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Foreign Exchange by David Goldman

How far will the dollar fall?

Although the present rapid fall may reverse, analysts see the deutschemark at 2.20 and even stronger.

The U.S. dollar stood at less than DM 2.27 at deadline on Sept. 17, fully 30 pfennig less than its peak during the second week in August, and down 6 pfennig from the previous day's opening of DM 2.33, an overnight decline of 4 percent. The rapidity of the fall indicates a basic shift of sentiment against the dollar irrespective of U.S. interest rates.

Western European bankers polled by *EIR* are less sure that American short-term interest rates will continue to decline, as they did marginally over the period of the dollar's sudden trouble, than that the fabric of the Reagan economic program will come unstuck.

Like the British pound during 1979, the dollar remained strong despite severe underlying economic weakness because the Federal Reserve made the dollar a good bet: speculators who bid up the dollar were safe as long as there were "greater fools" to take the dollars off their hands later. In the meantime, they enjoyed the highest real interest rate "since the birth of Jesus Christ," as German Chancellor Helmut Schmidt complained.

The same factors that bid the dollar up past all accounting for economic fundamentals are now working in the opposite direction. Dollar investors, including Arab groups, are more concerned to protect against exchange depreciation than to earn still-high dollar interest rates. Anyone still holding unhedged dollar assets against German mark liabilities has lost 12 percent of his investment in the past month, a small compensation for 17 to 18 percent interest rates.

The myth of dollar strength has been shattered. On Aug. 11, this column warned—while the dollar was at peak strength—that "international markets may boomerang against the dollar," citing the fact that the German central bank had prepared exchange controls to protect against *a dollar inflow into German marks,* the opposite of what then was occurring.

Now the German government's August prediction of a DM 2.20 rate for the dollar, still echoed through Frankfurt banking circles when the dollar began falling steadily the week of Sept. 14, appears conservative. One U.S. currency expert, Philadelphia-based investment adviser Nicholas W. Altemus, is now warning that "the dollar may be headed for real trouble."

Countervailing factors must be taken into account to prepare for the next few months' foreign exchange markets. The market's propensity to "overshoot" desired rates because of speculative backwash could easily take the dollar down below the DM 2.00 level before year's end.

Moreover, two factors are likely to work in the direction of short-term dollar recovery, without changing the medium-term outlook.

First, a sharp upward movement in short-term dollar rates is likely for the first week in October, if only due to the effects of change in settlement procedures at the Clearing House International Payments System, and additionally because the self-feeding credit demand in the U.S. and foreign credit sectors has not diminished. Although dollar interest rates have ceased to be the primary determinant of the dollar's behavior, a sharp rate movement would probably buoy the dollar briefly.

Second, a Soviet invasion of Poland by the end of the year, would almost certainly push the German mark down about 10 pfennig, that is, about one-third of the way it has already risen. Most of the money that might leave Europe due to "political risk" has already left, and the impact of a long-expected Soviet invasion would not have a permanent effect on the rate.

In summary, the current Federal Reserve policy stance and the prostration of the Reagan administration's economic program point to a dollar rate of DM 2.00 over the next three to six months. However, the downtrend is unlikely to occur in a straight line, and a dollar recovery of more than 5 percent interrupting the path down is a distinct probability.

The combined deterioration of the dollar and the stock market may, by the beginning of 1982, put U.S. equity at a discount of 40 percent relative to mid-1981 levels from the standpoint of foreign investors holding German marks or Swiss francs. The most immediate result of the decline will be that foreign investors, who already control up to one-third of American equity, will have a field day picking up sections of the U.S. economy.

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