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Central banks envision a decoupled Europe

by David Goldman and Laurent Murawiec

Several months ago, Venetian industrialist and monetary crank Carlo De Benedetti told the Italian daily *La Repubblica* that Western Europe would have to abandon the dollar as a transactions currency, because the combination of dollar appreciation and exorbitant dollar interest rates was crushing the European economies. This was before President Reagan told Western European leaders attending the Williamsburg summit May 31 that U.S. interest rates would moderate and that the United States would review its attitude towards currency intervention.

Now intervention has, apparently, come and gone, with the hard-core non-interventionists back in the saddle at Treasury the dollar continues to rise, and interest rates are poised to repeat their surge since mid-May. The London *Financial Times* Aug. 11 retreaded De Benedetti's argument in a new and ominous form, under the headline, "Decouple from the Dollar."

Decoupling from the dollar

The decoupled Europe envisioned by the *Financial Times*'s Samuel Brittan, as well as the German-speaking central banks, would combine the domestic policies of Bettino Craxi's Italy and the foreign economic policy of Austria: an immiserated protectorate of the Soviet bloc. The worst loser, after several months of European economic disaster, will not, however, necessarily be Western Europe. As Brittan commented, it will probably be the United States.

"The durability [of the dollar's sharp rise] is highly questionable. The dollar may go too high and eventually generate an excessive current account deficit. The official estimate for this deficit in 1983 has just been raised from $20 billion to $30 billion. Overseas holders of funds might eventually become conscious of an overhang of dollar assets either because of the U.S. trade deterioration or because other factors sap confidence. If the financial markets ever started to view the U.S. current account or budget deficits in the same light as those of Mexico or Brazil, the dollar would drop like a stone."

The conclusion offered by the central banks of *Mitteleuropa*, now endorsed by the London *Financial Times*, is this: a rapid end to the recovery illusion, the collapse of Third World debt values, the eventual collapse of the American dollar, as the United States absorbs the whole impact of the Third World debt crisis, and an era of permanent austerity. In short, the world will look as if the United States had lost World War II.

What senior administration officials fear is the conjunction of the European currency crisis, provoked by an out-of-control scramble for dollars, with the Latin American debt situation. One official in discussion in mid-August cited Fed chairman Volcker's contingency plans for the event of Ibero-American debt default, which amounts to a pledge to purchase whatever volume of banks' holdings of bad Third World paper might be required to maintain the liquidity of the banking system. At the point that the banking system runs into the buzzsaw, the official argued, the dollar would collapse.

Deflationary pressures

What the United States has, in fact, offered the rest of the world, is described by the *FT*'s Brittan as follows:

"There are three types of strategy possible towards the dollar by the main OECD countries. The first is for them to try to establish an old-fashioned dollar standard; that is, to

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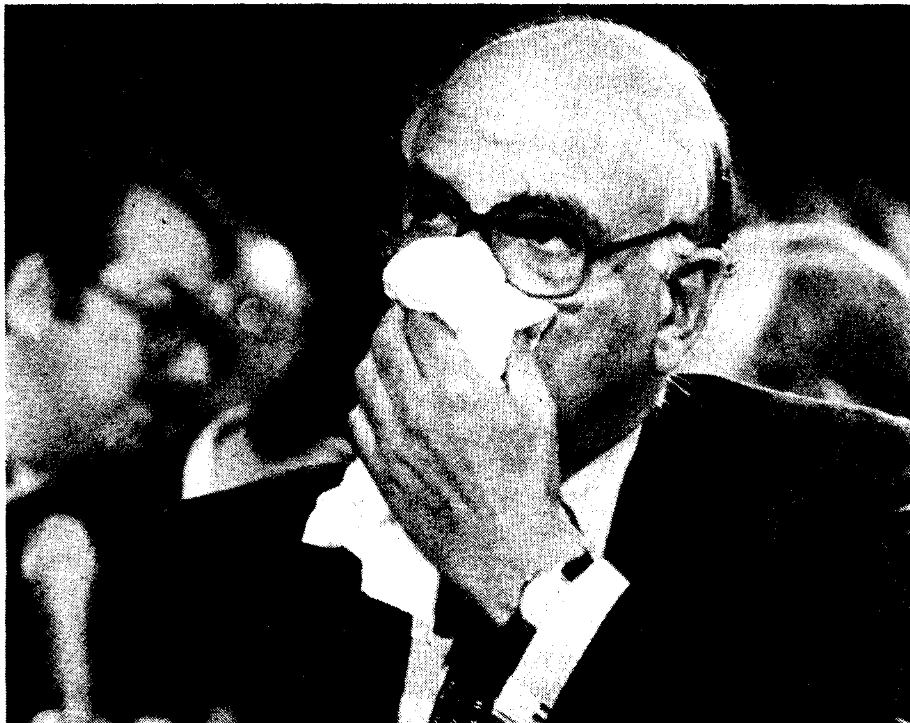
NSIPS/Stuart Lewis

