IMF meeting prepares breakup of the alliance

by David Goldman

As reported last week, the International Monetary Fund's staff report issued a week before its Annual Meeting in Washington warned that a precipitous drop in the dollar, to follow the dollar runup occurring at the time of the meeting, was the most dangerous eventuality facing the world economy. Reports from the "big five" meeting preceding the IMF event indicate that the foreign exchange situation was the major source of concern to attending ministers.

Strategic, not monetary considerations as such, are turning the wheels of the present crisis. The Soviet Union is playing both sides of the foreign exchange market for strategic purposes, driving funds out of Western Europe through direct military threats, and at the same time playing into European efforts toward monetary decoupling from the United States. Its objective is to use monetary crisis conditions to break up the Atlantic alliance, and prepare an ultimate "monetary Pearl Harbor" against the United States. The wild swings in the foreign exchange market the third week of September reflect this. It is not at all clear that the dollar's rise has been broken yet; a few weeks or even months of capital flight from Europe may hasten the planned break from the United States. Former Fed official Scott Pardee, who called attention to Soviet dollar operations last December, maintains this is still Soviet strategy. But the preparations for what the International Monetary Fund recently warned would be a "precipitous drop of the dollar" are in evidence, even if the event occurs late this year or even early next.

Europeans are buying the dollar at a loss in response to Soviet military pressures against Western Europe. The liquidity squeeze in the Eurodollar market, which supported the dollar through the summer, is not the cause of the present rise; on the contrary, the fall of the six-month Eurodollar rate to 11 15/16%, below 12% for the first time in months, shows that capital flight into the dollar has marginally eased Eurodollar market conditions.

This is the script to the drama played out over the wire services. First, on Monday, Sept. 17:

"ENNIS, Ireland—DJ—Finance ministers of the European Community took a number of steps this weekend to strengthen the European Monetary System. . . . The ministers also agreed to ask EC central bank governors to look at a number of other measures to improve the EMS. . . . Possibly increasing the rate of interest paid on official ECUs, a unit of settlement among the central banks, possibly increasingly the so-called ECU acceptance level, that is, the amount of ECU-denominated debt a central bank may hold, and possibly removing barriers to the commercial use of the ECU."

The same day, Sept. 17:

"FRANKFURT—DJ—Deutsche Bundesbank president Karl Otto Pöhl, saying he is opposed to massive central bank intervention in foreign-exchange markets, apparently is willing to let the dollar run its course.

"The central bank chief conceded the Bundesbank isn't happy with the dollar rising to 3 deutschemarks, mainly because of concern about imported inflation, but he stressed the futility of trying to batten down the dollar with market intervention."

Then, on Sept. 21, after the dollar rose:

"WASHINGTON—DJ—Finance ministers and central bank chiefs of the five major industrial nations, the U.S., Japan, West Germany, Britain, and France, met here yesterday, and sources close to the meeting said the so-called 'Big Five' voice grave concern over the dollar's recent strong gains."

And again:

"BERLIN—DJ—A member of Deutsche Bundesbank's board said the lack of foreign exchange and interest rate cooperation among major countries threatens to disrupt capital flow and hinder development of national economies.

"Claud Köhler warned that some countries may resort to administrative restrictions to protect themselves, a method he said wouldn't help international trade.

"Köhler's comments were in apparent contradiction to a hands-off policy laid down last week by Bundesbank President Karl Otto Pöhl."

That is the background to the extraordinary events on the markets on Sept. 21. First,

"In Frankfurt, frenetic dollar-buying early today drove the dollar to its highest fixing since the dollar was floated against other currencies in 1973 dealers said.

"The dollar was set at 3.1624 deutschemarks at the fixing, its highest level at the official setting since Jan. 29, 1973, when it was pegged at 3.1750 marks, according to the Deutsche Bundesbank."

Then,

"FRANKFURT—DJ—The Deutsche Bundesbank sold dollars heavily in the Frankfurt spot dollar market today, dealers said.

