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Washington's currency warfare against Europe

by Kathy Burdman

Federal Reserve Board Chairman Paul A. Volcker's latest round of unprecedented interest-rate hikes is aimed squarely at provoking maximal economic and political chaos in Western Europe, Washington commentators agreed this week.

West German Chancellor Helmut Schmidt and French President Valéry Giscard d'Estaing have for the past month led world calls for the U.S. to lower its rates and ease off on the depressed world economy. Volcker and his collaborators at the New York Council on Foreign Relations and the City of London, however, want Schmidt and Giscard to "get off that kick," as one Washington source put it. A new round of world interest-rate tightening is meant to tip European economies over the brink into serious recession, greatly weakening the domestic positions of Schmidt and Giscard and undermining their ability to negotiate international economic growth programs in upcoming meetings with President Ronald Reagan.

The Fed chairman acted this week to put world rates onto a new high plane, by moving the Federal Reserve's discount rate up by 1 percent to a historic 14 percent and tacking a 4 percent surcharge onto large city banks that would bring the effective discount rate for large borrowings up to 18 percent "I'd call that a stiff rate," Treasury Secretary Donald Regan told the press approvingly. With federal funds trading in the 17 to 19 percent range this week, the major banks immediately moved the prime lending rate up to 19 percent and further moves are expected.

"I don't think the prime will go as high as 24 percent," Secretary Regan told a press briefing, but he forecast several more months of current-level interest rates.

With European currencies already experiencing capital flight under the prospect of a Mitterrand Socialist government in France, the effect of Volcker's actions was electric. The French franc immediately plummeted by 5.2 percent to a 10-year low against the dollar the week of May 7 to 5.41 per dollar. The West German mark dropped by 5 percent to 2.28 per dollar, and the Italian lira fell 4.4 percent to 1,130 per dollar. Foreign exchange traders and U.S. multinationals are widely expecting the German mark to test the 2.30 floor. "The Fed is going crazy," a high official at West Germany's Dresdner Bank told *EIR*. "The mark may fall to 2.50, a complete disaster, but we are actually now contemplating U.S. rates rising well into 1982."

It was the worst foreign exchange market chaos since the U.S. dollar was toppled from the gold standard on Aug. 15, 1971, the expert agreed. "But it's not the dollar which is in trouble this time, it's everybody else," said Richard Erb, U.S. executive director to the International Monetary Fund (see interview).

In order to stem the capital flight into the dollar, said Mr. Erb, Europe will have to "raise their [interest] rates or suffer falling currencies." The Banque de France this week did move its discount rate up 1 percent to 13.5 percent, and the West German Bundesbank is reported contemplating a near-term Lombard rate hike of 1 percent to 13 pecent.

The crisis could greatly weaken West German Chancellor Schmidt and French President Giscard, now preparing for major economic negotiations with President

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Reagan. Schmidt arrives in Washington for a bilateral summit with Reagan May 20-23, and the world's seven leading heads of state will meet in early July at the Ottawa economic summit.

The Volcker offensive could badly destabilize and eventually even topple the Schmidt coalition government, said Harold van Buren Cleveland, chief international economist of Citibank, this week. When Schmidt arrives in Washington, the President will be forced to tell him that "the Federal Reserve is pursuing a restrictive monetary policy and they aren't likely to change it." If Schmidt complains, the Fed's response would be "Mr. Schmidt, that's *your* problem," he stated.

Treasury Undersecretary for Monetary Affairs Beryl Sprinkel, an ideological supporter of Volcker, is in fact trying to engineer a confrontation at the May summit between Schmidt and Reagan which "could have terrible consequences for U.S.-West German relations," a White House source complained this week. Sprinkel, an associate of the ferverently monetarist Mont Pelerin Society, "is telling the President to confront Schmidt with a fait accompli."

Sprinkel's argument is that the United States has determined for purely domestic reasons to have extremely tight money to fight inflation here, no matter what the consequences for the international economy.

Volcker is out to force a destabilizing realignment of the European Monetary System, which is the cornerstone of trade and economic stability in Europe, the London *Guardian* reported recently.

To further the need for EMS realignment, Undersecretary Sprinkel has also announced a return to the old Michael Blumenthal policy of "malign neglect," in which the Treasury intends to halt most intervention to support currencies on the markets altogether (see Foreign Exchange). "Any stress on the EMS will have to be handled by the Europeans themselves," said a Treasury spokesman. "Defending the EMS is their business."

Volcker's offensive is about to plunge the United States into a deep recession, which could also wreck the political future of President Reagan—and the White House is well aware of it. A backroom, cabinet-level policy fight has broken out on the Fed's policy.

Led by Treasury Secretary Donald Regan, members of the cabinet associated with the secretive Swiss-based Mont Pelerin Society, which promotes monetarist ideology, have come out supporting Volcker with both guns blazing. "The Fed knows what we want," said Regan, explicitly endorsing the new tightening. "It takes quite a fight by the Federal Reserve to control the money supply."

