

## Where will Europe go after the fall of the ERM?

by William Engdahl

On Aug. 2, the central bankers and finance ministers of the European Community's 12 member-states announced that henceforth, the Exchange Rate Mechanism (ERM) agreement to stabilize EC currencies within a narrow band of  $\pm 2.5\%$  would be abandoned in favor of a far looser 15%, in effect a decision to allow a free float. The decision, said EC officials, would be reviewed in six months. With the announcement, the dramatic crisis in European currency stability, which had been building since the summer of 1992, appeared to suddenly ebb.

As the dust settled, the initial damage began to emerge. The Bank of France found itself with virtually no foreign currency reserves left. In order to defend the fixed link between the franc and the German mark, the bank had had to spend all its marks and dollars in order to buy up the flood of francs being dumped on the market by speculators in the past weeks, in anticipation of an ultimate devaluation of the franc. Best estimates are that the Bank of France spent the equivalent of \$50 billion in its vain attempt to hold the line against the speculators, and had to heavily borrow from the German Bundesbank.

Since in this crisis the German deutschemark was the strongest currency, the Bundesbank, the largest European central bank, was obliged under ERM rules to come to the aid of the weakest currencies, intervening up to an estimated DM 60 billion (\$35 billion) in the last two days before the rules changed on Aug. 2.

### Soros's winning streak ends

Speculative pressures since Aug. 2 have dropped dramatically, according to market participants in the London-centered foreign exchange trading. This is primarily because, with such a wide allowable band of 15%, European central banks are no longer obligated to intervene to counter pressures of speculators such as George Soros or Citicorp, both

of whom boasted record profits from last September's attacks on the British pound and the Italian lira.

"The ERM has de facto collapsed," City of London economist Stephen Lewis commented to *EIR*. "But it was not quite the way that Mr. Soros and his friends would have wanted. Instead of toppling the German mark and seeing the franc emerge as the new 'anchor' currency of Europe, as Soros had wanted, the mark is stronger than ever, and it is the French franc that is under pressure."

On June 9, Soros declared war on the mark in a prominent open letter to the *Times* of London, in which the New York-based speculator said, in effect, "Down with the mark, up with the franc!" Soros, who is openly anti-German, is reported to have close ties to officials in the French Treasury and may have gambled against the mark based on private assurances from these friends.

Indeed, by July 26, when it became clear that it was the franc, not the mark, which was under pressure, Soros made a nervous disclaimer to the French daily *Le Figaro*, insisting that he was not speculating against the franc: "I do not want to be accused of destroying the European Monetary System," he said. On July 30, as the franc fell to the lowest allowed level within the ERM band, Soros said he was bailing out of francs. Traders said he may have gotten himself into a desperate bind and possibly faced insolvency had he not reversed course.

What enabled a band of private speculators to in effect defeat the combined concerted power of 12 European central banks? The short answer is the explosive growth of off-balance-sheet financial instruments called "derivatives," mainly currency swaps and forward contracts. By use of these derivatives, a speculator such as Soros is able to borrow from a bank or group of banks willing to back his betting acumen, in order to create pressure for a currency devaluation or upvaluation before some fixed future date. (See "Finding

a Cure for Derivatives, the Market Cancer," *EIR*, May 28, 1993.)

Soros is able to borrow for only 5% collateral. This means that if he puts up only \$50 million, a small sum for his Quantum Fund investment firm which has well over \$3 billion in net assets, he can speculate with a credit line worth \$1 billion. Last Sept. 16, when the pound was finally forced to formally withdraw from the ERM after the Bank of England and other EC central banks were unable to support its value, Soros boasted to British media of having made more than \$1 billion trading against sterling.

At a Frankfurt banking conference last January, in response to a question from this reporter, Bundesbank President Helmut Schlesinger noted the dramatic difference these leveraged speculations in derivatives have meant in the past few years. "We are studying the period prior to Sept. 15 in order to determine just why the order of magnitude of central bank intervention required was so large," he said. "To give an idea, in the currency crisis of 1987, EMS central banks made a total of DM 15 billion mandatory support intervention. In this past September the figure totalled DM 60 billion. This is a big change." As well, whereas in 1987 the central banks defeated the speculators handily, this time central banks, and ultimately, European taxpayers, have been forced to pay the mega-profits of sharks like Soros.

