Bank crisis creates dollar scarcity

But Fed chairman Volcker's commitment to "print, print, print" means it can't last much longer.

Despite the international banking crisis, the U.S. dollar recovered from a 10 pfenning drop against the West German mark at the end of May, and rose to the DM 2.69 level June 8. Gold, which had put on $19 at the end of May to rise to $394 an ounce, fell back to the $383 level.

Is the dollar a supernatural currency no longer subject to any laws of the economic universe? Not quite. The dollar is in big trouble—so big that the forces propping it up now will only make it fall harder.

Right now the only thing holding up the dollar is the run on American banks, which are still having tremendous difficulty attracting deposits, especially jumbo Certificates of Deposit in London. Despite the press ballyhoo that the banking crisis is over, foreign banks continue to quietly remove deposits from U.S. banks in Europe in advance of the end-of-June debt crisis looming for Argentina—and thus for Manufacturers Hanover, Citibank, Bank of America, and all the largest U.S. banks.

As they lose deposits, U.S. banks are forced to pay higher and higher interbank rates to attract what money they can. One-year Eurodollar rates rose to an incredible 13 7/16% the first week of June, as banks scrambled to bid for funds. This in turn pulled the Fed Funds rate in New York up from the 8% level the Fed created at the height of the Continental Illinois crisis in May, to 11%.

For a while, this massive banking demand for dollars will keep up the dollar's currency trading rate, and make the costs of carrying gold a bit high for investors.

But behind this facade, the dollar is being hyperinflated by the Fed, which is printing money in an attempt to liquify the banks.

In one end, and out the other. The Fed simply cannot print money fast enough to counteract the rate at which depositors are withdrawing it from the banking system.

"The fact that interest rates look reasonably normal, rather than shooting through the ceiling, reflects major injection of funds by the Fed," one top British banking source said May 31. "Also the fact that the monetary aggregates have not collapsed, due to flight to quality [as depositors move out of M-1 bank deposits] demonstrates merely the same thing," he added.

However, since the Fed is continuing to print dollars, at a certain point this will become obvious to investors. Then, no matter how high the rates go, no investor will be caught dead holding a dollar as a currency investment.

As Jimmy Carter's Assistant Treasury Secretary C. Fred Bergsten pointed out June 6, the United States in fact could be "challenging Brazil and Mexico for the rank of the world's top debtor nation by 1986."

In testimony before a Senate banking subcommittee Bergsten said that his projection of the cumulative current account deficits for the 1983-85 period exceeds $250 billion.

"At the end of 1982, the net U.S. creditor position was only $168 billion," he said. "Hence that position could be virtually wiped out by the end of this year and seems certain to disappear during 1985. We would thereby return to our 19th-century status as a debtor nation."

"One implication of this is increased vulnerability for the dollar," Bergsten pointed out. "Urgent action is required," he said, "to begin the adjustment process soon enough, primarily through action on the budget deficit, to foster the needed currency correction in a relatively smooth manner without a 'free fall' à la 1978 and the enhanced risk of overshooting to an excessively weak dollar."

He warned that a sharp decline in the dollar would add significantly to the inflationary pressures in the economy, and collapse the dollar further. "A fall of 25% in the exchange rate would add 3 to 4 percentage points to the price level."

Meanwhile West German Central Bank chief Karl-Otto Pöhl at a Philadelphia press conference June 6 reiterated his contention that unless the United States gets interest rates down, the dollar will soon collapse of its own accord.

Pöhl said that he and others at the London economic summit would demand that the United States lower its rates or face real problems for the dollar. "I don't think it will come to a big clash, but I consider it very likely that the subject of dollar interest rates will be a central point of discussion," he said.

Swiss National Bank chairman Fritz Leutwiler pointed out at the same gathering that a plan to have big debtors diversify their debt out of the "strong dollar" could backfire because the dollar is getting ready to swing the other way.