Foreign Exchange by Richard Katz

The dollar's sudden strength

It can't act like the British pound for long. Short-term inflows apart, it's declining as an investment medium.

At the close of trading July 30, the dollar stood at DM 1.77 and at $2.35 to the British pound, substantially higher than the levels of past weeks, when the dollar was nosing DM 1.73. Without intervention on the part of European central banks, the dollar would have risen even further against the leading European currencies.

Most of the dollar's strength is attributed to speculation that the rise in America's "leading economic indicators" implies some economic revival, higher credit demand, and consequently higher interest rates. The validity of this economic scenario is not taken seriously by European traders, who point out that the bulk of buying came from American commercial banks. However, there has in fact been some rise in dollar interest rates, including a rise in Eurocurrency short-term deposit rates from 9 ¾ to 10 percent on July 30, coincident with the 2 pfennig rise in the dollar-deutschemark rate.

A great deal of drum-banging has heralded the dollar's "recovery," including feature pieces in *Institutional Investor* and other financial trade publications. The essential argument seems to be that European interest rates are likely to fall while American rates will rise, putting the interest-rate differential in the dollar's favor.

In its July newsletter, Morgan Guaranty Trust used this explanation to make a virtue out of a long recession, applauding the new reduction of the American trade deficit (through a projected $15 billion reduction in oil imports this year compared to 1979) through the collapse of demand in the depressed American economy. The $2.28 billion June trade deficit, 40 percent lower than the $3.96 billion May deficit, appears to corroborate this view.

However, a great deal else will affect the dollar's rate besides the interest-rate differential and the trade imbalance. The "positive" factors cited on the dollar's behalf in fact amount to negative factors for the American economy.

The dollar is now behaving in the fashion of the British pound, i.e., attracting short-term money on the basis of interest rate differentials despite the abysmal state of the underlying economy. The British pound has indeed managed to maintain a parity about 30 percent above its value in productivity terms. But the American dollar, the world's principal financial instrument, cannot operate as a "hedge currency" for portfolio diversification the way sterling does.

Much more important for the dollar's medium-term strength than the interest rate and related considerations are two factors: the relative weight of European and Japanese banking in the Eurodollar markets, and the relative position of the European and Japanese economies with respect to the United States.

Although the petrodollar surplus has not diversified out of dollar currency, it has nonetheless massively diversified out of the traditional investment channels. This has left the American banks who traditionally have absorbed the bulk of petrodollar-country Eurodollar market deposits in a state of great perplexity. The perplexity is largely due to the fact that the dollars have not come their way. There is actually little mystery involved; the dollars are deposited in Western European and, to a lesser extent, Japanese institutions in ways that avoid the Eurodollar interbank market. That does not prejudice the dollar rate by itself, but bodes ill for the dollar's future health.

As one European investment banker put it, "People see that the West Germany economy is fundamentally a sound economy, and that the U.S. economy is fundamentally a rotten economy. Whatever the interest rate differential is, they are not going to invest in the dollar on this basis." The U.S. economy faces some unpleasant disturbances in the financial and corporate sector when Chrysler and other laggards go down later in the year, which will doubtless unsettle the securities and financial markets the way Penn Central did in 1970, and also faces a devastating inflationary blowoff at any point that the administration chooses to make a stab at economic recovery.

The future value of the dollar must be prediscounted for real problems a few months down the road, and it is likely that the rise of the last few weeks will disappear before the end of August.