Foreign Exchange by David Goldman

Bundesbank cuts loose from dollar

In a drastic reversal of policy, the West Germans flirt with monetary decoupling.

The dollar has lost 10% against the West German mark since the International Monetary Fund's Interim Committee failed to produce the deal that Treasury Secretary James Baker sought (and is still seeking): a second, coordinated reduction of interest rates among all the central banks.

Although the Japanese followed the Federal Reserve's April 18 drop in the discount rate, the facade of international cooperation was shattered at the IMF meeting.

Bad U.S. economic news merely confirmed the trend already registered in the foreign-exchange markets, as a political perception.

The warning sign came on April 22, when the Dow-Jones bond market index fell a stunning 3%, reportedly due to fears that European and Japanese investors were oversaturated with dollar paper.

That is probably true: The point has arrived at which foreign money managers must reckon up their currency losses in U.S. investments, and make the decision to cut future ones.

Thinking at the Bundesbank appears to reflect a broader pessimism concerning the longevity of the bubble in the dollar markets. The Bundesbank, was reportedly unwilling to cut its 3.5% discount rate at the April 24 meeting of its council, despite the rise of the deutschemark to its highest level since April 27, 1981.

In fact, the governor of West Germany's central bank had already given his answer to the American Treasury's plea for help in "managing" the dollar decline. That answer, in the form of a drastic reversal of previous West German policy towards the dollar, further eroded hopes for a "soft landing" for the U.S. currency.

Bundesbank chairman Karl Otto Pöhl speaking in Rome on April 18, told press that a "European currency issued and controlled by a European central bank" should be the final goal of monetary integration. He made a strong call for Britain to finally join the 1979 European Monetary System which he said would make a "major contribution to the political and economic integration of Europe."

Pöhl also praised recent dismantling of exchange controls in Italy and "the intention of the French government to liberalize capital movements."

European bank sources emphasize that all the above are prerequisite to the Bundesbank's eventual support for the creation of an actual European Currency Unit currency for Europe, a major part of monetary "decoupling" from the dollar. Until now, Bundesbank legal objections have been the major obstacle to European Community President Jacques Delors' proposals for a full ECU currency.

Previously, the German central bank despised the notion of a unified European currency, as a competitor to the U.S. dollar. That reflected the long-term Atlanticist viewpoint prevailing in West German politics.

U.S. dollar issues made up 85% of the Eurobond market during the second half of 1981; that proportion fell to 64% by December of 1985. Most of that decline is concentrated in the second half of 1985, that is, the period during which the dollar lost 30% of its value against European currencies.

Understandably, major lenders are reluctant to purchase paper in a currency which is rapidly losing value on the market. The German mark has been the biggest gainer at the dollar's expense; the rest is divided into 5% shares for the pound sterling, the Japanese yen, and the ECU.

As matters stand, the ECU is only a bookkeeping device, representing a mix of the currencies of EC members (excluding Britain). As such, the emergency of an ECU Eurobond market from scratch has been impressive; ECU issues did not exist before the second half of 1984, and now comprise 5% of the total market.

A Salomon Brothers commentary of April 18 suggests that a major European shift away from the dollar has already widened the yield differential between U.S. Treasury and corporate securities: "The dramatic widening of yield differentials from Treasuries in the past month has caused many sectors of the corporate and mortgage markets to sell at record percentage yield inducement over Treasuries. . . . Since late February, yield spreads of corporates and mortgages to Treasuries have increased by 50-70 basis points, placing them in the range of 100 to 250 basis points."

This is due to "a record volume of corporate bond issuance in recent months, totaling nearly $20 billion in March," but more to "a noticeable slackening of Japanese and European investor interest in the U.S. bond market in the past few months, in contrast to their rather conspicuous presence in the Treasury and higher-grade corporate markets in 1985."