Click here for Full Issue of EIR Volume 9, Number 29, August 3, 1982

Foreign Exchange by David Goldman

The dollar and the banking crisis

The key to the U.S. currency's fortunes is not interest-rate margins but the possibility of a debt blow-out.

Some well-placed money-market operators at New York commercial banks are projecting a 40 percent devaluation of the American dollar over the next 12 to 18 months, to about DM 1.50 against about DM 2.47 now.

Presuming that the Federal Reserve and the administration do nothing to alter the present disaster course, such expectations are well within the range of reason.

Nonetheless, these currency specialists caution that no gradual decline is to be expected in the near term; on the contrary, it would be possible for the dollar to rise another 10 percent before sinking like a stone toward the end of the year.

Far too much attention has been focused on the relation of American interest rates to the exchange rate. In fact, the failure of the dollar to move more than marginally when Eurodollar three-month deposit rates fell from nearly 16¾ percent on July 1 to below 14 percent on July 20 should indicate that something entirely different is at work.

The real mechnism has to do with the implications of the fact that the dollar is the currency of denomination of most international debt—in a period when it is uncertain debts will ever be paid.

The Eurodollar market is now undergoing a rapid phase of contraction, in which portfolio managers dive for safety, i.e., into Treasury bills, and this acts as a "reverse multiplier" for total Eurodollar credit.

That is to say in plain terms that many banks, mostly non-American ones, cannot refinance their liabilities at any price. Therefore they have no choice but to convert non-dollar currency deposits into dollars in order to repay their skittish depositors.

That creates a powerful, but temporary, source of support for the dollar. The situation thus has less to do with the price of credit than the absolute availability of credit (see article, page 4).

As the crisis worsens, the demand for dollars might also become stronger; one New York bank economist, analyzing the interbank market contraction, thinks the dollar may peak at DM 2.80.

Since the banking crisis is likely to coincide with a renewed rise in interest rates by early fall, there may be a double impetus for a stronger dollar.

None of this has anything whatever to do with perceptions or what economics mystifyingly call "expectations." It is all sheer necessity, the rip-tide of credit flows. No economist at any institution in the world, whatever his glaring faults, would disagree that the dollar is ridiculously overvalued in real terms.

However, a world in crisis does not behave by the normal rules based on real terms.

The dollar's problems emerge following a banking crisis. Such a contraction cannot last for many weeks or months before it is finally established which dollar-denominated paper will remain good and which will go through the banking equivalent of the shredder.

There are three possible end-states, with respect to the future value of the dollar, of a banking crisis:

1) In the event of a major central-bank bailout of the Eurodollar market, which amounts to replacing bank money with Federal Reserve money, the deposits left in the system would constitute the reserve base for a credit expansion many times in excess of the pre-crisis situation, and the foreign liabilities of the U.S. authorities would have risen spectacularly; that is to say that the dollar would be a drug on the market, and collapse.

2) The Eurodollar market would be left to its own fate, and the demand for dollars occasioned by the dollar's role as international lending currency would no longer exist; the demand for dollars would then dry up and the dollar would hit bottom.

3) The American authorities, either alone or with the cooperation of America's allies, would institute a gold-backed reorganization of the international markets to dry out the Eurodollar mess and substitute, in its place, new institutions for low-interest hard-commodity investment and trade finance.

Under these last mentioned conditions, presuming that America took suitable steps at home to outfit the American economy for aggressive exporting, the dollar would no longer be overvalued in real terms, and would be pegged at approximately the present value.

© 1982 EIR News Service Inc. All Rights Reserved. Reproduction in whole or in part without permission strictly prohibited.