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Foreign Exchange by David Goldman

Dollar crash to be forced on U.S.?

It's American Express Bank's "final solution" for the U.S. budget deficit.

American Express Bank, in a report published Sept. 29, while the International Monetary Fund's Interim Committee was announcing a collapse of the policy-consensus among Western nations, revealed the inner workings of Treasury Secretary James Baker's curious mind: Baker had warned that U.S. authorities would force the dollar down unless its trading partners agreed to reflate. Until then, Federal Reserve chairman Paul Volcker had been warning that a further fall in the dollar might provoke an outflow of the foreign investment that had financed both the current-account deficit and the budget deficit up to that point, with disastrous results.

It appears that a new policy consensus has emerged out of the ruins of the Group of Five's September 1985 "Plaza Agreement," to permit a dollar crash to force a sudden reduction of the U.S. deficit. Amex, about which it is not irrelevant to note that Henry Kissinger is a member of the board of directors, writes in its Sept. 29 *Review*:

"The evidence suggests that a level of well under DM 2.00 or perhaps even below DM 1.50 can be justified" for the U.S. dollar. The bank adds, "On strict competitiveness grounds this . . . view is supported by analysis of trends in inflation and productivity over recent years." Echoing the U.S. Treasury's threat to bring the dollar down even further, Amex Bank recommends a further dollar collapse as "the easiest way for the U.S. to resolve the problems created by the policy mismatch of recent years, without a recession."

How is this possible without recession? "The lower dollar will both reduce the U.S. trade deficit and stimulate faster economic growth. A falling trade deficit will make it imperative that the budget deficit is reduced—otherwise U.S. interest rates will inevitably rise as the capital inflow declines. Domestic investment would be 'crowded out' by the Federal deficit. But as exports rise and imports fade, this will stimulate the U.S. economy and provide a window of opportunity for Congress and the administration to finally reduce the budget deficit."

Meanwhile, the dollar-sterling crisis continues, despite a politically unpopular rise in British interest rates. The Bank of England's increase of its base lending rate from 10% to 11% on Oct. 14 will hurt Prime Minister Thatcher's re-election chances, but has not helped the sinking pound. Thatcher's increase indirectly puts additional pressure on the dollar, which has only European and Japanese central-bank support going for it—a staggering total of $38 billion of intervention this year so far, and most of it coming during the third quarter.

Because European central bank intervention has propped up sterling, the European faction which wants to cut loose from the dollar—centered in the German Bundesbank—has additional leverage to demand that sterling leave the dollar orbit.

According to the London *Times* of Oct. 13, the Bundesbank chief Karl Otto Pöhl will indicate to Prime Minister Thatcher that the Bundesbank is reluctant to continue supporting the pound as it has since the September "Gleneagles" meeting of European Community finance ministers agreed on common action to guard against a further fall of the dollar. Pöhl, who has advocated U.K. membership in the European Monetary System, will meet Thatcher in London on Oct. 20. Thatcher is reported adamantly against U.K. membership in the European currency zone as it would limit her ability to apply credit stimulation prior to the national elections. EMS membership requires strict central-bank adherence to common targets, regardless of domestic needs.

German Finance Minister Gerhard Stoltenberg warned over the Oct. 11-12 weekend that central bank intervention could not change the dollar's trend, echoing previous warnings by the Bundesbank. The domestic consequences of the Bundesbank's intervention have now become a political pretext for the German authorities to let the dollar collapse. According to a spokesman for the German economic institute, IFO, the Bundesbank target of 3.5% growth of money supply has been exceeded by double, to 7%. "The Bundesbank is in a bind. The EMS rules dictate the expansion of money supply to keep currency stability at present, while domestic policy calls for far tighter credit."

Thatcher's own position is slipping, and the sterling crisis is out of control. The Bundesbank faction that wants to let the dollar go (the so-called Swiss group) knows what the strategic consequences would be: They look to a neutralized Germany in the Soviet sphere of influence. But it appears that they have made Treasury Secretary Baker an *ex-officio* colleague.

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