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Foreign Exchange by David Goldman

Bundesbank fears a dollar collapse

International market strains may boomerang against the dollar: preparations are ready.

With the West German mark still close to a two-year low against the U.S. dollar, about DM 2.44 on July 29, it is out of the ordinary that the West German central bank is quietly making contingency plans against a dollar collapse.

Nonetheless, according to West German banking sources, the Bundesbank computer now has a detailed series of exchange regulations against capital inflows ready to go on the telex to commercial banks at a moment's notice. The same banking sources no longer fear further weakening of the German mark as much as they do an uncontrollable dollar fall.

Since U.S. interest rates do not appear ready to fall, most foreign-exchange market operators are still convinced of dollar strength for the immediate period ahead. Scenarios developed at Bankers Trust in New York, National Westminster Bank in London, and other institutions have predicted a dollar slide toward the end of 1981, on the assumption that interest rates will fall.

But, interest rates are not the only determinant of a currency's foreign performance. The muddiness of available data on the Eurocurrency market's composition by national currency has disguised an obvious supply-and-demand feature of currency shifts.

In the past six months, German commercial banks have "internationalized" the West German mark through a significant volume of short-term lending to cover the imbalances of Germany's trading partners, while the Bundesbank has internationalized the mark through intervention operations on behalf of currencies linked to the mark through the fixed-rate European Monetary System.

Although precise data are not yet available, it appears that the volume of expansion of the deutschemark section of the Eurocurrency market was several times in excess of Germany's DM 14.1 billion current-account deficit during the first six months of 1981.

On the public side of the ledger, the German Bundesbank had to create additional deutschemark-denominated liquidity in the first six months of 1981 via currency-support operations in the EMS. Its lending to the European Fund for Monetary Cooperation rose by DM 14 billion, as the Bundesbank helped other EMS members support their currencies. The quirk of the EMS is that it enables the Bundesbank to count liquidity creation in its own currency as a reserve increase. Reserves apart from this fell by DM 7 billion, i.e., the Bundesbank financed half its 1981 first-half deficit out of reserves.

In the context of last October's IMF annual meeting in Washington, Bundesbank President Karl-Otto Poehl agreed formally to the incorporation of the mark into a scheme involving "multicurrency reserves," for the first time—although the tendency has been in the works for several years.

The result has been that the West German current account deficit has covered a substantial portion of the deficits both of members of the European Monetary System, e.g. Italy and France, as well as of the developing sector.

Dresdner Bank chief economist Kurt Richebächer warned in a commentary that his country would have to abandon the policy of running a current account deficit to support its trading partners as a disquised form of inflation.

That is true: the creation of deutschemarks has not gone into expansion of the domestic money supply, but into the deposit base of the Eurodollar market. Germany's ability to continue this sort of operation is exhausted.

Depression economic conditions, and possibly also budgetary austerity from the federal government, are already reducing the current account deficit. The weight of capital export is now shifting onto the United States.

As IMF officials put it, the United States will turn into the big "recycling center" for international money destined for deficit financing on behalf of the Third World, as of the third quarter of this year.

In other words, the U.S. banking system will dump significant amounts of its lendable resources into the Eurodollar market, in order to cover over the $100 billion deficit of the developing sector.

The tables will be turned, in the West German evaluation. The same "oversupply" of currency will hit the dollar instead of the mark.

The more unsettled the deficit financing, the worse for the U.S. currency.

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