"If it leads to short-run problems, it's well worth the prices we're paying," Sprinkel told the press. He said he is urging the Fed to tighten faster, although it will slow the economy and cut "production, jobs, and income for about half a year." The Fed's action was also endorsed by Council of Economic Advisers Chairman Murray Weidenbaum in a New York speech May 5. "We support the Federal Reserve's perseverance in restraining excessive money supply growth," he stated, "notwithstanding any short-term repercussions on interest rates. . . . We're no longer in the stop-and-go policy mode."

The White House, however, is not so sure. The White House, syndicated columnists Evans and Novak reported this week, called an emergency closed-door cabinet meeting April 30 on the collapse of the nation's financial markets induced by rising interest rates. The aim, White House sources said, was "to put the blame squarely on the Federal Reserve, headed by Paul Volcker." White House officials were said to be worried about a "financial panic" later this year, with "failing lending institutions and bankrupted small businesses."

Key administration officials want a "quick, well-publicized Oval Office meeting where Ronald Reagan would deliver a 'Dutch uncle' lecture to Chairman Volcker. . . . The spectacle of the Fed paying homage to the President might sweeten the temper of the financial markets," they wrote.

The level of economic recession which is about to hit Europe as a result of Volcker's new crunch should be enough to destabilize any European government.

Domestic recessions have induced severe trade deficits in Germany and France, which are exacerbated by the fall in their currencies against the dollar and hence a soaring oil import bill for Europe. Germany, for example, paid 15 percent more for oil in the first quarter this year than last, about $5.7 billion—although because of its recession, the oil imported was 20 percent less in volume terms. The economic ministry, which believes consumption will continue to decline all year, is still projecting a $27 billion oil bill for 1981. Germany's overall first quarter 1981 current account deficit was $4.2 billion, much of it accounted for by oil.

The same situation is occurring in France, where the trade deficit is projected to rise to $11 billion, on top of $10 billion in 1980, and the current account deficit to rise to $8 billion after $7 billion in 1980.

The wider the European deficits, the faster their currencies are being hit.

Treasury's Beryl Sprinkel and Franz Scholl, foreign director of the West German Bundesbank, are arguing that Germany should allow the deutschemark to fall to as low as 2.50 or even 2.70, in an attempt to cheapen German exports and lessen the trade deficit. "This is crazy, and will never help German exports, because at these world interest rates no one can afford to buy them anyway," the Dresdner Bank official told *EIR*. According to Jörg Schill of Deutsche Babcock, the heavy machinery manufacturer, the interest rates now being charged by the Bundesbank for export finance are so

high that foreign orders for machinery have fallen in real volume terms by 5 percent from the end of August 1980 to the end of January 1981.

The West German economy depends on exports; Chancellor Schmidt is in trouble if this trend continues.

Interviews

Citibank, Treasury, and White House comments

Federal Reserve Chairman Paul Volcker's latest increase in interest rates will enforce economic austerity and political chaos in Western Europe which could collapse the government of West German Chancellor Helmut Schmidt, said Harold van B. Cleveland, senior vice-president and chief economist of Citibank this week.

Mr. Cleveland is the leading international monetary economist of the Council on Foreign Relations, a board member of the NATO Atlantic Council, and chairman of the OECD's Task Force on International Monetary Policy.

Q: Will Chancellor Schmidt succeed in convincing President Reagan to lower U.S. interest rates when they meet in Washington in June?

A: No. I think he'll try, but I really can't see that Reagan, in his position with the Federal Reserve, can do anything about it. The Federal Reserve is pursuing a restrictive monetary policy and they aren't likely to change it. We're in a very bad spike of interest rates; the markets are putting interest rates up and the Fed is going to have to tighten.

Q: Aren't the Europeans screaming pretty hard about the Fed's actions?

A: Yes, because of the effects on their currencies, but there's nothing that can be done about it.

Q: Special Trade Representative Bill Brock has just accused high rates of wrecking the U.S. auto industry. Is the White House getting cold feet?

A: No. Even if they got cold feet, what could they do? I don't think anybody's getting cold feet. They aren't going to be panicked by another rise in interest rates. It's just a phenomenon we've got with us now. They're going to hang in there and wait out a fall in inflation.

Q: What if Chancellor Schmidt complains this will topple his government?

A: They'll just have to say, "Mr. Schmidt, *you* are the Chancellor of Germany and that's your problem." What else can they say? They will make some pious commentary about getting rates down by curing inflation first.

Q: Do you expect the currency markets to continue chaotic?

A: Yes, as long as interest rates in this country continue to gyrate, the same will be true of exchange rates. They'll just have to get used to operating in this kind of market.

Q: What about the July heads of state economic summit in Ottawa? Will they accomplish anything on interest rates?

A: Name me the last summit that accomplished anything. That's not the real world.

Q: Might they not agree on a joint policy to lower rates at Ottawa?

A: I cannot imagine Reagan agreeing to any reflation program. In the area of monetary policy and interest rates, nothing, but nothing, will happen which will support the general desire of both governments—both the German and the U.S. government—to lower rates, given inflation.

Q: But Schmidt is facing the West Berlin elections and he cannot take this recession.

