Dollar Weakens Before London Summit

FOREIGN EXCHANGE

The dollar weakened abruptly in the latter part of this week against most Western European currencies as well as the Japanese yen. In the space of two days — May 4-5 — the U.S. currency dropped 2.5 pfennigs vis-a-vis the deutschemark. It also depreciated in terms of the Dutch guilder and Swiss franc in particular, and this general climate allowed the Belgian franc to hold steady despite an unexpected cut in the central bank lending rate of half a percent to 6.5 percent. The Bank of England was obliged to intervene to keep sterling from rising above the $1.72 level.

The proximate cause of the dollar's new slide appeared to be the sheer volume of essentially non-investible dollars in circulation at a conjuncture of uncertainty and mistrust regarding U.S. policy. The *Journal of Commerce* even reported May 5 that an "avalanche of dollar selling" is anticipated for May 6, the last trading day before President Carter meets other Western leaders at the London summit. Traders around the world, at any event, quickly decided that the dollar confidence following Federal Reserve Chairman Arthur Burns' May 2 pledge to counteract inflationary dangers had been an unwarranted reflex.

At the same time, rumors have persisted that the London summit will see some sort of agreement to officially encourage the appreciation of the deutschemark and the yen, in accordance with U.S. demands for a reduction in the trade surpluses of West Germany and Japan. The new head of the West German central bank, the Bundesbank, Otmar Emminger, has repeatedly indicated that he would agree to a revaluation policy for the mark. It is quite likely that some realignment of the mark-dollar relationship will soon take place; there are two distinctly different forms this realignment could take.

The first, of course, would be a degree of appreciation of the mark, and with it probably the Dutch guilder, that would widen these currencies' spread against the others so far as to make the joint-float "snake" itself no longer viable, with immediate chaotic side-effects for sterling and the French franc as well. This has been the explicit hope of Wall Street banking strategists since they developed the "two-tier" policy of deflation for the weaker Western European economies plus a combination of inflation and export curbs for West Germany and Japan. The *Journal of Commerce* claimed May 5 that it is widely believed that "the market can expect the breakup" of the snake very soon.

The second possible kind of realignment would involve the appreciated mark and guilder bringing the other snake currencies upward with them — a de facto devaluation of the dollar. This option would portend less damage to West German export competitiveness, since so much of its trade is with European partners; beyond this, the shifted relationship to the dollar would take on political significance.

Meanwhile, the mark has already reached the floor of the snake in terms of its Dutch guilder parity, burdening the rather strict central-bank intervention controls that have thus far sustained the snake's narrow fluctuation band. Market-watchers agree that the upward pressure on the mark this week was an operation conducted by a relatively small group of traders betting on a mark-yen appreciation. Given the atmosphere of skepticism toward the dollar, the maneuver had magnified effects. In one of the petty ironies of the markets, this operation, described by the Bank of America as an "essentially political" thrust on behalf of the trade- and snake-wrecking scenario, was fueled by reports of the improved payments surpluses of West Germany and Holland, as well as the 12 percent increase in Japan's letters of credit since last April.

Gold remained basically stable at a London price in the $147-149 range. Swiss sources confirmed New York reports that various non-Wall Street investors in the U.S. have been liquidating portions of their dollar-denominated holdings in favor of gold. It was also notable that, at the Puerto Rico conference of the Bankers Association for Foreign Trade this week, the director of the central bank of Belgium, Cecil de Stryker, made a call for a return to fixed foreign-exchange parities and added that "the United States must accept discipline" with reference to the world inflationary threat. Officials at the New York Federal Reserve, while hoping that the London summit could force the deutsche mark up at the expense of the snake, confirmed that they see the dollar as gravely worrisome because — by contrast with what they described as the political questions affecting the lira and French franc — its fundamental economic position is so shaky.

Inflation Fears Depress Capital Spending Plans

BUSINESS OUTLOOK

Fears of an inflationary upsurge prevailed in the money markets this week, and continued to throw a large damper over business plans for capital expansion.

The increase registered for March of the nation's factory orders by 5.2 percent and construction spending by 5.6 percent — is, if fact, a key index of the overall problem: an even moderate increase in U.S. economic activity requires a corresponding tremendous increase in money supply to finance and circulate the large volume of debt built into U.S. prices.

Thus, the U.S. money supply has been charging ahead for the past five weeks as wholesale prices have risen at a 13.2 percent annual rate for the first four months of this year.

The wholesale price increases were the shock the heavily indebted economy had to pay for industry to find it profitable enough to build up inventories by $7.5 billion in the first quarter, and to facilitate parts shipments, etc., for the March-April auto boomlet, itself financed by a huge increase in consumer installment credit.

