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Central banks boost sterling and dollar

The Federal Reserve wants the D-mark to come down as much as 25 percent.

The surprising strength of the U.S. dollar and the pound is a by-product of the Federal Reserve and Bank of England reaction to the failure of last month's annual meeting of the International Monetary Fund. In the short term, the rise of sterling to $2.43 and the dollar to $1.86 against the West German mark is the result of an increased differential in interest rates between those currencies and their major competitors, the leading currencies of the European Monetary System. But, the policy causing the interest rate differentials is less obvious.

In the last several weeks, the extreme fluctuations in the yield curve on Eurodollar deposits has indicated great uncertainty among market participants concerning the near-term behavior of interest rates. Normally, the spread between the rates for one-month and one-year Eurodollar deposits indicate market expectations concerning interest rates; a lower rate, on one-year money shows that borrowers believe rates will fall, and prefer to borrow for one month.

Apparently, the market's uncertainty indicates that its perceptions are a few weeks behind the initiatives of the British and American central banks. In brief, the Federal Reserve and Bank of England want to enforce a global liquidity squeeze, in retaliation for the dismal response they received to their standing plan to turn the International Monetary Fund into a world central bank in the 1980s.

The authority of the IMF was undercut by its potential funders, including the U.S. Congress and the petrodollar-rich Arab countries, and by aggressive debtors like Brazil, who are successfully holding out against the IMF's proposed harsh debt rescheduling terms.

The two central banks' objective is to squeeze their potential competitors. A result of this objective is a flow of short-term funds into the dollar and sterling, due to higher interest rates in both sectors.

It happens that this coincides with the central banks' domestic policy. As *EIR* has reported during the last several weeks, the frustration of the Bank of England and Federal Reserve over the failure of a year of monetarist experimentation has reached a turning point. With some trepidation, the Fed is now evaluating the merits of "shock therapy," watching the semipublic debate over the extreme version of monetarist doctrine in such arenas as the Group of 30. For strictly domestic reasons, interest rates are most likely to keep rising in the short run. As soon as the rise in rates undercuts the housing market and other interest-rate-sensitive parts of economic activity, perhaps around the beginning of 1981, credit demand and interest rates are likely to fall again.

This is the standard Wall Street forecast, and the reason why economists like Lawrence Kudlow of Bear, Stearns forecast a severe dollar weakening when the interest rate cycle finally breaks.

But the situation is more complicated than this. The central banks are principally concerned with the state of the international monetary system. In conversations with *EIR*, senior Federal Reserve officials insisted that no matter what happened to the domestic economy, real interest rates must be kept at about 3 percent. That is, the Fed's interest rate objective is the rate of inflation plus 3 percent, or a level considerably higher than the present one. Chairman Volcker's insistence that the Fed is now concerned with money-supply aggregates rather than interest rates should be ignored. However unconcerned the Fed is about the effect of rising interest rates on the U.S. economy, they cannot be unconcerned about the effect of interest rates on the dollar.

Senior Federal Reserve officials are now predicting a German mark rate against the dollar of DM 2.25 to 2.50—a devaluation of 17 to 25 percent. *EIR* thinks this prediction is ridiculous. However, the Fed and Bank of England commitment to a weaker German mark could produce some weakness over the immediate period ahead. It assumes that world trade will decline in the context of global austerity, and that export-dependent nations like West Germany will suffer most.

However, this approach also leads to a global payments crisis which ultimately could destroy the dollar's ability to function in offshore markets. The central banks, having failed to impose their IMF plan, are subjecting the leading currencies to warfare that can produce sharp and misleading fluctuations.

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