A: I don't know what else he can do. He's not going to force the U.S. government to do something that it doesn't want to do and that it doesn't think will be effective. There will be a communiqué, which will say nothing; it will describe the situation and then say that our priority is to lick inflation.

Q: French President Giscard, if re-elected, has promised to use the EMF [European Monetary Fund] to expand the European economies.

A: I don't see how Europe can pursue an independent policy. If they expand credit, their currencies will fall further. I think they're stuck, and not for the first time. The Europeans have had to follow our policy for the past ten years. They can't do anything else. This situation can continue ad nauseum.

The following excerpts are from a May 4 interview with Richard Erb, the U.S. Treasury's executive director at the International Monetary Fund.

Q: What does the new U.S. currency policy mean for Europe?

A: It's not the dollar that is in trouble this time, it's everybody else. Mr. Sprinkel's statements mean that U.S. interest rates will continue high for some time, and this

will continue
their rates or suffer falling currencies.

Q: If the dollar does rise and puts pressure on the EMS [European Monetary System], will the administration act to help the EMS from being pulled apart?
A: No. It is likely that any stress in the EMS will have to be handled by the Europeans themselves. It is our position that defending the dollar by fighting inflation is our business, and defending the EMS is their business.

Q: Does the current politically motivated run against the French franc constitute "disorderly markets" in which you'd intervene?
A: No. These are not disorderly markets.

Q: But the franc has just fallen by 3 percent.
A: There are underlying economic reasons for this. We have wound down our intervention since the beginning of the year; we're not intevening now, and I see no prospect of our intervening.

Q: The Europeans are putting tremendous pressure on the United States to lower interest rates.
A: Haven't you noticed that their complaints have been muted lately? I haven't heard anything in a few weeks. The reason is that Mr. Sprinkel and the administration have made it clear to them that the U.S. must and will have high interest rates to fight inflation here as a first priority for a long time, and there is absolutely nothing they can do to move us from that position, nor should they try if they are serious about fighting inflation. The Europeans are now satisfied that we are not going to do anything on the basis of what they say, and they've stopped pressing the case.

Q: Won't the Europeans press for "interest-rate disarmament" at the June Ottawa economic summit?
A: I doubt it. There is very little to coordinate on. We have our policy, and it's our policy. We do intend to bring up the question of IMF suveillance of interest and foreign exchange rates, but to get that implemented is very farsighted at this point. All we can continue to do is to make our case that our domestic policy of tight money is primary.

From a May 6 interview with a highly placed White House source, provided to EIR.

Q: Regarding reports of a closed-door U.S. cabinet meeting April 30 at which the President was urged to censure Fed chairman Paul Volcker's high interest rates, is there someone in the administration who has begun to take the part of West German Chancellor Helmut Schmidt in his call for lower U.S. rates?
A: No. There is disagreement between the monetarists led by [Treasury Undersecretary] Beryl Sprinkel, who say that the Fed is printing too much money, and others who say the Fed is doing the best job it can. But there is no fundamental dispute with the idea that we have to ignore interest rates, and ignore foreign exchange rates, and continue tightening until we control monetary expansion. I would say that Schmidt's pleas have fallen on deaf ears.

In fact, Undersecretary Sprinkel, who has been doing most of the communicating with West Germany, is telling the President that Schmidt will have to get off his kick of calling for lower rates, and recognize that real international stability depends on the U.S. tightening credit and stengthening the dollar.

Q: I thought Sprinkel had no real stature in international affairs.
A: It's true that he knows nothing about it, but he regards this as a virtue. His position is that the U.S. will do what it has to do for domestic reasons and there isn't a damn thing that the Germans can do about it, that what they think doesn't matter in the least. He's telling the President to confront Schmidt with a fait accompli. This could have terrible consequences for U.S.-West German relations. In fact, I've been working on White House and State Department officials to get them to impress upon Sprinkel that what people like Chancellor Schmidt think does matter. He just doesn't believe it.

Sprinkel is telling the President that Schmidt just doesn't have a good case, that his argument that high U.S. rates are causing Germany's economic troubles is full of holes. Too much federal spending, low investiment, and a terrible trade and current account deficit. So naturally the deutschemark is weak, and there is no reason to blame U.S. interest rates for that. In fact Sprinkel is telling Reagan that Schmidt should just let the deutschemark go, let it devalue, it will improve their exports. The danger is that the President will believe this by the time Schmidt gets here, because there is no one else of any stature on international monetary affairs.

Q: Can't Schmidt go directly to the President?
A: The President listens to his advisers, and Sprinkel is an ideologue. You have to realize that we have already had half a dozen high-level meetings, leading up to the recent London finance ministers' summit with the Germans and other Europeans, and at evey meeting the U.S. delegation has told them flatly that we will not budge.

At every meeting, they come in and scream, and we politely but firmly explain our policy. But now what worries me is confrontation. We're not going to change our policy, but we have to at least give them the idea that we care what they think. The fact is, Sprinkel does not. The judgment now is that there are no possible retaliatory measures the Germans can take, and therefore we can, in effect, ignore them.