

Foreign Exchange by David Goldman

Flows into the dollar end

Analysts detect the end of the big inflow into the dollar, and the beginning of dollar weakness.

New York investment bankers who manage portfolios for foreign institutions and individuals report that the wave of inflows into the American markets from abroad has ended.

Although full data are not available, "the basic portfolio adjustments have all been made, and no new funds will be placed in the United States," according to a former Federal Reserve foreign-exchange specialist now in the investment sector.

"Even if there were to be a bull market—and foreign investors think the stock market has been getting ahead of itself—there would simply be a shift from bonds into stocks, rather than a commitment of new funds to the United States," the investment analyst adds.

Chase Manhattan Bank's weekly newsletter *International Finance* raised the question, "Does a weaker current account mean a softer dollar?" in the title article of its Nov. 22 issue. Chase points out that while the United States has already moved into current-account deficit (on exchange of goods, services, and interest payments) the dollar's extraordinary strength since the summer has been based on "shifts in global preference for dollar-denominated assets—relative to assets denominated in other currencies."

In other words, the falling demand for dollars due to the negative commercial account has been outweighed by capital inflows.

However, Chase's comment misconstrues the source of demand for

dollars.

The principal portfolio shifts from abroad into the United States took place in the form of transfers of dollar-denominated deposits in the Eurodollar market, into U.S. Treasury securities (of which \$217 billion were on offer in fiscal year 1982).

This shift had little to do with the comparative attraction of Treasury securities, but reflected, instead, the conviction of a large number of Eurodollar-market depositors that the offshore banking centers might collapse, and that even large banks might "walk away" from the obligations of their foreign branches.

Demand for dollars, on the other hand, has been generated abroad as a spinoff result of the liquidity crisis in the Euromarkets.

The inability of many European and other banks to fund their existing deposits at acceptable interest rates, as a result of the ferocious quality premiums dominating the market since June, forced them to convert local currency into dollars in order to meet their dollar obligations.

It appears that the dollar has reached the peak of a perverse cycle, and that major foreign investors, who funded perhaps \$40 billion of the previous fiscal year's Treasury deficit, are preparing to move to greener pastures.

The principal talk among investment managers is the Tokyo stock exchange, which is expected to benefit from the unwinding of the Wall Street bubble, despite the difficult situation

in Japan's home economy and foreign trade.

In the second week of November, foreign purchases of Japanese stocks reached a record of \$309 million. Japanese securities firms in the United States report an annual surge of buying interest from major institutional investors, including life-insurance companies and pension funds, who earlier showed little interest in Japanese equities.

What is now under intense discussion at the Fed and other central banks is whether the dollar is going to have a hard or soft landing. Paul Volcker's problem, European central bank officials report, is the American dependence on foreign funds to handle the mammoth Treasury borrowing requirements which will certainly continue through next year.

A stabilization or rise in U.S. interest rates would produce a crash on the stock and bond markets—which are dependent on cheaper funds—possibly then persuading foreigners to liquidate en masse.

But an attempt to reflate the economy and to lower interest rates by permitting a surge in credit expansion would, also, persuade foreign investors that the Fed had given up attempts at monetary control, and potentially produce the same result.

The situation is eerily similar to 1929, when the Federal Reserve presented itself with a Hobson's choice between loose money, which would encourage the speculative bubble on Wall Street; or tight money, which would raise interest rates and draw in additional foreign funds. Ultimately the Fed chose the latter, on the counsel of the Bank of England, and blew the bubble out in the October 1929 crash. There is no reason to suspect that the Fed has matters under better control today.