"The dollar plunged from nearly 3.1640 marks to around 3.0900 marks in late afternoon trading before recovering to 3.1030 marks near the end of the day.

"'The Bundesbank intervened very strongly in the market this afternoon,' one dealer said. 'Beginning shortly after 3:00 p.m.—local time—they sold over *$500 million,*' the dealer said."

And,

"FRANKFURT—DJ—The Bundesbank's heavy dollar sales may represent a concentrated intervention by other European Central Banks with the Bundesbank taking the lead role, dealers said.

"There were also unconfirmed reports in the market that the *Soviet Union liquidated a number of large long-dollar positions held through commission houses selling their holdings at about the same time as the Bundesbank's intervention. Market sources estimated the alleged sales by the Soviet Union at $300 million.*"

It almost appears as if the Soviets and the European central banks were conducting joint intervention operations, a view rejected by Federal Reserve specialists who maintain that the Soviets were simply engaging in smart trading. As far as the day's events are concerned, that is true. However, the Soviets have, since November 1983, conducted quiet negotiations with friendly Swiss and German business groups on the gradual integration of the Comecon monetary bloc into a clearing arrangement with the European Monetary System. European exchange controls and related developments toward a European bloc will tend to push events in that direction.

Temporary help for U.S. markets

The most striking monetary consequence of the run into the dollar is the fall in Eurodollar rates, which stood the morning of Sept. 21 at 11 9/16% for six-month money, versus 12 1/8% one month earlier. The huge influx of dollars into the Eurodollar market in response to Soviet pressures against West Germany has permitted a general lowering of interest rates in the dollar sector by roughly 1/4%. Momentarily reduced perception of banking risk due to the Ibero-American debtors' inaction at their Argentine meeting on Sept. 13 and 14 was also a factor in reducing Eurodollar rates.

Toward the second half of the week of Sept. 17, the previous drop in Eurodollar rates was reflected in a somewhat lower Fed funds rate in New York. Although the Fed has aggressively put funds into the market, the flows in and out of the dollar sector, rather than Fed action as such, are the principal determinant of short-term interest rate behavior.

The easing is reflected in all U.S. financial markets, and accounts for the rise in bank stocks in particular during the week of Sept. 16. For example, Manufacturers Hanover has risen four points during September to over $31 per share. For the past year, since the United States became a net debtor nation, the offshore tail has wagged the onshore dog in the money markets, and the temporary elimination of pressure on the foreign side of the markets has permitted a continuation of the present relatively high levels of securities prices.

The dollar's rise is not hard to understand in the global strategic context. Nonetheless, the dollar's vulnerability, as recounted in the International Monetary Fund's latest annual report (reported in this space last week) and below by New York Fed President Tony Solomon, should be exposed following the U.S. elections.

In a speech in Washington on Sept. 14, New York Fed president Anthony Solomon cited four major elements of the current situation that he termed "unique and troubling."

1) The expansion of the economy has been fueled by an "exceptional" growth of credit running five percentage points above the pace of the average recovery. This, Solomon said, "could have profound consequences for the future and poses formidable problems for policy if interest rate pressures were to intensify."

2) The current U.S. expansion has been supported by an "extraordinary" inflow of savings from abroad, the long-term consequences of which are "unknown."

3) The high value of the dollar is sharpening differences between those who benefit and those who suffer from a strong currency.

4) Continued large federal budget deficits are providing considerable fiscal stimulus.

The overall situation is one in which, in a number of areas, the short-term benefits of various developments are undercut by long-term risks, Solomon said.

If the Soviets choose to militarily invade Western Europe, the dollar's value against European currencies will become infinite. However, if the Soviets achieve their more immediate objective, i.e., to use military threats to make Europe their economic colony, they will have control of the purse strings of the United States. In this context, read recent warnings by New York Federal Reserve president Tony Solomon, former West German Chancellor Helmut Schmidt, and the International Monetary Fund that the dollar will collapse after the election.