Further Dollar Weakness Expected

FOREIGN EXCHANGE

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The U.S. dollar has lost slightly less than one per cent against the deutschemark since the close prior to the New Year's weekend. It also lost one per cent against the pound sterling, slightly less than one per cent against the French franc, one per cent against the Canadian dollar, and half a per cent against the Japanese yen. The underlying depreciation potential of the dollar, however, is considerably greater than the figures indicate, due to between $50 and $75 million per day in central bank intervention on the dollar's behalf in an extremely thin market.

A combination of factors strongly indicate further downward pressure against the U.S. dollar, and consequent buoyancy for the deutschemark and firmness for other leading European currencies. Most critical of these factors is the current policy stance of the West German government and monetary authorities, which the U.S. monetary authorities view as the principal cause of the dollar's weakness. The second critical factor is the continued unwillingness of large Arab investors to accumulate further holdings of dollars, and probable Arab disinvestment from dollars into other currencies. Since these political factors are in line with virtually all the technical factors, the dollar has only one way to go: down. The only major source of strength the U.S. fund can draw on is likely to be the shift in the policy of the Japanese monetary authorities and government under the new prime minister, Fukuda.

Although there are widespread reports that there is sentiment at the U.S. Treasury indifferent to a further decline in the dollar-deutschemark parity, the Federal Reserve is extremely concerned about the sharp December fall, which ran counter to their and the New York market's expectations. Federal Reserve sources identify the slight uptick in short-term U.S. interest rates on Monday and Tuesday as a means of testing the response of all markets to a somewhat firmer interest rate stance. By late Tuesday, the Fed concluded that the experiment had been a failure, and concluded that it had no short-term means of preventing further dollar depreciation.

In addition, the Fed has been intervening strongly in favor of the dollar, using principally sales of deutschemarks which it had borrowed from the Bundesbank. Bundesbank foreign exchange staff place their level of intervention at $5 million on Monday and $10 million on Tuesday, and attribute most of the rest of intervention to the Fed. This extraordinary intervention policy indicates how upset the Fed is about the dollar's behavior. Fed staff express great disappointment about the failure of the Bundesbank to cooperate with them, both in intervention policy and overall monetary policy.

Bundesbank Will Not Reflate

Considerable armtwisting by the Fed and by spokesmen for the incoming U.S. cabinet have failed to convince the West Germans to adopt an easier monetary stance, despite Washington's aim of "goosing Germany and Japan to expand faster," in a view cited by New York Times columnist Leonard Silk. On Thursday Jan. 6 the Bundesbank Council met and announced no change in its restrictionary policy; the Fed estimates that nothing but a public announcement of a policy change would aid the dollar against the deutschemark. On the contrary, the West Germans are taking great pains to prevent the current glut of liquidity from lowering interest rates. The fall in Euro-deutschemark interest rates from a high last week of 5 per cent to 3.5 per cent on Jan. 5 was a side-effect of the large borrowings and sales of deutschemark by the Fed; rates rebounded to four and one-eighth on Jan. 6. Contrary to some wire-service allegations, the weakening of interest rates did not help the dollar; rather it reflected intervention in support of the dollar. In any case, the market is making allowances for day-to-day fluctuations resulting from the logistical difficulties that the Bundesbank is having in mopping up the liquidity glut. Apart from the DM 14 billion current-account surplus West Germany has racked up for 1976, a government-sponsored employee savings scheme matured this week, releasing DM 25 billion into the banking system. This situation has not only removed the large Federal government spending deficit from the list of weakening factors, but has forced the Government to borrow more than it needs in order to hold down the monetary aggregates.

A Jan. 5 dispatch from Bonn in the Milan daily *Corriere della Sera* reports that Schmidt has determined that further intervention for the dollar would undermine his economic program and arouse political opposition, and that Schmidt has obtained the agreement of Bundesbank president Karl Klasen to stop intervening. Numerous West German sources, including Bundesbank foreign exchange staff, confirm this estimate.

In this context, the West German outlook on foreign exchange problems has changed fundamentally. Previously West Germany would accept virtually unlimited amounts of dollar flight capital in order to prevent the appreciation of its exchange rate. According to many New York estimates, fear of a rising deutschemark and consequent injury to West German exports would compel the West Germans to reflate. At this point the West German monetary authorities are concerned about the stability of the deutschemark rate within the broader European currency group and about domestic inflation. They are entirely unconcerned about the dollar rate. There are no indications that Carter's advisors appreciate this point; however, the New York Federal Reserve, among others, does.

