Foreign Exchange by David Goldman

The era of exchange controls begins

Italy's stringent new dollar borrowing policies are the first shot in a European war against Volcker's looting policies.

A little-noticed wire-service item on July 20 announced that Italy had frozen the net dollar borrowings of the Italian commercial banks at their June 30 level, a form of exchange control responding to the fall of the Italian lira to its lowest-ever level against the American dollar. Unlike the mere prohibitions against export of capital employed by Italy and other nations (and flouted daily by the likes of Sophia Loren and Carlo Ponti), the new measure drives at the source of the problem, and may be the first shot of a new monetary war.

European residents in deficit nations cannot export capital except by increasing the net borrowing of their country's banks. To convert liras, for example, into dollars, Italians must first have access to dollars. In one form or another, Italian banks must provide the bulk of these dollars; since Italy does not earn sufficient dollars to finance export of capital, these dollars must be borrowed on the international markets.

If the Italian banks are forbidden to borrow the dollars, a dozen loopholes (including most phony invoicing of exports) are closed off.

Although Italy is the first nation to adopt such an exchange-control measure, the announcement typifies the forces unleashed by Paul Volcker's policy of looting capital from the Europeans in order to finance the enormous American deficits. The dollar no longer functions as a reserve currency in any normal sense of the word; that function disappeared when Continental Illinois Bank went down in a flood of deposit withdrawals overseas May 11, and Eurodollar rates rose to prohibitive penalty levels.

Although Eurodollar rates, after rising to 12¾% for six-month money, have since fallen to about 12⅜%, commercial bank analysts argue that the fall in Eurodollar rates reflects a swell of European currency lending to replace dollar lending, especially on the short-term markets. This corresponds to similar developments in Japan, where the change in policy with respect to the yen's international role has permitted a sharp increase in yen lending activity.

European central banks have, meanwhile, encouraged the development of a multibillion-dollar market in European Currency Units (ECUs), the composite, or artificial, reserve currency of the European Monetary System. Belgium's central bank governor, the successor to retiring Fritz Leutwiler at the Bank for International Settlements, was one of the designers of the ECU plan, whose intention is to replace the dollar as a reserve currency.

All the required machinery has come into place to eliminate the dollar from European markets, at the point that the developing nations' debt crisis and related turmoil in the dollar banking sector force a fall in the dollar's international value. Europeans have been livid at Paul Volcker for years, and the European central banking circuit is working this rage up into monetary warfare against the United States.

"The reason why Paul Volcker, the Fed and the Treasury are letting U.S. interest rates go up and up and up is that it is the best, easiest, cheapest way of funding the liabilities of American banks which are not being paid by Third World debtors. High interest rates suck in billions of dollars which the banks can use," a City of London financial insider said.

Another British source said: "The U.S. has simply decided that the only way to live with the deficit is to have somebody else finance it—that means the rest of the world. The Fed and the Treasury are in a corner and they are doing whatever they can think of to get out of it."

A second, slower but more powerful factor operating on behalf of a European currency zone is the drop in oil prices, punctuated by a reported Soviet announcement on July 27 of a $1.50-per-barrel price cut for August deliveries, combined with a $4- to $5-per-barrel cut in Iranian prices. Rumors are flying (and being denied) that OPEC is about to break up, through the departure of Iran, Nigeria, or some other financially pressured member.

As *EIR* warned subscribers to our *Alert* service on May 7:

"View this from the Soviet strategic perspective . . . an oil price decline could accomplish Soviet objectives more subtly [than by shutting the Gulf], and perhaps more effectively—without creating the risk of American response. A drop in oil prices would constitute an enormous bribe to the Western Europeans (e.g., Thatcher, Genscher, Andreotti) who are now discussing replacing the dollar as a principal European reserve asset with a basket of their own currencies.

Add to this the devastating impact of an oil-price drop on heavily indebted Third World producers, especially Mexico, as well as the impact of OPEC deposit withdrawals from the already-tense Eurodollar market."

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