As more money was needed to finance the price rises, money supply aggregates rose steeply: M1 increased by $1.7 billion for the week ended May 4, while M2 shot up by $2.1 billion, jumps of 22.2 percent and 14.1 percent respectively for the last four weeks, far above the Fed's target ranges.

In response to the steep rise in money aggregates for the week ending May 4, and fears of wider inflationary pressures if the economic expansion gets underway, the Fed raised the fed funds rate to an effective 5.25 percent by Thursday May 5, an increase of 50 basis points in one week.

This is only the beginning of a nasty cycle. The fears of a rise in interest rates will awaken fears of inflation — and hence increase inflation through anticipatory "preemptive" price increases, etc., with the predictable further leaps in money supply.

The lead *Wall Street Journal* editorial of May 5 substantiated this point, complaining of the "rational explanation" of inflation moving in tandem with money supply, which makes these virtually an identical phenomenon.

Inflation Shudders Hit Nation

The money markets were for the most part quiet this week in immediate response to the fears of hyperinflation, but with an air of foreboding hanging over more long-term decision-making. Increases of only 10 basis points took place for most market instruments this week. The important exceptions, which might be important to watch, are the rate for three month Treasury bills, which sold at 4.81 up from 4.52 the week before, and six month Treasury bills, which sold at 5.05, up from 4.84 the week before. The Treasury successfully completed a $3.75 billion sale of securities, all of which is for refinancing, at "normal" interest rates.

Corporate bonds sold well, in a month that will see less than $1 billion in new corporates come to the market. Most of this is accounted for by the fact that: a) most corporations have already restructured their debt, b) the short-term markets and the commercial paper market are more attractive to corporations than the longer-term markets (short-term rates are about 2 percent lower currently), and c) of overriding importance, according to most analysts, there is a lack of aggressive corporate financing for capital spending arising from corporation uncertainty over the Carter "no energy program," and the worrisome state of the dollar.

There is a sufficient flush of life and fire insurance and pension funds for the municipal and Treasury market.

In comparison to the Treasury's paydown of $2 billion in the second quarter, the Treasury must go the market for $15 billion in the third quarter, and possibly a lot more if Carter's public works proposals — aimed at creating an increase in "make-work" employment — are passed by Congress on a large scale.

This latter prospect worried one Texas gold specialist who commented, "Our major concern out here is the new spending bills in the Democratic Congress." Commenting on the overall national inflationary tendency, he predicted that "gold will climb to $170 to $180 an ounce by the end of the year, as investors drop out of their positions in inflation-soaked dollars.

More ominous is the impossible financing situation confronting the weakest point of the U.S. banking system, the near insolvent New York banking majors.

Left to their own resources, the shaky New York banks lack the means to handle the financing at moderate interest rates — if at all — of some $16 to $18 billion in Third World debt due around the end of the second quarter.

Regional U.S. banks, whom the New York banks have arm-twisted into Third World loan syndications in the past, are moving out of such syndications in droves, particularly in the sourthwest, according to reliable banking industry sources.

The mere fear that the New York majors will be unable to refinance this debt — with the result of widespread defaults and moratoria — is sufficient to turn the existing liquidity flush into an illiquidity crunch.

Parallel to the inflationary fear surrounding the money markets, is the problem confronting industry. Exemplary of the problem is the by no means exceptional case of the country's steelmakers, who responded this week to the anticipated steady 7 to 9 percent increase in prices for the year, and the need to boost their lagging profits by announcing planned price increases of their own.

Allegheny-Ludlum, a major producer of stainless steel announced May 2 price increases on stainless sheet, strip and speciality strip which will take effect May 9. Allegheny-Ludlum's chairman, Robert J. Buckley, cited "severe competitive pressure from subsidized imports" for keeping steel prices below 1974 levels, while noting that the price of stainless steel scrap has risen 25 percent in the past 24 months (although overall steel scrap prices have been falling sharply) and also that energy costs have increased by as much as 45 percent for the steel industry for the last 24 months.

Edgar Speer, chairman of the board of the largest U.S. steel producer, also announced May 2 that U.S. Steel will take "under study" whether to raise prices, and that such rises may occur within the next 30 to 45 days.

The worries of the debt-bloated steel industry are that profit margins are paper thin: first quarter profits for the steelmakers were down by 93.1 percent over the same quarter last year. In response to these conditions, the steel industry is sounding the trumpet of protectionism, and threatening an all-out trade war, thus reinforcing the very same tendencies in Europe's depressed steel sector. President Carter's proposal to remove import quotas on specialty steel items, which were set up by President Ford, and worked with some degree of effectiveness, are thus viewed with alarm.