deposits have become scarce offshore since the Continental Illinois disaster.

As Paul Volcker keeps warning, conventional investment demand for the dollar is running dry, and Regan's machinations in favor of "bearer" bonds or some equally anonymous equivalent packaged by New York brokerage houses show how willing the Treasury is to dip into the polluted part of the well. The dollar has survived on a regime of flight capital since 1982, and is now riding the wave of financial crisis. How long it may continue to do so is uncertain.

European central banks clearly have a very different idea than Regan. The Europeans are now making an open play for flight capital.

That is the content of a proposal offered by former French government member Michel Inchauspe, now a member of the Finance Committee of the National Assembly, in *Le Figaro* Aug. 13.

"Europe today could, like France used to with the countries in the franc zone, allow some small Latin American countries to enjoy a relatively guaranteed currency. This could be the case of Uruguay, Ecuador, and Bolivia, whose total combined indebtedness amounts to $17 billion. . . . The European Community could set up an ECU zone with these three countries, just as there is a franc zone with some African countries."

The countries Inchauspe refers to are the principal centers for distribution of flight capital out of Ibero-America.

Wrapping his proposal in pro-growth rhetoric, Inchauspe suggests that long-term infrastructural and industrial investment credit could thus be issued. "How could Europe fail to take its part in this possibility of recovery by guaranteeing the currencies of the three countries that would freely accept the disciplines of an ECU zone?. . . Should the experiment succeed with the three countries, it could gradually be extended to the other nations of Latin America, the operation being structured with two monetary unions and two operating [central] banks. . . ."

A City of London banker commented: "In the 1930s, France ran the so-called 'Gold Bloc' with Switzerland and the 'Latin' countries of Southern and Central Europe. . . . They used the devastation of the dollar, sterling, and the mark to do that . . . and this today is also what is being prepared with the ECU of the European Community, the substitute to the dollar."

Jesuit monetary planner Robert Triffin is the godfather of the plan. Inchauspe, the scion of a banker family of the French Basque country, might entertain dreams of establishing a colonial successor to Basque emigré Iturbide, who became Mexico's "Emperor" in the 19th century.

British and French reductions of interest rates this week, a probe of the dollar's strength, should be seen in this light. The British clearing banks brought their base lending rates down by 1% to 11% during the first two weeks of August, and reduced it further by ½% Aug. 17.

The drop followed the Bank of England's ¼% reduction of its money-market dealing rates in early operations Aug. 17. The central bank had also lowered its rates by ¼% a day earlier.

In a commentary entitled, "British hopes for a further round of rate reductions—continuation of the attempt at de-coupling," the Swiss daily *Neue Zürcher Zeitung* warned the British that all would in be in vain unless they joined the European Monetary System.

"Perhaps it were more sensible for the Londoners not to pursue illusions of decoupling, but to give a great deal of thought to the question of the European Monetary System, which they still hesitate to join, if they wish to maintain lower interest rates as, for example, in West Germany."