Currency bloc proposal: Britain's monetary trap

by David Goldman

Despite the apparent warmth of his meeting last week with President-elect Ronald Reagan, West German Chancellor Helmut Schmidt is on course for an economic policy confrontation with the United States around the time of Reagan's inauguration. This is the direct opposite of Schmidt's intentions. But he has blundered into a deal with the likes of former British Prime Minister Edward Heath and European Community Commission Chairman Roy Jenkins which will have precisely that result.

In practical terms, the implications of Schmidt's blunder mean for the United States the formal bankruptcy of the American dollar, either through currency controls or through a distress sale of American assets. Schmidt's blunder has equally grave consequences for the Federal Republic of Germany.

Redirecting the EMS

Schmidt is placing too much trust in British leaders like former Prime Minister Edward Heath, who have made eloquent recent peace offerings to the West Germans, proposing that Britain join the European Monetary System (EMS). In fact, Heath and others count on the European Monetary System to become a currency bloc opposed to the United States, following a predicted collapse of the U.S. dollar shortly after Reagan's inauguration.

Heath made the overture to the chancellor at a New York conference last week sponsored by the *International Herald Tribune,* appparently breaking two years of British hostility toward the Franco-German-inspired currency group. But the actual content of Heath's offer emerged in a speech at the same conference delivered by Heath's friend David Montagu, the chairman of Merrill Lynch London and scion of the Montagu merchant banking family. Montagu pronounced the dollar a "suspect currency," predicting a drastic dollar crisis when U.S. interest rates fell (see Foreign Exchange).

No great wisdom is needed to determine that if Fed Chairman Paul Volcker continues to wreck the dollar's standing as a long-term investment currency, while promoting its value as a vehicle for hot money seeking high interest rates, the dollar will tumble as soon as the interest-rate prop is removed. Volcker has engineered a blow-by-blow repeat of the monetary events of October 1979 through March 1980, when interest rates rose to a peak of about 20 percent. The interest rate peak coincided with a sudden collapse of real economic output in the United States during the second quarter of 1980, after which interest rates fell spectacularly, bringing the dollar down with them.

The main difference is that both the economy and the dollar financial structure are both much weaker at home and internationally due to the effects of the first round of record interest rate levels. The deposit base of the American banking system, including the thrift institutions, has been "indexed" to interest-rate changes and is much more susceptible to rapid outflows of deposits. There will be a terrible thinning of the ranks of American depository institutions if this scenario proceeds.

Chancellor Helmut Schmidt—who is a good financial manager if not a good economist—knows this. But he is also under great economic pressure at home, largely as a result of the international tight-money regime imposed by the Federal Reserve. As *EIR* report-

Photo courtesy of the German Information Center

Chancellor Helmut Schmidt addressing a Social Democratic Party conference before his re-election.

ed Nov. 18, West Germany prevented a collapse of its own currency due to hot-money flows toward high-interest dollar paper by persuading the Saudis to sell dollars and buy West German marks. This maneuver was indispensable. But under conditions of extreme dollar weakness, the flow of petrodollars into European currencies would create its own set of problems.

The program

What should have made Schmidt suspicious is that the worst enemies of what he has tried for years to accomplish through the EMS have suddenly become its most ardent defenders. At a talk before the *International Herald Tribune* conference in New York—the same affair that heard David Montagu augur the collapse of the dollar—Edward Heath proposed to build up the European Currency Unit as a haven for petrodollar flows. He added that Britain should join the EMS, from which sterling has held aloof, as soon as possible; that Europe should find a means to deal with the Arabs by supporting a Palestinian state; and finally, that new vehicles for petrodollar investments should be created through hard-currency-indexed bonds.

That summarizes what Schmidt has in mind, according to very well-placed West German political sources.

That is why some leading British spokesman, who bitterly opposed the European Monetary System at its founding and viewed the projected European Monetary Fund as a threat to the existence of the City of London markets are now calling for European monetary unity. EC Commission Chairman Roy Jenkins called last week for rapid progress toward the EMF, a view Heath echoed in his remarks in New York. In Brussels last week, Jenkins hosted Britain's Queen Elizabeth II and Prince Philip before a Community meeting, where the Queen praised the role of the European Community in what the British press called unusually strong terms.

But the bottom line of this change in British public attitudes is something entirely different. In background discussions during the weeks prior to the American presidential elections, *EIR* editors talked with some well-known names in the Hamburg "mafia," the banking and political circuit which first fielded Helmut Schmidt for public office. What we heard could be summarized: the United States has collapsed economically and strategically and cannot easily be revived; however, the European financial elite will manage somehow to get by through clever, defensive use of the European Monetary System. That is the British attitude, and it is the policy Helmut Schmidt has stumbled into.

The European Monetary System, ironically, should be the dollar's most important support. It is the most efficient vehicle on the world monetary scene for the successful reorganization of the $1.2 trillion Eurodollar market, the speculative sinkhole that has weakened the dollar to the point that a really dangerous crisis is possible. Helmut Schmidt knows this in a way that Governor Reagan does not, and his responsibility to the Federal Republic of Germany and to his American ally is to make this clear. Instead, he has adopted a path of short-term expediency that will run him into problems that he is not at all equipped to handle, and push the United States toward the worst of the economic options it can choose from.