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Foreign Exchange by David Goldman

The dollar's last rally?

The worsening liquidity squeeze is good for the dollar's short-term performance and bad for the continuing existence of U.S. banking.

On June 22, the dollar was fixed in Frankfurt at 2.7868 Deutsche marks, up sharply from DM 2.7573 the previous day. The dollar's strength has variously been attributed to the administration's announcement that Gross National Product was growing at a 5.7% annual rate during the second quarter and related expectations of continued "overheating" in the American economy.

All that is nonsense. The dollar is momentarily strong because the Fed has gritted its collective teeth in the face of a global liquidity crisis which, among other things, has driven the overnight interbank rate (Federal funds) to around 12% during the week ended June 22, against about 8.5% in the corresponding week of May.

The London interbank rate for six-month money, the benchmark rate for international lending, stood at 12.75 on Friday, the highest in two years. This is what British banking sources describe as a "prohibitive rate," i.e., one that prevents borrowing. Not all American banks, after the Continental Illinois disaster, can find funds at any price, and those who do pay substantially more than the listed rate. The Eurodollar interbank market, which contracted about 5% in the immediate aftermath of the Chicago bank's problems, has contracted further since, through steady bleeding of deposits.

It also means that the Latin American debtors, whose interest costs carry a "spread" above the interbank rate, now pay 14% or over. This simple fact has forced the hands of the debtor nations, who cannot pay and must band together, whether they prefer to or not.

American banks, meanwhile, have been scourged from London and must fund themselves, to a rising extent, in their own interbank market, pushing domestic rates up towards the "prohibitive" rates charged in the offshore market.

Under the circumstances, a large number of dollar debtors, especially in Western Europe, prefer to liquidate their own currencies to obtain dollars required for interest payments, rather than pay the prohibitive rate to borrow dollars. The worsening liquidity squeeze is very good for the dollar's short-term performance and very bad for the continued existence of the American banking system.

For obvious political reasons, the Federal Reserve does not want to open the monetary floodgates quite yet; this would be to admit that the banking crisis is out of control. It would send the wrong signal (from the Fed's vantage point) to the debtors in particular. The fact that money supply grew above the Fed's target range as of the June 21 Federal Reserve announcement is extraordinary proof that the Federal Reserve is putting huge amounts of money into the system, nonetheless. Under conditions of "flight to quality," fear itself produces a measure of contraction of the monetary aggregates, as depositors leave the banking system in favor of Treasury bills. The sharp growth of money supply shows how hard the Fed is working the pump.

Still, the contraction of Eurodollar deposits is clearly more rapid than the Fed's action, as the rising interest rates show. They also show that the Fed's restrained largesse is not sufficient to prevent major new institutional disasters, either in the form of runs against American banks, or write-offs of large chunks of foreign debt, or both.

The latter have probably been postponed until July and August, when much of Argentina's debt will exceed 180 days' arrears, and banks will have to write it off. Whatever the pretext for the next crack, time is running out for the Fed's monetary stoicism. *The Fed will print, and print wildly, to save the American banking structure. If it delays until the last moment, a further rise in the dollar and a sharp fall of bond and precious metals prices might emerge.* But the dollar's strength, under such circumstances, would be short-lived as a tuberculosis victim's last flush of energy.

This much is the content of the just-issued annual reports of the Bank for International Settlements and the Organization for Economic Cooperation and Development, which warn the United States of a withdrawal of foreign capital and a precipitous fall of the dollar.

David Henderson, OECD chief economist, told wire services June 21 that the U.S. payments deficit has sustained the recovery, because international capital markets have been willing to finance the U.S. current account shortfall. But Henderson warned, "The absolute numbers for both deficits are very large, larger than the world has seen before."

Henderson warned that the result might be "a sudden decline in the dollar on the foreign exchange markets, which could cause U.S. authorities to tighten monetary policies to prevent a resurgence in inflation, destroying the so-called recovery," Henderson concluded.

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