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Foreign Exchange by David Goldman

The temporary dollar consolidation

The dollar has firmed for reasons which promise a worse dollar decline in the future.

Between Wednesday, March 7, and Friday, March 22, the dollar regained marginal lost ground against major currencies. Although the dollar will fall considerably during the next year, it is difficult to know what will happen during the next three weeks.

Apart from the Persian Gulf threat to European and Japanese oil supplies (less of a brake on the dollar's fall than we expected during February and early March), a short-term factor in the dollar's favor is the pressure on American banks due to the March 31 payments deadline. Pressure on U.S. banks, predicted by this service in January and reflected in last week's trading and comments by bank analysts, translates into pressure on the interbank Eurodollar market, and therefore into pressure on the major European currencies.

Our mid-October prediction of a "vicious dollar snapback" last year was based on Europe's $400 billion in short-term Eurodollar market liabilities. Tightening of interbank market conditions forces European debtors to liquidate local currencies to pay dollar-denominated debt service. This factor is still present, as noted by British investment banker Geoffrey Bell in the *New York Times* March 12.

Since, as presidential economic adviser Martin Feldstein has been telling Congress, the United States will become a net debtor nation in the course of 1984, the ground rules have changed in the determination of dollar interest rates. This is especially true since the American banking system became a major net borrower from the Eurodollar market (at a $54 billion annual rate) as of the third quarter of 1984, the last quarter for which Bank for International Settlements data are available.

A regime of dual governance over the dollar credit system has existed since the Federal Reserve permitted the Eurodollar market to grow out of control during the late 1970s. Increasingly, the reserve-free Eurodollar market has been able to generate credit independent of the short-run decisions of the Fed. Conversely, any tightening of conditions on the Eurodollar market cause a contraction of available dollar credit. Such a tightening is now in the works, for the simple reason that Manufacturers Hanover and other big U.S. banks are hesitant to issue paper lest it trade at a discount.

In the short run, this is equivalent to a contraction of available dollar supply. It feeds into the profit-taking attitude among large currency speculators and hedgers, and has produced a slight recovery of the dollar during March.

The banks' problems, however, are a fundamental negative for the dollar: They will force the Fed to create liquidity in defense of the big American banks, with a devastating effect on the dollar. This is a much more important constraint on Paul Volcker than widely discussed "election-year pressures" to loosen money growth.

Read in this context the formulation March 7 in the Swiss daily the *Neue Zürcher Zeitung*, which is shared by most European portfolio managers:

"In earlier discussions about the prospects for the dollar in official circles, there was always a certain worry that a trend turn of the dollar could lead to a chain reaction and a rapid collapse. This sort of concern at least appears to remain in the background for the moment. The possiblity that a fall of the dollar exchange rate would produce a rise in American interest rates has a certain braking effect on these fears.

"Above all it is not excluded that the dollar could continue to fall despite the rising interest rates during which the downward tendency would be interrupted by certain consolidation phases.

"Finally, the further development of the dollar brings the American monetary and economic policy questions one step further. A notable loss in the dollar exchange rate in the context of an outflow of foreign capital urgently needed for the financing of the current-account deficit could exercise pressure on American interest rates. How the American monetary authorities would react to such a development remains open. Martin Feldstein, President Reagan's chief economist and a voice crying alone in Washington's budgetary desert, has recently signaled that a tightening of the monetary reins as a defense against an otherwise unavoidable dollar correction is unwanted. The pressure on the Federal Reserve to counter a rise in interest rates with a loosening of monetary policy should be considerable in an election year."

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