

Foreign Exchange by David Goldman

'Volcker is the uncertainty factor'

The expected rebound of the deutschmark indicates the German commitment to defend the EMS. Problems remain.

Following last week's decision by the West German Bundesbank to restrict the Lombard facility—the normal means of providing liquidity to the banking system—West German interest rates have shot up. At this writing the three-month Euro-DM rate is at 16 percent, or higher than the U.S. federal funds rate, a striking reversal of what was at the start of the year an 8-point spread between the two rates.

This rapid interest-rate movement indicates the limitations of the Bundesbank's strategy to deal with what the West Germans are hoping will be a short-term problem of capital flight due to the U.S. credit squeeze.

The fact that the Euro-DM rates have moved rapidly ahead of short-term domestic DM rates indicates German commercial banks have stopped exporting funds to the Eurocurrency market, precisely what the Bundesbank wanted.

But it also shows that the potential implications for the German capital market of the Bundesbank's currency defense measures are not sustainable for more than perhaps another quarter.

At the moment, the mark is in a trading range between DM 2.08 and DM 2.12. The leading West German business daily *Handelsblatt* noted that traders are reluctant to take positions. "The U.S. Federal Reserve is the principal uncertainty factor in the market," the

West German newspaper said. It added, "It is unlikely that the restrictive efforts of the Federal Reserve will be crowned with success."

The reason for the high degree of uncertainty and reluctance to take positions is that the Europeans can already foresee the Volcker policy backfiring. The Feb. 25 announcement of a January fall in durable goods orders of 2.2 percent, the first hard sign of economic downturn since last August, produced some dollar selling immediately, according to wire service reports. As the U.S. economy continues to turn down through the first quarter—this is *EIR's* standing forecast—the dollar will continue to come under pressure.

Based on forecasts circulated by the New York Federal Reserve and some members of the Bundesbank's directorate at a conference in Hamburg last October, some market participants tried to drive the DM down to about 2.25 to the dollar earlier this month, losing them a lot of money. That the dollar could fall back immediately to 2.10, a 12 percent decline in less than three days' trading, shows how weak the dollar's underlying position was.

West German bankers emphasize that the new strength of the dollar is not related to interest-rate movements, but in newfound confidence in American economic management. Except for the predictable enthusiasm in Brussels and in

Switzerland for monetarist measures, reaction to the Stockman budget and the endorsement of the Fed's monetary stance by the administration produced immense disappointment in Europe, as *EIR* has emphasized. More than the short-term problems for the DM, the West Germans fear a "blowback" effect against the American dollar once it becomes evident that Stockman's program will be disastrous for the U.S. economy.

The West Germans' problem is that a recession-related decline of the dollar will not make matters easier for them, even if it eliminates the present problem of capital flight. In an interview this week with *Der Spiegel* magazine, Chancellor Schmidt acknowledged that the rising problem of unemployment in West Germany was due, in part, to external economic factors beyond his control, and promised to "request and even demand" of Germany's allies (i.e., the United States) cooperation in interest-rate matters. He showed optimism over winning agreement to his plan from Reagan "by early summer."

This, of course, depends on the ability of the White House to recognize that David Stockman, for all his pretensions of avoiding an "economic Dunkirk," has left them adrift. The first West German emissary, Bundesbank President Karl-Otto Poehl, arrived in the U.S. this week to lobby for a global reduction in interest rates. On March 11, Schmidt's man in the West German Finance Ministry, Horst Schulman, will make the same case at the Working Party III meeting in Paris of the Organization for Economic Cooperation and Development, before Schmidt's projected April visit to Washington.