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Foreign Exchange by Richard Katz

Will the dollar bust?

The interest rate spread has kept the dollar high, but a certain investor "safety factor" ensures that it will go down again, and awfully fast.

Both American and European analysts believed that this past week might have been the peak of the dollar's spectacular rise against European currencies. On April 1, the dollar touched Dm 2.00 in late New York trading, and had fallen back to Dm 1.96 in Frankfurt trading' April 3. A certain stability remains behind the dollar's strength for reasons of simple arithmetic: there is now a stupendous 10 percent spread between the Eurodollar and Euro-deutschemark interest rates. A speculator holding dollars assets and mark liabilities for, say, six months, will still make money even if the dollar falls to DM 1.75 over the entire period. The extra interest is great enough to displace even a fairly sharp loss in the dollar's foreign exchange value.

However, there is more to the dollar's weakness than simple interest rate differentials, especially in the opening phase of a full-scale financial crisis on the American markets. To put the problem inversely: the fact that West Germany has not had to raise interest rates while the interest differential between the mark and dollar rose 4 points indicates that the West Germans believe the dollar rise is a short-term phenomenon. They have not attempted to prevent the dollar rising on what are essentially thin European markets. Virtually all intervention has taken place to stabilize the relative parities of EMS currencies against each other.

One top West German banker predicts"at the first bad news from the American financial markets, all the short-term funds will flow out, and there will be a terrible crash in the New York market." The dollar's situation is as fundamentally unstable as the British pound's was two years ago, when the Bank of England had to support it with similar interest rate differentials. The Europeans must liquidate their dollar positions at a certain point precisely because the Federal Reserve has such grave reasons to maintain their dollar positions! In other words, the safety factor, however marginal, must outweigh the interest rate differential at a short period of time. When this threshold is crossed, "the dollar will go down awfully fast," predicts a leading New York bank economist.

This makes timing an entirely unpredictable factor. Added to the requirement of safety is the political consideration that Europe would, in effect, be severing a large part of its financial links to the United States by taking responsibility for worsening an already grave financial situation on the other side of the Atlantic. Some New York bank economists are already speaking in low tones of a "Crash of '79" style pullout by Europe, citing the heavy dependence of the American market on foreign funds. The Europeans are, therefore, waiting for the "first bad news," i.e. the beginning of the actual crisis due to "internal factors" in the United States, so that there will be no imputation that Europe is responsible for New York's problems, one European banker believes.

The importance of the safety factor came out strongly in American markets this week in the sudden widening—by more than 1½ percent—of the spread between Treasury bills and similar-maturity bank IOUs. Bills generally bear lower interest because they are guaranteed by the Federal government as much as green backs are, and represent a place of refuge in the worst market conditions. If American investors place this type of question mark over the certificates of deposit of large commercial banks, European suspicions are an order of magnitude higher.

For the moment, Eurodollar dealers are still buying into long-term dollar paper on the grounds that the underlying interest rate factor will maintain the dollar's strength for the immediate future, and foreign exchange dealers have not discovered any significant movement into short positions against the dollar. Various Washington oracles are assuring the Europeans that American interest rates will remain high even if the economy fails, in order to maintain the dollar's stability.

No conventional formulas should be applied to this market. The dollar financial structure is moving into a basic crisis—in fact, is being pushed into one by the Federal Reserve—and past rules will not apply.

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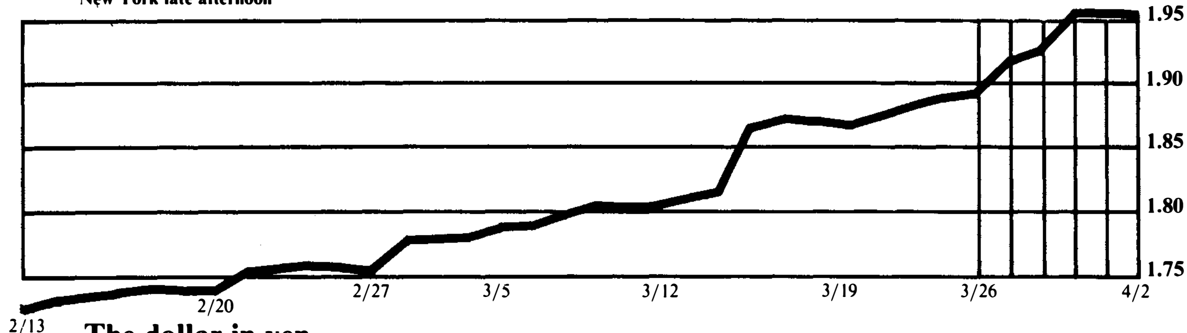
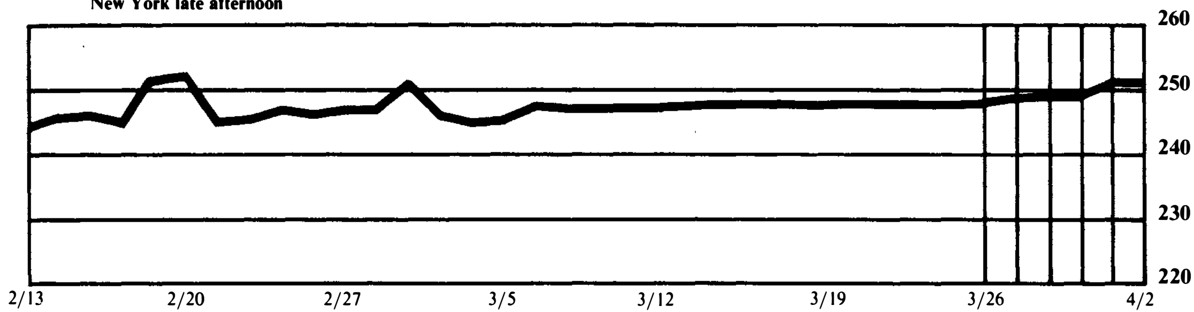
The dollar in deutschmarks

New York late afternoon



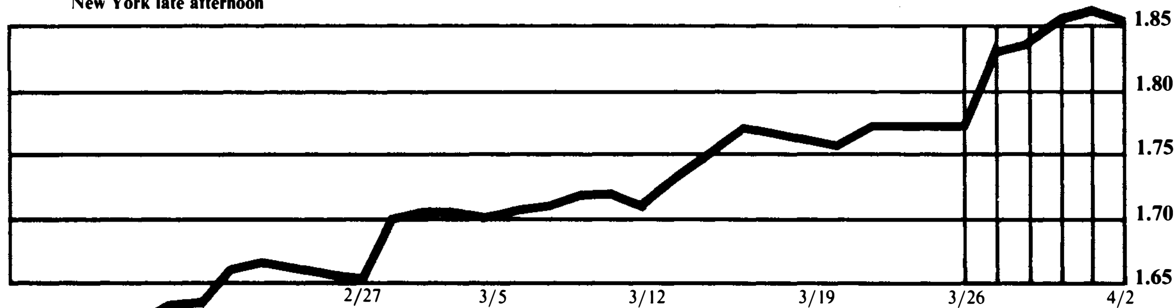
The dollar in yen

New York late afternoon



The dollar in Swiss francs

New York late afternoon



The British pound in dollars

New York late afternoon