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Two financial zones

The Anglo-American sphere has run out of options

Currency dealers have noticed that for the past two months, the U.S. dollar and the British pound have functioned as part of the same currency zone, while the European Monetary System currencies have acted as a separate group. This does not presage the much-forecast era of "controlled disintegration" into currency blocs—on the contrary, the present state of affairs is in no way viable, as we shall show. As changes in government policies occur, however, they are tending to play themselves out in this context.

The pound sterling is currently in the range of $2.20-

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2.24. Since the dollar began crumbling in June, most of the outflow went into British gilts and similar instruments, not into the mark or Swiss franc; to the extent the dollar has recovered, it has mainly been due to a reflow from sterling.

In large measure this has taken the form of British buying up of American strategic assets. What the volatility of the sterling-dollar rate shows is the transfer of labile institutional investment money between these two areas.

The OPEC connection

Both the British and American institutions, who are trading short-term funds back and forth, will own up to the limitations of this game in private discussions, chief of which is the fact that their share of *new* deposits in the Eurocurrency pool is diminishing. The real "big potatoe," the newly increased OPEC oil surplus, is not finding its way to London for the most part.

Since the British and American governments threw their fortunes into the Camp David agreement, the field has been open to the French and West Germans. This is why there has been no progress over British entry into the EMS and why senior officials of the West German banks predict that it will never happen.

The petrodollars are flowing, and will continue to flow, along the channels of real trade. The Europeans have had the edge on state-to-state oil deals, technology transfer, and third country ventures with OPEC. The deposits have followed such arrangements with the result that the Europeans have dominated international lending markets.

A side-feature of this process is the dramatic improvement of the West German export surplus—export orders have climbed 14 percent this year unexpectedly—while American and Japanese trade performance has deteriorated over the same period. The West Germans are financing their exports lavishly, despite the complaints of Bank of England Governor Gordon Richardson about "over-lending." The detailed figures are not available, but private banking and U.S. government sources agree substantially that the above is the case.

Basis of EMS stability

All the talk about an end-of-June crisis for the European Monetary System, the centerpin of which is the French franc-deutschemark rate, has turned out to be a bunch of nonsense.

There has been virtually no pressure on the EMS currencies, and nothing is owed on this account to the turbulence in the dollar. The European trade profile has been, in real terms, at least sufficient to hold the currency system together. That has proved far more valuable than interest-rate changes in maintaining currency stability.

In fact, the relatively ineffectual quality of interest-rate policy (due to the largely political character of major currency flows) has been striking. For example, on July 12, West German Bundesbank President Emminger, an interest-rate hawk, raised the central bank rate 1 percent; French interest rates dropped marginally; and nothing whatsoever happened to the franc-deutschemark parity.

With the gold price apparently stable at over $290, the Europeans are in the strongest financial position ever, despite the oil price increase. It is a still undetermined matter of their political resolve whether and when they will opt for some form of gold-backed credit

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to take direct control of the international market's surplus of funds. But on the energy side, both in terms of oil supplies and nuclear prospects, the European position is strong.

The commodity scenario

In its most recent editorial, the London *Economist* suggests a way out of the Anglo-Americans' predicament—one which British bankers do not privately claim will really work, but which is worth mentioning in any event.

The *Economist* wrote on July 7 that the 40 percent rise in wheat prices and the 45 percent in primary metals prices over the past year makes it easier for the West to handle the OPEC price increase. Read straight, this statement is nonsense; OPEC does not buy enough wheat or metals to reduce its surplus, and other price rises would surely hurt the Western economies.

What the *Economist* means is that since most wheat and metals are produced in North America and the British Commonwealth, i.e. the dollar-sterling area, the additional income will accrue there.

This play on relative prices of commodities in international trade might not be insubstantial, if it could be made to work. If other prices than oil rise commensurately, the loss of the "big potatoe" might be easier to bear. What the *Economist* wants in addition, along the same lines, is energy taxes in the advanced sector to lower the income going to OPEC, more centralization of liquidity through the IMF, a threat to aid "dissident minorities" in the OPEC countries unless they get into line, and so forth. Correctly, the *Economist* says that monetary policy is really irrelevant to all of this.

IMF, market ploys hamstrung

The problem is that the British will not get through a single one of these proposals.

First, there is no way that Carter will get away with raising fuel costs further in the U.S. The only ones moving in such a direction are the masochistic Japanese.

Secondly, the International Monetary Fund is pretty much a dead duck at this late stage, with the French and Germans successfully blocking any efforts to give it more control over international liquidity, Special Drawing Right issuing powers, currency surveillance responsibilities, or anything of the sort. *Executive Intelligence Review* received confirmation of this picture from both the U.S. State Department, which bemoaned it, as well as European official sources at the IMF itself.

Thirdly, the rise in the prices of non-oil raw materials is by no means as certain a fact as the London *Economist* believes. The European Economic Community has for some time had a set of proposals on the table for direct purchases of raw materials from developing-country producers, bypassing the London Metals Exchange. West Germany has directly approached Malaysia and Zambia on this count during the last two months, with the likelihood of success.

