Foreign Exchange by David Goldman

Europe prepares for dollar crash

Great Britain may join a restructured European Monetary System.

Federal Reserve chairman Alan Greenspan's maiden appearance at the Bank for International Settlements' monthly gathering of central bankers appears to have been irrelevant. After his private consultations with Bundesbank President Pöhl and Bank of Japan Governor Sumita, both officials made *pro forma* statements that the central banks would continue to stabilize exchange markets.

Meanwhile, the European central bankers met separately, to prepare to handle the end of stability on the foreign exchange markets. They agreed upon a strengthened intervention system to hold together the European Monetary System, the fixed-rate alignment of European currencies, anticipating an uncontrolled crash of the U.S. dollar.

Italian central bank chief Carlo Ciampi delivered what European newspapers called an "extraordinary public briefing" following their deliberations. Normally, the discussions of BIS central bankers are the most secretive of all diplomatic gatherings. The Europeans clearly intended to send the most powerful signal they could.

France and Germany founded the EMS in 1978, at the worst of the dollar's woes under the Carter administration. It was then characterized as an effort to create a "zone of stability" in Europe, while the dollar sector tumbled out of control. Now more than ever, appears to be the thinking of the European central bankers. Their plan will be presented, and doubtless adopted, by European finance ministers meeting in Denmark Sept. 16.

A turning point is Britain's likely entry into the EMS, on the strength of the changes just accomplished. The City of London previously acted as an appendage of the dollar sector, and successive British governments have linked the pound sterling more closely to the dollar than to the German mark.

That ended with Japanese financial ascendancy, and the reduction of the United States to the world's biggest debtor nation.

Crédit Suisse/First Boston economists Gerald Holtham, Giles Keating, and Peter Spencer wrote in the London *Financial Times* Sept. 9, "The British government has been living in sin with the EMS. Since February, the pound has been pegged in the range DM 2.90-DM 3.00 without the U.K. actually joining the EMS's exchange rate mechanism."

The real, underlying issue, is, whom will the Germans subsidize? During the first half of 1987, foreign central banks (Japan and Germany) created $70 billion of their own currency to "stabilize" the dollar on foreign exchange markets. They printed that volume of their own currency to purchase dollars, financing virtually the whole of the American foreign deficit on their printing presses.

Now, apparently, the Germans have decided that this is money thrown down the drain, and they were better advised to purchase the currencies of their European trading partners. "The EMS has worked as a deutschemark zone," write the Crédit Suisse economists. "The Bundesbank has set a monetary policy exclusively based on its perceptions of German interest. . . . Now the decline of inflation and doubling of European unemployment has created a situation in which priorities for policy are likely to diverge increasingly in European countries. . . . Reforms of the system along the French lines would remove one of the British objections to entry . . . namely that politically the U.K. cannot become a mere monetary satellite of Germany. The entry of the U.K. into the EMS debate at this stage would be of great importance."

The content of the 16-page report to EC finance ministers and EC central bankers meeting in Basle, amounts to a much greater commitment for strong-currency countries (i.e., the Germans) to purchase the currencies of their weaker partners. It calls for more so-called intramarginal intervention before currencies reach their maximum limits under the eight-currency EMS. Also, greater use of the European currency unit for repayments within the short-term credit mechanisms of central banks would be allowed.

France, which has sought to avoid restrictive monetary measures to keep its currency in line with the stronger deutschemark, wanted unlimited credits. This the Germans refused, but they allowed sufficiently greater flexibility to please France, and entice Britain.

"The point of the deal is to help the EMS withstand strains from a weaker dollar," wrote the *Financial Times* Sept 9.

Whether Britain will join yet is far from clear. The *Financial Times* editorialized Sept. 9, "Incidentally, but perhaps not accidentally, the changes go some way towards undermining the British government's longstanding objection that the time for membership of the EMS is not ripe."