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Foreign Exchange by David Goldman

Can the dollar join the EMS?

A plan raised at last week's meeting of European finance ministers could stabilize a dollar-EMS parity.

The leading West German financial daily *Handelsblatt* reported March 19, "In the confidential portion of the European finance ministers' discussions in Brussels yesterday, a proposal was made to unite the separate arrangements concerning swap credits between the monetary authorities of European countries and the U.S. Federal Reserve into a single comprehensive agreement with the Fund for European Moneatary Cooperation."

These swap lines—central bank to central bank credits to finance currency intervention operations—now total $16 billion. From the European standpoint, there is a valid technical reason to unify the different central banks' relationship with the Federal Reserve, as the German daily notes, namely, to make possible currency intervention in dollars as well as European currencies, to smooth the intervention process.

However, centralizing the swap lines into a single fund through the Fund for European Monetary Cooperation—the joint checking account of the European Monetary System—implies something much broader. The only type of currency operation for which such an action would be indispensable is the stabilization of the dollar against the European currencies, e.g. an intervention target for the dollar parity against the European Currency Unit.

Such a plan was mooted last month in a speech by West German Bundesbank President Karl-Otto Poehl at Davos, Switzerland. Poehl said that "if the dollar were to return to long-term stability, then the dollar and the EMS together could provide the foundation for a stable world monetary system during the 1980s."

What is important in this context—when the principal European economic initiative toward Washington revolves around bringing interest rates down in coordination—is the efficacy of the cited currency proposal on the interest rate front. Most American commentators, including those of the administration, belittle the Franco-German plan for "global interest rate disarmament" on the superficial ground that the plan is not possible. This follows the monetarist argument that increasing the money supply in order to bring down interest rates would, on the contrary, have the perverse effect of raising inflationary expectations and hence raising interest rates.

This form of sophistry ignores the simple problem that the bulk of speculation centers around currency instability in the first place. Currency hedging alone takes up perhaps $200 billion of gross world credit demand. If they were successful, vigorous counter-speculative actions would eliminate the artificially high credit demand ensuing from "floating currency rates," and make it much easier to bring down interest rates.

Obviously, a bigger intervention fund for currency support would not be sufficient to peg the dollar versus the European currency joint float. The United States would have to adopt an economic stance parallel to the Franco-West German commitment to nuclear energy and capital-intensive exports to the developing world, and correct the huge American trade deficit, the original source of dollar instability.

The United States would have to throw out the foreign economic policy (see International Credit) devised by Undersecretary of State James Buckley and his collaborators at Treasury and Office of Management and Budget, and vastly expand the size and functions of the U.S. Export-Import Bank.

By the time Helmut Schmidt arrives in Washington in May, however, some rethinking may well have been done at the White House. The dollar, far from shooting towards the DM 2.50 level that the New York Fed and some others were talking of recently, has fallen back to DM 2.05. This is only indirectly the consequence of the fall in American interest rates; the interest rates themselves have dropped as a result of the second leg of the present economic depression. The multiple consequences of the depression put the dollar into a weak position, and give the Europeans considerable bargaining room in Washington.

Clearly, the DM has bottomed out on the foreign exchange market. The fact that the German current account deficit is susceptible only to slow-working solutions makes a spectacular DM rise unlikely. But now that President Reagan must look to the stability of the dollar, the European offer is a serious one.

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