Germany, Japan Refuse Full-Steam Inflation To Bail Out Dollar

The West German government and the central bankers at the Bundesbank delivered their verdict Aug. 10 after a week of U.S. Federal Reserve pressure on them to initiate an "expansionary" monetary policy. The answer — seconded by Chairman Morinaga of the Bank of Japan — was *no.* The central banks will not cut lending rates and reserve requirements to loosen available liquidity. Down to the last minute, the Fed had been on the transatlantic phone to Frankfurt, demanding a step which is ostensibly aimed at upping West German and Japanese ability to absorb U.S. exports, and thus mitigating the American trade deficit which, Treasury Secretary W. Michael Blumenthal said this week, he hopes will run no higher than $30 billion!

The Treasury has been screeching for West German-Japanese reflation since Jimmy Carter moved his dungarees into the White House, with the most recent backup coming from Robert Roosa of Brown Brothers Harriman in the Aug. 10 *Journal of Commerce.* Roosa's investment-banking counterparts at Lehman Brothers made it clear in an interview this week what is actually at stake in the reflation issue, however: not exports per se, but the dollar and dollar debt. "Germany will grow much faster than we will next year, (chuckle) which will put the burden of the international monetary system on them." Added liquidity is intended to help refinance the debt burden, while lower interest rates and higher inflation will keep yen-mark appreciation from making the dollar look too outrageously weak.

The Bundesbank's *Nein* was curt, but not entirely unqualified; a combination of genuine unemployment problems and disingenuous political pressures has induced the West German government to make concessions in the direction of expanded public-works spending for energy "conservation" and other Carteresque goals. The concessions to date are, however, vague in character and indeterminate in appropriations.

Meanwhile, the Bundesbank's decision — described as "quite a coup" against the dollar by Citibank — obliged Federal Reserve Chairman Arthur Burns to drain liquidity, through forced sales of Treasury paper, from the U.S. banking system, in order to jiggle up interest rates and stabilize the dollar. The West Germans and Japanese are well aware of the situation *Business Week* underscored in its Aug. 15 issue — that under his Scrooge wig, Burns had been acting like a Micawber who got his hands on a bill-printing press, and since June has impelled double-digit money-supply expansion. They are also aware of what the new "contraction" will do to the real economy and to refinancing capacity. Small wonder that the Bundesbank and Bank of Japan refused to follow either Burns' instructions or his example.

One key international consequence of Burns' acrobatics will be the collapse of that notorious "boom" sector of the capital markets, the Eurodollar bond market. New York bankers point out that spreads are shrinking and — despite a plethora of investors looking for someplace to put their funds — there are few borrowers, given the state of capital expenditure. The fundamental weakness of the dollar plus a rise in interest rates will make a fixed-interest dollar placement like a Eurodollar bond about as attractive as Robert Hall stock. (Declining spreads and cutthroat competition are also hitting the West German banks involved in the Euromark bond sector, however.) Analysts say that, since there are no new dollar issues to speak of, it is too soon to say when the U.S. interest-rate trend will catch up with the Eurobond market, but some fear that in the fall, the new issues will never materialize!

The foreign exchange markets were fairly subdued last week as speculative positions against the Scandinavian currencies unwound in the wake of the IMF Group of 14's disinclination to press for a devaluation in Paris the preceding weekend. Short positions are reportedly building up against the French franc, however, in what is most probably a New York-orchestrated blackmail effort against French policymakers' energy and nuclear posture. The heat was off the dollar, partly for technical reasons, partly because of the interest-rate lift, and above all because Western Europe and Japan took no direct action to pull the plug. The lower Manhattan strategists had to content themselves with potshots against the Austrian schilling, instead of wrecking the Western European joint-float currency snake on schedule with the Scandinavian devaluations, but they have been left in their sniper's seat for another dangerous week.

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