Foreign Exchange by David Goldman

How long will the dollar rally last?

The dollar's way down will be tortuous, but predictable: here are the reasons why.

The U.S. dollar stood at just under DM 2.28 in Frankfurt at deadline Sept. 23, or about 2 percent 2.23. Considering how fast the dollar had fallen—it stood at DM 2.58 on Aug. 10, one day before I warned of a "dollar crash"—the recovery is not surprising.

However, it is important to understand precisely what factors are at work in the temporary recovery, which could well run up another 10 pfennig or so before the dollar begins to fall again. So-called technical factors are irrelevant, and interest-rate questions are secondary. At the moment, the market is not yet dealing with movements of petrodollars, and secondary influences are determining the short-term events.

The dollar's fall occurred simply because long-term investors had long considered it overvalued, and looked for alternative assets; at a point when the Reagan budgetary problems surfaced, they took the opportunity to protect themselves against the foreign exchange risk of holding dollars, and the slide began. And on some of the worst days for the dollar, interest rates in the U.S. were rising.

The market "overshot" the DM rate considered appropriate by well-informed Frankfurt financial circles, or DM 2.20 to the dollar. Most of the institutions who had decided to limit dollar exposure had already done so, and the selling pressure evaporated.

What brought the dollar back sharply on Sept. 22, despite a fall in U.S. interest rates, was the weakness of the whole European Monetary System, brought on by the weakness of the French franc.

Before the French government announced its emergency currency defense package on the evening of Sept. 20, the French and German authorities had spent upwards of $2 billion to prevent the collapse of the French franc rate in the European fixed-rate alliance. Much of the intervention represented sales of DM to purchase French francs on the part of the Bundesbank, i.e., a sudden massive infusion of German mark *supply* to the Eurocurrency market.

The rise in DM supply contributed to a fall in Euromark interest rates on the markets Sept. 21 and 22, but it would be incorrect to say that the subsequent weakness of the mark was due to the drop in interest rates as such (particularly because the American prime rate dropped half a percent at the same time).

As I have argued before in this column, the German mark's biggest problem was not American interest rates as such, but the fact that under EMS rules, the West German central bank must create its own currency de novo to support other European currencies which are substantially weaker than the mark itself—a point made with some bitter irony by Bundesbank President Karl-Otto Poehl.

The French and West German authorities are now attempting to negotiate on what terms the French franc shall be devalued inside the European currency "snake." The French insist that the Germans revalue at the same time, which the Germans have no intention of doing. If the French are, indeed, forced to devalue on their own, the DM should resume its upward climb more quickly that otherwise.

Also important is the outcome of the budget debate in the German Bundestag. Although the CDU opposition came off weakly in the parliamentary sessions, well-informed German banking sources believe that Chancellor Schmidt's political position suffered as a result of the tricky compromise package of budget cuts he presented. Schmidt's ability to put through cuts much more limited than the Bundesbank would like, and still persuade the Bundesbank (whose central council is split on the issue) to lower interest rates enough to ease pressure on the German economy, is a swing factor in the situation.

Perceptions of Schmidt's political problems are exaggerated in the United States; through each successive crisis, the German chancellor has learned to be a better crisis manager. However, in the short run, Schmidt's budget problems may weigh on the DM rate.

These problems could well account for a significant drop in the mark during the next month or so. However, the myth of the strong dollar evaporated during the last several weeks, and a new selling wave will emerge on major signs of trouble in the President's economic program—probably before December.