Foreign Exchange by Richard Katz

The credit squeeze and the dollar

Paul Volcker's interest rates are temporarily keeping the dollar's value up, but it can't last.

Fears of a new dollar crisis of unmanageable proportions two or three months down the line are becoming increasingly prominent among Washington and New York policymakers. A debate is already beginning to rage over whether to maintain high interest rates—the only current cause of the dollar's rise—or to impose exchange controls, letting interest rates relax to stave off impending corporate bankruptcies.

Foreign exchange traders note that almost all the monies coming into the dollar now are short, three-month, at most six-month, funds ready to leave as soon as necessary. "After all," said one European banker, "how long can he keep up 20 percent interest rates."

A hardline faction in the U.S. in fact is prepared to maintain the credit squeeze indefinitely to sustain the artificial value of the dollar. U.S. Trust economist James O'Leary, a colleague of Volcker's in the influential Ditchley Foundation, assumes, "Both inflation and interest rates will remain high through the end of the year." A well known economist now working for Congress added, "Normally a recession would lower interest rates and increase exports by cheapening the dollar. This would also lead to a capital flight, so I don't think Carter and Volcker will let interest rates fall. They will stand firm. Volcker earned the failure of a stop-go, stop-go policy. He won't let up." Asked about the expected spate of bankruptcies Volcker's policies are producing, he replied, "Look, we had Penn Central, we had Franklin National. Sure there were problems, but we got through it. We can do the same thing now."

Others are not so sure. "If it weren't an election year, they would stand firm," explained Kuhn-Loeb Vice Chairman Nathaniel Samuels, "but no one knows what Carter will do over the next few months. We face liquidity requirements yet there is a credit crunch, restraint. Who knows what Carter will do?"

The presumption among certain New York bankers is that interest rates will relax not because inflation will have peaked but because the political pressure of unemployment and bankruptcies, including major banks like First Pennsylvania, will become too great. At that point, they see Carter opting for the proposal made by Henry Kaufman of Salomon Brothers to the American Bankers Association meeting in February: selective exchange controls. "If there is a weak and deteriorating economy," commented a senior economist for one of New York's largest banks, "combined with continued hyperinflation, the dollar will be hit again. At that point it would be very easy, especially for this administration, to impose exchange controls and wage-price controls."

Imposing selective controls, e.g. Kaufman's proposal to restrict U.S. citizen purchases of foreign currencies, would in fact shatter the last shred of dollar credibility.

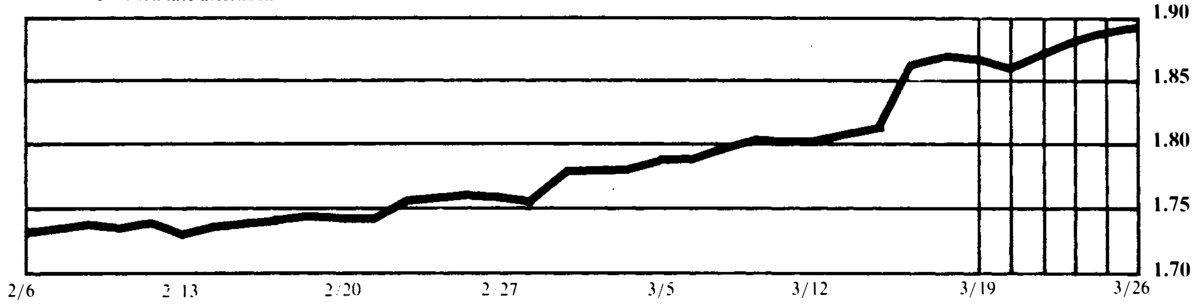
While some Europeans and Arabs are making a quick buck on the dollar's temporary rise, other Arab money is going directly into French and German hands. The West German government secured last week an unprecedented direct purchase of 5 billion marks worth of government bonds by Saudi Arabia while marketing several billion marks worth of promissory notes to OPEC countries via the commercial banks.

One foreign exchange trader noted, "The French franc is actually much higher than it should be given the current rates of the mark and Swiss franc. The only thing we can see is that they have some arrangement with somebody, perhaps the Saudis, keeping it propped up."

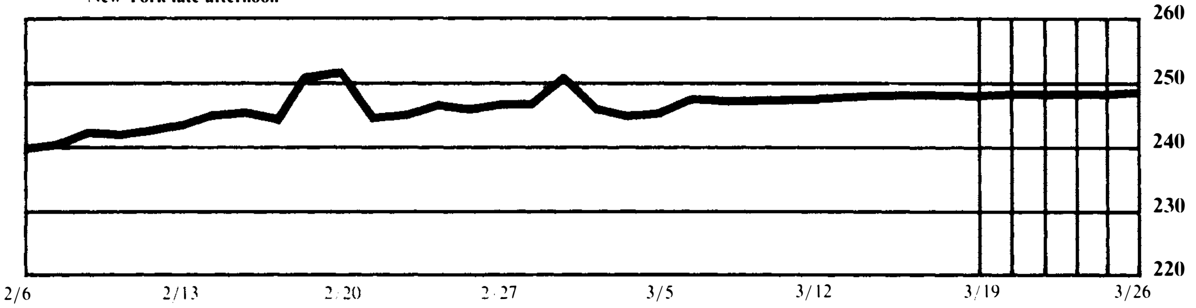
Even Japan, currently on the outs with OPEC for its support of Camp David, is preparing to market yen, mark and dollar-donominated bonds in Saudi Arabia while it doubled its exports of machinery to that country this year over 1979. One firm, Nagitta Engineering even issues a riyal-denominated bond for $20 million early in March.

The dollar at present shows a continued rapid rise, propelled by the interest rate hikes, but traders are already speculating on where it will peak—"Mark at 193-95, Swiss franc at 180?" wondered one trader. When it does, Volcker will have very little ammunition left to keep it from taking quite a tumble.

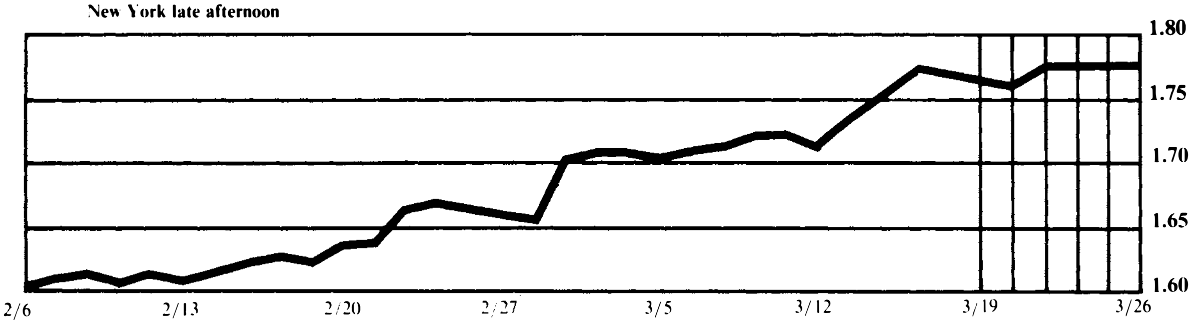
The dollar in deutschmarks
New York late afternoon



The dollar in yen
New York late afternoon



The dollar in Swiss francs
New York late afternoon



The British pound in dollars
New York late afternoon