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Foreign Exchange by Richard Katz

The dollar's new decline

The U.S. currency began a downswing, despite a 10 percent interest rate differential in its favor. The "risk factor" is now the most important.

In the week to April 10, the American dollar lost roughly six percent of its market value against the West German mark, the Japanese yen, and other major currencies (except for sterling, which only rose 2.5 percent against the dollar). This development was largely foreseen and predicted in this column during the past four weeks. There are, however, certain special features to the dollar's fall which require more careful analysis.

Foremost of these is the failure of what the Europeans call interest rate warfare. Contrary to most predictions in British and American media, West Germany's Central Bank Council failed to raise interest rates at its April 10 session. The fact that the dollar fell sharply despite a continued interest rate differential of 10 percent between short-term Eurodollars and Euro-deutschemarks is impressive. As indicated in last week's commentary, risk now is more important than the interest rate factor.

Nor is this an issue of exchange risk; at a 10 percent spread, a speculator selling deutschemarks to hold dollars would make a profit even if the dollar fell to DM 1.75.

The other well-circulated explanation for the dollar drop is that a "peak" of American interest rates is now expected. In fact, despite the April 9 statement to this effect by Citibank Chairman Walter Wriston, no such expectation is generally held in Western Europe. Economic contraction produces both increases and decreases in "demand" for credit, i.e., the willingness of the Fed and the commercial banks to supply it. In this case the dropoff of Federal tax revenues plus the additional funding requirements of unemployment insurance and similar items on the account of the Federal government alone will strongly counterbalance the drops in mortgage and other credit already underway. If the Fed and the banks shut the private sector off in a major way, the resulting chain reaction of bankruptcies will make the conventional discussion of an interest rate peak irrelevant.

Should Europe unload its dollar holdings over the next weeks that action could well push the American financial situation over the edge. The next week will be critical. If Europe chooses not to bail out the dollar, at its own expense, this time around, the implication is that the split between Washington and the European capitols is nearing finality.

The Iran crisis as such is not a sufficient explanation for the dollar's troubles, either; a shutdown of Iranian oil supplies would hurt Europe and Japan more than America, and damage their currencies.

Today's announcement by the European foreign ministers refusing to take part in the sanctions President Carter plans against Iran is as good a surface indication as any of what is in the works. Europe has not chosen to take the bait that Washington set out: a round of interest rate warfare leading to what Federal Reserve officials call an "in-phase" European recession matching the American recession. The Europeans, instead, are counting on 1) trade and financial contracts with the Arab world and 2) a major export drive to keep their economies moving through 1980, no matter what happens to the United States. That implies that Europe will not devote its financial resources to investments in short-term American paper.

This doubly complicates Federal Reserve policy. A sharp outflow of foreign holdings in Treasury or private market obligations will add to the liquidity squeeze on the American markets. At the same time, European fears for the safety of American markets, and the widespread evaluation that a chain-reaction financial panic is near, will tend to accelerate the dollar's problems.

If Western Europe chooses to remonetize gold and replace the dollar component of its reserves with gold-backed national currencies or European Currency Units, a procedure that is technically trivial under the European Monetary System, the United States will enter a depression alone. Europe would, of course, be affected. But the side effect of a declining American market for European goods would be a greater incentive to press ahead with expanded trade relationships with the Soviet sector and the developing sector.

Unless there is a substantial cutoff of oil supplies to Europe, the dollar has a long way to fall.

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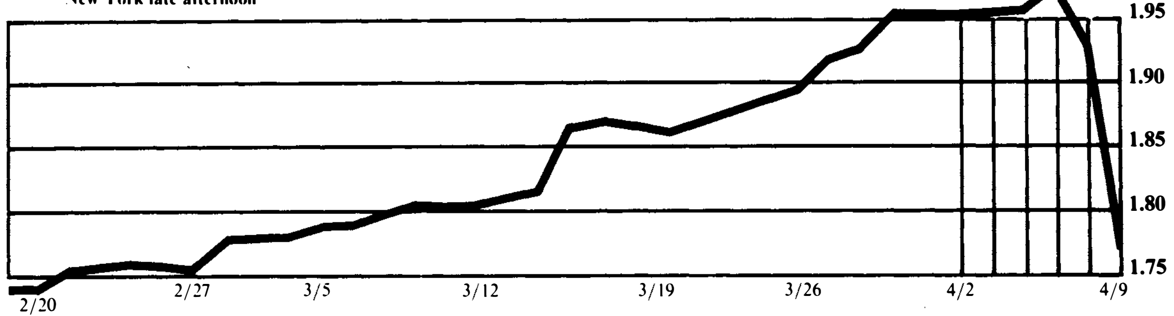
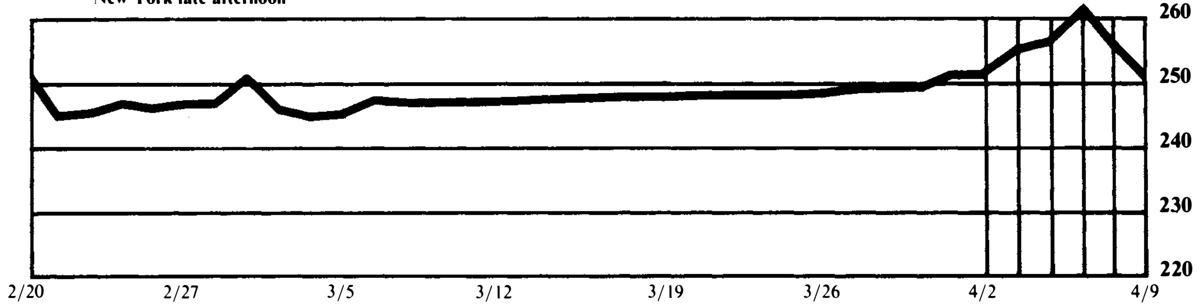
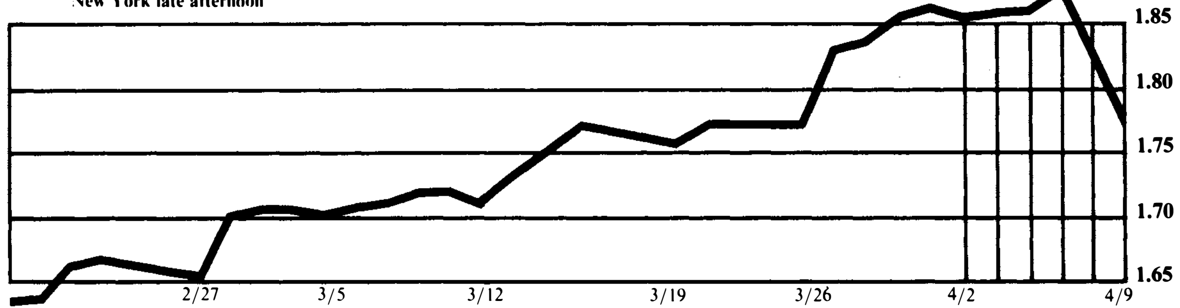
The dollar in deutschmarks
New York late afternoon



The dollar in yen
New York late afternoon



The dollar in Swiss francs
New York late afternoon



The British pound in dollars
New York late afternoon