There is absolutely no reason to believe that the existing channels of raw materials distribution, in which the British Commonwealth has a dominant role, will survive. Under such institutional discussions as the ongoing renegotiation of the Lome Agreement with the Europeans and their former African, Caribbean, and Pacific (ACP) colonies, and the "trialogue" between Africa, OPEC, and Europe proposed by French President Giscard, the Europeans are likely to pull a great deal of raw materials trade into their own orbit.

Two factors give them a special edge. First of all, the European banks are willing to lend to the LDC's, as noted. All that Gordon Richardson and Fed Governor Henry Wallich's efforts against commercial bank "overlending" have accomplished is to pull the unfortunate Japanese out of the running, while leaving the Europeans free room. The American and British banks are not even in the markets. The latest Comptroller of the Currency survey on American banks' foreign lending says that loans rose only 12 percent during 1978 to foreign borrowers, and that most of this rise was due to money market operations in London. The implication is that there was no new net lending to LDC borrowers.

Secondly, the Europeans' energy program gives them the edge in refined products. The prospect of cheaper nuclear-generated electricity in Western Europe and the Soviet Union provides a strong incentive for investment in new refining facilities there, not in the United States.

After the two-zone interlude

It may be concluded—and this follows the direction of the most realistic private discussions in London—that the British viewpoint is nine-tenths bluff. The entire set of present currency arrangements, in which the dollar rate is figured each day against sterling, is an aberration.

Ultimately, the dollar will have to reconcile itself to the European Monetary System, while sterling goes through a painful bankruptcy. The so-called threat of a major dollar fall is not as much of a threat as some commentators think, simply because the Europeans have the capacity to absorb a great many dollars, despite the Bundesbank's spinsterish upset about the effect of such support operations on the monetary aggregates in Europe. The moment that the Europeans opt for a credit-taking and -issuing arrangement out of the European Monetary Fund, they will effectively direct the flow of dollars on the international markets.

The next move is from Paris and Bonn.

—David Goldman

Let's jack the other prices up'

The following is from the London Economist *cover story of July 7, titled "Nightmares again"*

The oil shock of 1979 is not nearly as great as the shock of 1973-74.... This year's price rise in oil is not uncommon in other commodity prices. Metal prices have risen 45 percent in the past year, and world wheat prices by 40 percent. That's bad. But it is not 1974....

The bare necessities for policy are, first, that the big rich countries should act fast to put the International Monetary Fund back in the forefront of recycling, instead of relying on the commercial banks.... [The IMF] now needs a new "oil facility" to plug this year's wider deficits....

Second, the rich countries need to take some measures of interest-rate disarmament.... Stern monetary policies are a useful weapon against over-demand and perhaps against cost inflation, but they are not the most obvious means when it is necessary for countries to force their citizenry to accept some transfer of real incomes from themselves to the oil shieks. It would be folly if, out of mere change in political and economic fashion, it was forgotten that incomes policies work at their best to take a country through some once-for-all shock to real incomes....

At Tokyo last week the seven heads of government thought they faced an oil crisis.... They need to learn how to take advantage of the modest drop in the real price of oil which stagflationary recession might bring: say, only a 5 percent rise in crude oil prices next year but a 10-15 percent general price inflation in most other things? ...

The required policies for the year ahead? Higher petrol taxes, which have fortunately already been imposed in Britain and should be copied elsewhere....

The aim need not be "to break OPEC" (however desirable that might sound); it will be enough to cripple OPEC's power to impose real price rises.... For the longer term, there is room for some of the sorts of encouragement for nuclear power and for synthetic fuels.... But there is a danger ... in neglecting the encouragement of small-scale, messy, but in aggregate immediately more important measures of conservation....

A delicate point in the world economy

A London investment banker had the following to say when interviewed on July 11 by Executive Intelligence Review.

Q: *Have you read the* Economist *lead on how to rig the world commodity markets to deal with oil prices? Would such a scenario work?*
A: No. We're at a very delicate point in the world economy. Did you hear Blumenthal may resign? There has been no policy proposed that will work.

Q: *I hear the French and Germans told Carter to shove it on the International Monetary Fund surveillance question at Tokyo.*
A: Exactly; the interests of the two trading blocs—U.S. and Europe—do not coincide.

A: *You mean that the U.S. and Britain couldn't get the French to go along with stabilizing things by hitting OPEC back in turn with a price boost in everything else? The French would just go to the other raw materials producers the way they now go to the oil producers and do major direct deals....*
A: Precisely, the French will continue to do their traditional "French" own thing.

Q: *What about sterling being increased as a reserve currency? Wouldn't that help to stabilize the monetary situation?*
A: Forget sterling; it won't work. Sure, exchange controls will give, they'll lift them, but once any volume of sterling significant enough to matter gets into international financial markets, they won't be able to control the exchange rate. Sterling will be finished again. There is no policy.