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FOREIGN EXCHANGE

Volcker's initiative can't support dollar

The problem with any attempts to support the U.S. dollar by dramatic interest rate increases and a clamp down on money aggregates—such as Paul Volcker of the U.S. Federal Reserve is now doing—is that such a policy must weaken the dollar.

Although some international analysts have compared Volcker's Oct. 6 "package" to the measures introduced since 1978 by the Swiss Central Bank to keep the Swiss franc in tow with the West German mark, the fatal flaw in drawing any such comparison is that the dollar is the international reserve currency; the impact of Federal Reserve policies will show up in the direction and volume of capital flows between the domestic U.S. and international markets.

A well-placed Swiss financial source (many of whose colleagues are also finding it increasingly difficult to live with the Swiss Central Bank's interest rate/capital controls regime) warned that the dollar will now continue to fall against the West German mark and other European currencies.

Volcker's severe "credit-tightening" measures will force large foreign holders (of U.S. securities) to liquidate held stocks and bonds, he explained. The international gold market will be the safest attraction for these funds. As the gold price rises and dollar securities fall international investors in dollar-denominated paper will become disappointed. As they dump their dollar holdings, the dollar will fall again, forcing the Federal Reserve to push rates up further to fuel the whole rotten cycle.

"If the dollar lends at interest rates of 20 percent, it will be looked at as no better than the Brazilian cruceiro," he added. "It will become an exotic currency. No one will want it."

Chaos foreseen for Euromarkets

In response to the record rise in the U.S. prime rate to 14.5 percent, interest rates on the Eurodollar market also took off this week. Three-month certificates of deposit rose 150 basis points between Oct. 6 and 10 to over 15 percent.

There are two immediate impacts this overall interest rate climb will have on Eurodollar lending.

In the short term, it is very likely the West German Central Bank will marginally hike deutschemark interest rates to offset the danger of capital outflows to higher earning Eurodollar paper.

Hovering around a 7.75 percent on short-term funds, West German rates still offer a prime investment because domestic inflation in West Germany is so low. The latest monthly figure for inflation was .1 percent, compared to the U.S. wholesale price inflation at annual 17 percent.

Several European financial journals including France's *Le Figaro* and the London *Financial Times* issued warnings early this week that international "interest rate warfare" could erupt now.

The threat of major interest rate fluctuations in an upward direction raises the prospect of a huge dollar-dumping spree hitting the markets at any time in the near future, as under such conditions, the dollar would have no credibility as a reserve currency.

What Volcker's approach to dollar "support" ignores is that the dollar's international exchange value is primarily based on levels of international dollar lending. For example, in recent months prior to Volcker's move, the dollar's relative stability around the 1.75 deutschemark level had been based exclusively on the creation this year of the European Monetary System, a currency and central banking stabilization agreement among continental European nations which permitted West German and French banks to continue to issue large volume dollar loans, particularly to Third World borrowers who used them to generate European imports. Without this international activity, there would have been little to stop the dollar from hitting 1.6 marks or far lower.

Now, it will become increasingly difficult for these banks to continue such "stability"-oriented lending, most of which occurs as six-month papers (based on six-month borrowings by the banks) whose rate of return is adjusted after that time to currency Euromarket rates.

If these strongly "prodollar" banks cannot lend, they will never be able to hold the tide against repeated rounds of dumping by "antidollar" banks—particularly British banks—and panicky international speculators.

Full impact in abeyance

As we go to press, the dollar is firm and the markets are quiet. On Oct. 10, the dollar traded for 1.7825 marks (slightly higher than Oct. 9 at 1.7730 markst) and 226 Japanese yen (compared to 225.40 the day before). However, this stability can mostly be attributed to intervention in bahalf of the dollar by the West German Central Bank and to the low volume of trading, as international speculators and dealers take a "wait-and-see" attitude.

To date, only the French press among continental Western European financial journals has expressly denounced the Volcker package. While France's *Le Figaro* warned of "intensified dangers of recession" in the U.S. this week, West German bankers and currency traders universally approved of Volcker's package on the grounds that someone had finally taken the bull by the horn and that West Germany also has repeatedly gone through credit-tightening.

—*Renée Sigerson*

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