

Foreign Exchange by David Goldman

A sterling-dollar crisis and the ECU

The collapse of Mrs. Thatcher's pound jeopardizes intervention on behalf of the weakening dollar.

It is now agreed among Wall Street seers that the Federal Reserve must continue to print money, and at least stabilize, if not reduce, U.S. domestic interest rates, no matter what the cost to the U.S. dollar—as this column has warned for weeks. The simultaneous collapse of sterling against the strong currencies not only makes the foreign-exchange crisis more difficult to contain in the short-run, but contributes to breakaway tendencies in the Atlantic Alliance.

In his widely read "Comments on Credit," Salomon Brothers economist Henry Kaufman pronounced on Oct. 3: "A renewed decline this week in the value of the U.S. dollar juxtaposed with fresh evidence of ongoing economic sluggishness, highlights the policy dilemma that now confronts the Fed. Efforts to spur growth through greater monetary accommodation could create additional strong downward pressure on the dollar. The Fed expressed its sensitivity to this quandary immediately before the last discount rate cut, noting at the Aug. 19 Federal Open Market Committee meeting that if the cut 'was followed by a substantial weakening of the dollar in foreign exchange markets, a little greater caution in the provision of reserves through open market operations was appropriate. . . . But as economic sluggishness persists, the Fed will eventually have to ease further, regardless of the dollar risk, and hope that parallel moves by other countries will dampen the dollar's descent."

Of course, no such parallel moves by other countries are in the offing, following the dismal failure of the administration's demand for "reflation" in West Germany and Japan at the International Monetary Fund meeting the first week of October.

The dollar has continued to flail just above the DM 2.00 level, exclusively because of heavy intervention on the part of the Japanese and European central banks. There is a definite limit to their capacity to sustain the U.S. currency in any event; what makes the present situation even less stable is the simultaneous crisis in the pound sterling.

Salomon Brothers notes in the same report: "Since mid-September, the British pound has slumped by 4% on a trade-weighted basis. The decline reflects mounting fears that reflationary policy moves may be implemented after the next general election, which could come within the next 12 months. Bearish sentiment has been further reinforced by a deteriorating current account performance, as exemplified by August's record 1.5 billion pound trade deficit. . . . The authorities have steadfastly kept official rates unchanged at just under 10%, and instead, the Bank of England—together with the Bundesbank—have intervened in the foreign exchange markets. . . . It is still likely, however, that British officials will see higher interest rates in the near future. . . . The markets may conclude that an increase in British rates of more than 100 points is necessary."

Sterling's situation worsened after the IMF meeting's conclusion. The British pound opened sharply lower against the mark Oct. 8, after a brief respite following the announcement of encouraging British money-supply figures. It sank to record lows on its trade-weighted index, starting the day at 67.6% of its 1975 value against a basket of 18 major currencies, 5 points down on Oct. 8's close. Against the West German mark, it opened at 2.8570 marks compared to Oct. 8's close of 2.88. . . . Reuters news service quoted foreign-exchange dealers saying that "apart from central bank intervention, there were no other factors supporting the pound."

In London, there are new warnings of anti-American sentiment following the administration's miserable performance at the IMF meeting. "The European banks, especially on the continent, are in an increasingly isolationist mood. This has sharpened especially since the tension between Washington and the German Bundesbank over policy. These European banks don't want to get further involved in what they see as U.S. incompetent handling of problems such as Mexico," one City of London source said. "Some of these continental European banks want an independent European financial system. There are signs of increased openness of the Germans to allow a private use of the European Currency Unit (ECU) which, if other things were cleared, could open an ECU as an independent reserve currency." The German Bundesbank on Oct. 8 denied that it is considering a change in its constitution to allow such use of the ECU, but admitted that Finance Minister (Trilateral Commission member) Gerhard Stoltenberg told a recent meeting of European Community finance ministers that he was planning to bring up the issue with the Bundesbank.