The reason is derivatives, a trade which has grown explosively since 1987, primarily because of regulatory permissiveness by U.S. and U.K. authorities. The U.S. Federal Reserve recently estimated that U.S. banks had a total of some \$7 trillion in derivatives obligations outside the regulatory purview in what is called the over-the-counter or off-balance-sheet holdings. The biggest bank, Citicorp, admits its own share to be \$1.5 trillion in off-balance-sheet derivatives. No reserves are required for such trading, despite immense danger of default, as was seen in July in the collapse of the giant Italian Ferruzzi empire. Ferruzzi reportedly left Citicorp and other U.S. derivatives banks with a mountain of defaulted derivatives. The matter is being treated with utmost secrecy by U.S. officials and banks, reportedly because were the truth to leak out, it could trigger panic selloff in the huge derivatives markets worldwide.

### **Deeper causes of the ERM breakdown**

A more fundamental critique of the deeper reasons for the present currency instability inside the EC has been put forward. French businessman and financial commentator Michel Albert, president of the French insurance group AGF, in an Aug. 3 interview with the French paper *Libération*, commended French Prime Minister Edouard Balladur for refusing to cast blame on Germany for the breakdown of the ERM: "It is Europe that has failed. At a time when our partner, Germany, was faced with the task of reunification and development of a remarkable economic opportunity, Europe, and France especially, said to Germany: 'Do it alone!' Instead, we should have joined with Germany in some form

of Marshall Plan to support transformation in eastern Europe, which would have prevented the need for German high interest rates. We French did not understand that it was also not in our own interest to isolate Germany."

Repeatedly, beginning in 1989, Chancellor Helmut Kohl's government and the Bundesbank made overtures to France, as Germany's key economic and political partner in Europe, to join with her in rebuilding eastern Germany and all of eastern Europe. And repeatedly, Mitterrand's government rebuffed Germany. In the midst of fierce anti-German propaganda in both British and French media after the fall of the Berlin Wall in November 1989, the French elite, through EC Commission President Jacques Delors, insisted on binding Germany into a supranational monstrosity called the Maastricht Treaty, which called for freezing exchange rates and rapid motion toward a single European currency.

"The French regarded the ERM as one of the stepping stones toward creation of stronger European federal institutions to limit policy autonomy of unified Germany. Indeed, it would not be exaggerating to say the French government viewed the Maastricht Treaty as an appendix to the German unification treaty itself," U.S. economic strategist David Hale noted in his latest investor advisory. "This perception was very expensive because it greatly limited the autonomy of French monetary policy, destroyed the French Socialist Party, and caused French unemployment to rise to 11.6%."

The question is whether the Balladur government in France will be able to shift from the paranoid anti-German policy of its predecessor and forge a new alliance, reviving the spirit of the early 1960s, when Gen. Charles de Gaulle offered economic and political cooperation to German Chancellor Konrad Adenauer, laying the foundation for not only French-German cooperation, which stands to this day, but for what became the European Community.

The first hint in this direction came Aug. 6 in Paris during the meeting of a special ministerial Franco-German economic commission. French Finance and Economics Minister Edmond Alphandery told journalists that his government planned to "take measures to control foreign exchange trade." It has been widely mooted in Paris financial circles that Alphandery was referring to some form of taxation of derivatives to control the speculative pressures.

Control of derivatives is urgently needed, but it is far from sufficient. France and Germany are each other's largest export partner; the two economies are inextricably interlinked. Only through a revival of de Gaulle-era dirigist state economic goals and guided investments in public infrastructure, this time directed to eastern Europe, will Europe be able to pull out of the current economic free-fall. American economist Lyndon LaRouche's proposed Paris-Berlin-Vienna "Productive Triangle" for high-speed rail and electric infrastructure investment would be the most appropriate topic for the next Franco-German summit. The alternative is more financial chaos, unemployment, and, ultimately, a derivatives-led collapse of the entire banking and financial system.