Why the Treasury threw a tantrum

The Treasury's decision to return to 'benign neglect' is a response to a bold European plan.

Returning from a meeting with other members of the Group of Five finance ministers' club in London April 12, Treasury Secretary Donald Regan told a New York financial writers' audience April 14 that the U.S. would limit intervention in the foreign exchange markets to a level below that conducted during the last two years of the Carter administration. In press statements later in the week, Treasury Undersecretary Beryl Sprinkel, the department's keeper of the monetarist faith, reiterated the decision to stay out of the markets.

The Treasury's statements drew an immediate outcry from bankers, including former Treasury Undersecretary Robert Roosa, now a partner at Brown Brothers Harriman, and from Dennis Weatherstone, vice-chairman of Morgan Guaranty Trust and a foreign-exchange market specialist. Both bankers had helped draft the elite Group of 30's report on the functioning of foreign exchange markets, published in February 1980. The upshot of Roosa's comments was that the Treasury's statments were dangerous and unnecessary, and opened the dollar to new turbulence of the 1978 variety.

The motivation for the out-of-the-blue switch to a "benign neglect" foreign exchange markets stance had nothing to do with Sprinkel's University of Chicago ideological bias. In reality, it was a response to a plan formulated by the finance ministers of the European Monetary System in mid-March at a Brussels closed session, approved by the March 24 summit meeting of European heads of governments at Maastricht in the Netherlands, and presented to the Treasury at the April 12 London meeting.

Europe proposed to peg the dollar to a narrow band of fluctuation against the European Currency Unit (ECU), the numeraire of the European Monetary System. This would return the world to a regime of fixed rates for the first time since the aftermath of Aug. 15, 1971.

The European plan was the subject of a memorandum circulating among White House staff in early March.

Nor is the European plan an ideological exercise, motivated by the longstanding French commitment to fixed exchange rates. Europe offered it by way of concrete implementation of its major proposal at the April 12 meeting, namely, a global lowering of interest rates. This avenue toward lower rates is more indirect than the approach which the French and Germans have adopted as a matter of domestic economic policy, namely, the institution of a two-tier credit approach (see *EIR*, April 28) aimed at providing low-interest credits for long-term investment. However, it is hoped that the currency approach will be easier for the Reagan administration to swallow, given its "free-market" bias against directed credit.

The logic is simple and impeccable: at present the great single source of credit demand in the dollar sector is borrowing for foreign exchange hedging purposes. Total borrowing to hedge against the fluctuations of the dollar against other international trading currencies now amount to over $150 billion, by an *EIR* staff estimate, or more than the entire U.S. mortgage market. The presumption is that a commitment to currency stability will persuade traders to abandon some costly hedges, thus reducing credit demand and interest rates.

According to Federal Reserve officials who reported the European plan to *EIR*, the West German mark will tend to weaken because the Bonn government has adopted an "expansionary" program. This estimate is not necessarily to be taken at face value; the Fed last November predicted that the mark would be at 2.50 to the dollar by this time. If anything, the foreign exchange markets will be subject to greater fluctuation in the near term due to the Treasury's tantrum over intervention policy.

Indeed, there are serious prospects for a new attack on the dollar, especially if the Reagan program fails to go through, in which case the Fed itself believes that the dollar will come under strong attack. A further explosion of U.S. money-supply growth could also weaken the dollar. It is significant that on April 23 the dollar was at DM 2.16, off its highs for the week despite slowly rising U.S. interest rates. The West German expansion program, especially if it continues to attract foreign investment at double last year's rate, could turn into a plus for the mark.

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