Federal Reserve Chairman Paul Volcker's monetary policies have provided the pretext for further savage economic contraction in Europe.

stabilize more or less permanently—and presumably at higher levels than today's—their own currencies against the dollar.

"To make a dollar standard work, OECD countries would have to reduce the supply of their own currencies, which are now less attractive internationally relative to the dollar. . . . To stabilize the D-mark anywhere within hailing distance of the DM 2.1 top of the old target range could require actual deflation—falling prices—in Germany and other European countries."

The U.S. Treasury's alter ego, the *Wall Street Journal* editorial page, has been recommending this type of deflation to the complaining Europeans for some time, on the grounds that the strong dollar is just what is required to bash them into line.

For the record, West Germany's economic leadership does not disagree, in principle: West German central bank chief Karl-Otto Poehl said Aug. 10 that the rise of the dollar was good for West Germany, citing the supposed benefit for West German exports. Finance Minister Gerhard Stoltenberg echoed the sentiment. The trade argument is nonsense, and both men know it; the most likely result of rising dollar interest rates and European capital outflows will be French protectionism and the sudden attrition of a market which absorbs close to one-fifth of total West German exports.

However, the rising dollar gives Germany's ruling Christian Democratic Union the chance to unveil what one Swiss banker called "the economic wonder weapon," privatization of large chunks of German industry, combined with drastic rationalization of German heavy manufacturing capacity. This is on the agenda for the autumn.

More important, it gives the German-speaking central bank group—the Swiss, Austrian, Dutch, and German institutions—a springboard to an eventual *Mitteleuropa* financial policy, premised on a Central European currency bloc independent of the dollar. This has been the objective of the Swiss game since 1971.

Mont Pelerin Society economist Prof. Christian Watrin of Cologne University commented, "It means massive capital outflows from Europe—and that will hit Germany extremely hard. But the weakness of the mark is a vote of no confidence for this sclerotic government of ours which has only been able to postpone decisions. A change is overdue."

Similarly, at the Kiel Institut für Weltwirtschaft, international economist Dr. Lehment thinks that a 13-14 percent American prime rate is in the cards. Then, "Europe's current account surplus will simply finance the U.S. current account deficit . . . a huge transfer of purchasing power from Europe to the United States. The U.S. will be driven off of third markets in manufactured goods, it's already begun, and the next step is that the U.S. itself will be invaded by foreign goods. . . . But there is a 6- to 12-month fuse for the dollar to explode."

Volcker's funny money

The dollar's sharp rise will make the subsequent fall all the worse, argues the French daily *La Vie Française*, in an editorial entitled, "Dollar: The Clay-Footed Colossus."

The French newspaper states, "The dollar rise is the symptom of the deepening of the world crisis. The dollar is dear . . . because of the bankruptcy of the international banking system," since the dollar demand is either dollar-liability refinancing (borrowers) or dollar-asset refinancing (lender

banks).

