

## Foreign Exchange by David Goldman

### Rumblings against the dollar

*Volcker will not be able to maintain tight money abroad and loose money at home in the long run.*

The principal question now asked by European money managers is, how long can the overvalued dollar hold up? The discussion was not helped by Morgan Guaranty Trust's widely quoted "World Financial Markets" newsletter, which argued in July that unreported "services income" actually made the American current account payments deficit look better than it was. Morgan's economist Rimmer de Vries argued, in effect, that flight capital was holding up the dollar nicely, reducing the pressure on the U.S. currency resulting from the \$30 billion per annum current account deficit.

As Olivetti chairman Carlo de Benedetti warned in June, the Third World debt situation represents a "floating mine for the dollar." Morgan's analysis failed to make explicit the fact that the "unreported services income" reflects large doses of international flight capital, especially from Ibero-America. Since most Ibero-American trade is conducted in dollars in any event, the collapse of Latin American currencies does not benefit the dollar vis-à-vis the major European currencies.

However, Ibero-American capital flows into the U.S. have dried to a trickle since the financial crisis makes it hard to bring money out. Venezuelan capital flows replaced Mexican after Mexico's bankruptcy late last year, but now it is virtually impossible to bring funds out of Venezuela, or any

other Ibero-American country.

The short-term determinant of the dollar's relationship to other major currencies is not so much the Ibero-American situation as the Western European position. More to the point than inaccurate reporting of current-account flows are capital-account flows. European portfolio managers have stopped shifting money into dollars and are shortening maturities of their existing dollar paper, anticipating higher rates. A shift downwards of Euro-Swiss franc rates shows some funds moving to Switzerland.

Most of the Western European institutions are poised to move out of the dollar, and could leave in one great rush. However, they are not likely to do so immediately.

The Europeans, for the most part, believe the dollar will continue to strengthen in the short run, due to the funding problems of European countries and their national banking systems in the Euromarket. As Union Bank of Switzerland's foreign exchange group argues in UBS's current markets report, European dollar debt on the Euromarket is about \$300 billion, with annual interest of about \$40 billion; a large chunk of the interest must be paid by converting local currency into dollars, supporting the dollar. This compensates for the U.S. current-account deficit of about \$30 billion per year. The dollar has been held within a relatively narrow trading

band by this odd equilibrium. Slowly rising dollar interest rates and a persisting overvaluation of the dollar are both due to the worsening world liquidity situation.

There is no immediate reason for this state of affairs to change. *EIR* does not believe American rates will come down nor that the financial position of the weaker European nations will improve. On the contrary, the brief respite accorded the French franc following the introduction of Finance Minister Jacques Delors's austerity program will not last long. The question may well be asked, why should the dollar not remain high indefinitely?

This is where the Ibero-American financial picture becomes decisive. Fed chairman Volcker has played a balancing act between an extremely loose monetary regime in the United States (since the third quarter of last year) and a tight monetary regime abroad. The two are inseparable, i.e., the Volcker reflation at home could not work if the dollar fell in response to domestic liquidity creation. The Fed's ability to preserve this anomalous and unstable situation depends on America's role as the world's major creditor.

When the Ibero-American bomb explodes, the Fed will abandon what is now a neutral policy stance and discount banks' loan-paper in huge volume, triggering a major fall in the dollar. Bank of England sources look for a big and sudden, rather than gradual, drop in the dollar early in the fourth quarter, due to the triggering of the debt problem, or perhaps due to announcement of a series of very bad U.S. trade numbers.

It is impossible to assign a date to any of this, since the anticipation of trouble could become self-fulfilling at any time the major European fund managers decide to act.