The Bundesbank now assumes that the inflationary effect of dollar inflows is limited by the depreciation of the dollar. Against West Germany's current-account surplus of DM 14 billion last year, which reflects an even larger volume of currency inflows, the Bundesbank was able to write down the value of its foreign exchange holdings by DM 6.16 billion, due to the 11 per cent depreciation of the dollar over the year. If the Bundesbank permits the entire brunt of flight capital activity to hit the dollar's parity, the amount of "imported inflation" will approach zero, and even become negative.

Further strong indication of the underlying weak position of the dollar is the willingness of the weaker European countries to ease monetary restrictions. On Jan. 5 Belgium lowered its discount rate from 9 per cent to 8 per cent. On Jan. 6 Holland lowered its discount rate from 6 per cent to 5 per cent. Both France and Britain are taking a less restrictive policy towards the rate of increase of monetary aggregates and-or bank lending. The French franc, which behaves as a "borderline" currency between the deutschemark and Swiss franc on one hand, and the lira and pound on the other, has moved almost precisely in tandem with the deutschemark.

Less significant factors weighing against the dollar include:

1) The seasonal end of repatriation of profits by U.S.-based multinational corporations motivated by Financial Accounting Standards Board regulations.
2) Continued weakness in U.S. interest rates, particularly as U.S. banks permit the runoff of money-market instruments they accumulated as window dressing for their year-end balance sheets.

Otherwise, there is no question that large Arab dollar holders will shy away from accumulating further dollars. Large Arab placements of funds in dollars virtually halted on Carter's election Nov. 2, due to Arab perception that Carter favored Israel more than did the present Administration. This Arab attitude will intensify as a result of, first, Carter's cool response to Sheikh Yamani's demand for a quid-pro-quo with respect to the moderation of Saudi Arabia's oil price increase, and secondly Carter's insistence on meeting Arab heads of state one by one over a period of months, rather than helping to convene a Geneva Mideast peace conference. This week, the West German conservative weekly *Deutsche Zeitung* attributed the dollar's overall weakness to Arab reluctance to hold dollars. As the dollar continues to depreciate, Arab withdrawals of dollar holdings could very well snowball.

On Jan. 5 the new Japanese prime minister Fukuda announced a reflation program including a mid-January cut in the discount rate and a $1.2 billion rise in government expenditures in the first three months of 1976. Probably the yen will tend to move in parallel with the dollar, while most European currencies move in parallel with the deutschemark.

New Activity Due to Business Confidence in Schmidt Monetary Policy

INTERNATIONAL STOCKS

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The new spurt of activity in the West German equity market measured by a 3 per cent rise in the Commerzbank index during the past week after several months of total flatness, directly reflects the buoyancy of the deutchemark over the dollar and resultant business confidence in the Schmidt government. Schmidt, with the firm backing of the pro-growth wing of the Christian Democracy led by Schleswig-Holstein Minister Gerhard Stoltenberg, has resolved to maintain the integrity of the mark even under the current tremendous pressure to inflate emanating out of the Jimmy Carter transition headquarters in Plains, GA. (See Foreign Exchange report.)

In particular, activity was strong and future prospects are bright for the energy and machinery sectors. The former, typified by Veba Gelsenberg AG, are part of the European network including the Italian state oil company ENI which is developing relations with the oil-producing countries including Arab investment and joint ventures. The machinery sector, led by Mannesman, is about to benefit from a new spurt of East-West trade under the impact of increased Soviet initiatives for new mechanisms to finance expanded trade exemplified by their offer of Comecon transferable ruble financing to the West last month.

Schmidt made his commitment to expanded trade, with OPEC in particular and in general, in his year-end message to the nation. "Today, we can consider it an advantage that our most important oil suppliers can learn and experience practically, through their participation in our industry, what turning the oil spigot means for us and our economic well-being," he said, in a direct call for cooperation. "Isolated, single dealings of individual states will become more and more difficult."

Otto Wolf von Amerongen, president of the German Trade and Industry Federation, strongly seconded Schmidt in denouncing isolationism and dismissing all arguments against further expansion of East-West trade as "misinterpretations of the differences in the international division of labor."

The energy-related stocks are benefiting directly from the European-wide move for cooperation with the OPEC nations. Veba has risen a dramatic 11.9 per cent since the beginning of December, and 7.9 per cent in the past week