Quoting former Banque de France Governor Olivier Wormser, the editorial adds, "From August 1982 through May 1983, Volcker had decided to generate about as much dollars as the international banking system required . . . he has manufactured funny money to meet the banks' demand." Now, the Fed must tread the narrow path of continuing to bail out the banks while continuing to draw in dollars to fund the budget deficit. As a result, interest rates are bound to soar.

Otmar Emminger drew the consequences of the capital drain from Europe in a particularly chilling speech Aug. 8. 'Positive real interest rates are here to stay. . . . We are living in an over-indebted world. . . . We are bound to make the appropriate adjustments. . . .'

The editorial continues, "The U.S. central bank has one and only aim: to create as much liquidity as needed to save the banking system without torpedoing confidence in the U.S. currency . . . as Volcker himself admitted: 'We've only been able to keep interest rates down by attracting capital.' Volcker's true problem . . . is to effect the indispensible monetary creation without the markets reacting on cue. . . . When the markets understand what the actual U.S. strategy is, or when it is advanced enough, the dollar will not drop, it will tumble, it will collapse. The greenback's future drop is implied in its present rise . . . the dollar will collapse not out of overvaluation but of overabundance. . . . From the moment that world leaders chose to save the bankrupt banking system, refusing to accept a global renegotiation of the debt of insolvent nations, from the moment that IMF austerity has proven unpracticable, the U.S. and Volcker have had no other solution than this monetary policy. . . . The present non-solution is the most cowardly."

Otmar Emminger's analysis

Former West German central bank governor Otmar Emminger drew the consequences of the capital drain from Europe in a particularly chilling speech before the Aug. 8 International Investment Conference in Cambridge."In the years ahead, a major challenge in the monetary and financial field will be learning to live with stability," Emminger said, equating stability with the "withdrawal symptoms after too much growth."

Emminger argued that there has been "a fundamental change in the real interest rate picture. . . . I do not need to stress what this turnabout from zero to very high real interest rates on dollar debt means for the world economy and particularly for debt-ridden Third World countries. For those latter countries, the real rate of interest of their dollar-denominated debt has risen well above that for American borrowers . . . in the years 1981 and 1982 their combined payment deficits on current account were nearly entirely made up by their net interest payments . . . nearly all their net capital imports had to be used for interest transfers abroad."

The former central bank chief continued, "Positive real interest rates are here to stay and in the foreseeable future probably at a relatively high level, especially for dollar debt . . . deficits are bound to keep real interest rates relatively high."

This means, Emminger added, that countries with large debt burdens must submit to savage adjustment. "Over the recent period of inflation the world has accumulated an awesome volume of debt. This is true not only in the international field. It is equally true of inflated domestic debt, particularly government debt . . . world debt (outside the communist bloc) both domestic and external increased in the decade from 1971 to 1981 at an annual rate of at least 15 percent while world production in real terms increased at about 3.5 percent. We really are living in an over-indebted world. Some have been saying that this problem can be solved only by inflation or bankruptcy. But we can afford neither. We are bound to have to make the appropriate adjustments.

"In the field of domestic debt, the adjustment has barely begun," Emminger declared. "I do not intend to go further into all these problems except to draw the conclusion that the government debt situation in the major industrial countries calls for an enormous adjustment effort with scarcely any room for stimulatory fiscal policies."

To argue that the high interest rates proceed from the U.S. budget deficit (which Emminger considers to be a permanent fact of life) is absurd, he continued, because "it is precisely the American budget deficit which is the chief propellant of the present recovery in the U.S.A. Ironically, this pure Keynesianism—government deficit spending through income tax cuts and high defense expenditures—provides the driving force behind the Reagan recovery."

Emminger politely ridicules IMF managing director Jacques de Larosière's argument that 3 percent growth recovery in the OECD countries might make the problem manageable. "At least for 1983 and 1984," he argues, "this is highly doubtful. . . . The present indications are that the world economic environment for the necessary payment adjustments of the debtor countries appear less favorable than that assumed by [de Larosière]."