# Foreign Exchange by Renée Sigerson

## Tracking the dollar's decline

*A Persian Gulf crisis is the only barrier to the kind of free fall* EIR *has been predicting.*

Recent commentaries have, belatedly, adopted *EIR*'s longstanding view that high U.S. interest rates do not necessarily have anything to do with the dollar's exchange rate. The dollar's fall from 2.86 marks in mid-January to about 2.67 on Feb. 17, a decline of almost 7 percent, occurred despite rising U.S. interest rates and fear of further increases.

The moment that both Fed chairman Paul Volcker (as reported in *EIR* last week) and the Council of Economic Advisers stated publicly that the United States was now dependent on foreign capital inflows signaled the end of the dollar boom.

If the Soviets and their Iranian surrogates succeed in shutting the Strait of Hormuz, which now appears likely if not inevitable, the dollar will snap back, at least temporarily. Otherwise, the dollar is open to a virtual free fall. Capital inflows were not caused by high interest rates, but capital outflows will, as Volcker threatened, cause higher interest rates, the reverse of what was conventional wisdom until the beginning of February.

The deutschemark, of course, has been the principal gainer due to the dollar's weakness. In certain respects this is not surprising; the mark had fallen more than 20 percent against the Japanese yen during the past year, taking the brunt of the dollar's strength. Germany showed a DM 19 billion ($7 billion) capital account deficit for the year 1983, according to Bundesbank data; since the country ran a substantial trade surplus, the outflow to the dollar sector was even higher than the deficit indicates.

The fact that Japan is the oil importer most dependent on the Persian Gulf does not yet appear to have affected the foreign-exchange markets. But it is clear that the yen has the most to lose in the event of a Gulf disaster.

At the point that European portfolio managers decided to pull out of dollar holdings, short positions against the mark had to be covered, including a substantial amount of Soviet mark purchases.

Subjective decisions on the part of a handful of large foreign portfolio managers, including the Russians, will determine what the foreign exchange markets look like in the next several weeks. These gentlemen know that America is *dependent* upon foreign-exchange inflows, and, in principal, that this dependency permits them to demand any interest rate they please from the United States. Rising interest rates in the short-term do not outweigh the expectation now universal among European economic commentators that many foreign investors will decline to continue financing the United States, i.e., take their profits.

The Economic Report of the President transmitted to Congress in February 1984 contains the following startling admissions concerning the dependency of the United States on capital inflows:

"The U.S. current account deficit in 1983 was nearly three times the previous record, which was set in 1978. The immediate connotation of the current account deficit, as of the trade deficit, is lost production in import-competing and export industries. But there is another way to look at it. The current account deficit is financed by a capital inflow from abroad. Foreigners have been investing in the United States, for example participating in the rising stock market and buying Treasury bills.

"This capital inflow has an important implication for the U.S. economy. Under the natural assumption that the capital inflow is not somehow offset by an equal decrease in domestic saving, it keeps real interest rates lower than they otherwise would be. As such, it allows those components of GNP that are especially sensitive to the real interest rate—housing, consumer durables, and business investment in plant and equipment—to be higher than they otherwise would be. Of course, the capital inflow has not been large enough to prevent real interest rates from rising since 1980. . . .

"In 1984 the U.S. current account deficit is forecasted (sic) to be roughly 40 percent the size of the federal government budget deficit. This means that a capital inflow from abroad is financing the equivalent of 40 percent of the budget deficit, and the crowding out of other sectors of domestic demand is reduced correspondingly. International capital flows of this magnitude are consistent with the increasing integration of world capital markets.

"Is the inflow of capital and the associated strength of the dollar desirable?. . . the strong dollar has substantial benefits. . . It keeps down the general price level, both directly through lower dollar prices of imports, and indirectly through lower prices for domestically produced goods that compete with goods produced abroad."



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