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Foreign Exchange by Laurent Murawiec

Fed's currency pump bloats the dollar

"Nobody has found a constructive way of solving the American banks' tremendous liquidity squeeze," stated a London broker.

'Raise money at any cost, in terms of interest, and whatever the price for other countries, that's the Fed's motto, and the Treasury's," an astute City of London analyst described Washington's monetary policy shortly before the regular meeting of the Fed's policy-making arm, the Federal Open Market Committee. "Whether they decide to tighten credit directly by increasing the discount rate, or decide to do officially nothing and let the markets take care of tightening rates themselves, the result will be essentially the same: a higher dollar," the analyst added.

Political considerations—the need to avoid a frontal clash with the election-oriented administration—and banking reasons—the terrible liquidity squeeze suffered by American banks whose asset side is non-performing wholesale, from domestic agricultural, housing, energy, and other loans, to loans to Ibero-America, while liabilities are harder and costlier to fund—both militate against any rash action by the Fed. Some weeks ago, the accelerating debt crisis and the worsening plight of Continental Illinois, whose net market value is estimated at minus $1 billion by a leading London broker, pointed toward a general, 1982-style Fed bailout of the banks. The result would have been to suddenly release billions of dollars of liquidity in the banking system, and thus lower interest rates. The dollar was expected to tumble as a result.

But apparently, Messrs. Volcker and Donald Regan have found novel techniques to bail out the banks at the same time as the ballooning, $170 billion Federal budget deficit. Their predicament—how to pump money into banks and Treasury bills without shooting interest into the stratosphere, i.e., 1981-82 levels—was analyzed by a Central European central banker: "They got all the international money that agreed to invest in the dollar sector at yields which implied an interest differential of 3-4% with the German Mark or the Swiss Franc. Now, they are reaping the money that demands a 6-7% differential. It's money that dismisses the exchange risk. If the differential decreased, the United States would fail to attract the additional margins of liquidity required. At present, they are enough to convince the Austrian dentist or the Swiss doctor to put his money in dollars."

But since going higher is difficult, the monetary circle has to be squared otherwise: The decision to abolish the 30% withholding tax on U.S. bonds purchased by foreigners, and the decision to make U.S. Treasury bills "bearer" (i.e., anonymous) rather than nominative securities, are designed to incite foreigners to shift funds to the newly "liberated" American market, and U.S. investors who used to make use of the tax-free Euromarkets to repatriate their money. The net effect would be the inflow of several dozen billion dollars a year, as was announced in June at the Nice conference of the International Bond Dealers' Association (IBDA) by Morgan's chairman, Stanley. At the time, and since, the decision raised angry eyebrows in Europe, a Deutsche Bank spokesman even mentioning the possibility of splitting the IBDA!

With the new liquidity, the plugging of the gaping fiscal holes should be easier, as well as the funding of the banks as well. This squeezing of international money should avert the danger of immediately rising interest rates.

Still, as Wall Street oracle Henry Kaufman noted, if this is the intent of the Fed and Treasury, it might not be the result: Given the opportunity, non-American investors may choose to switch their U.S. investments from bank deposits to Treasury bills, and thus aggravate the yield gap between Uncle Sam's paper and the banks', whose paper has been bearing heavy discounts ever since the Continental Illinois crisis started. In fact, a City merchant banker said, "the switch from bank deposits to Government paper has already started." Volcker and Regan might just be igniting the fast fuse of the banking crisis to avert an interest squeeze!

Where is the hapless victim of all these grotesque manipulations, the dollar? In spite of Bundesbank interventions of up to $600 million in one day the week of June 9, the dollar has been smashing through decade-old ceilings, and trades above 2.40 Swiss Francs. A given level of "dollar devaluation" has already been effected, since higher and higher rates, plus all too clever technical manipulations are required to keep it up there. Our diagnosis of a coming tumble—fully anticipated on future markets where the U.S. currency trades at 6-7% discounts against the Swiss and German currencies—based on the acceleration of the debt crisis and its devaluing the currency in which debt is primarily denominated, is still perfectly valid.

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