Foreign Exchange by David Goldman

Wallich predicts dollar trouble

A soon-to-be-published tract by Federal Reserve Governor Wallich talks down the dollar.

The American dollar concluded the week of July 30 at about DM 2.86, down substantially from the 13-year high of 2.91 achieved earlier in the week. It does not appear that this was what the commentators dismiss as a "technical reaction." Instead, it reportedly reflected the realization that the Federal Reserve has not tightened monetary policy and will not in the foreseeable future.

The dollar's fall, in other words, is the flip side of the wild rise in stock prices during the first week in August. Whether this is good or bad for the future of the world monetary system is an interesting question, and Wallich's comments, made available in draft form by sources at the Federal Reserve, suggest that the answer is a thunderous no.

The dollar's weakness coincides with a reasonably sharp drop in Eurodollar deposit rates, which stand now at 12% for six-month money, against 12.75% only six weeks ago. The drop in the six-month rate, according to London market participants, reflects some relief at the bailout of the Continental Illinois Bank announced the preceding week, but the bailout itself has convinced market participants, at last, that the Federal Reserve cannot afford a tight money policy.

The essay by Wallich, to be published next month by the giant accounting firm Touche Ross, is of note in this situation. Wallich, the Fed's link to the oligarchical Bank for International Settlements in Basel, argues that currency inflows have financed the U.S. budget deficit, and that an end to the current-account deficit and its accompanying inflow of capital would merely put more pressure on American interest rates. He also warns that the pressure upon the rest of the world, which has reluctantly born this burden, will ultimately damage the dollar's status as the world's leading reserve currency:

"If, as seems likely, the United States continues borrowing abroad and moving toward net debtor status, causing the rest of the world to hold ever larger amounts of dollar-denominated assets, the good acceptance that our currency has had in the world may wear out. In the longer run, it seems probable that the dollar-depressing effect of the external deficit will begin to overwhelm the dollar-supporting effect of higher interest rates. I do not believe, therefore, that the current value of the dollar is sustainable. . . ."

In fact, the rise in non-dollar lending in the Euromarkets during the past several weeks (reported by banking sources) shows that Wallich's warning is already a reality: The dollar has become unusable as a reserve currency, with the channels of the interbank market still clogged by fears concerning the safety of American banks overseas since the Continental Illinois disaster. Although the Federal Reserve bailout of Conti arrested further deterioration of the interbank market, no well-informed observers believe that anything has improved. On the contrary, they are waiting for more fireworks from the Ibero-American debtors. The expansion of non-dollar lending markets is a bad sign for the long-term health of the dollar. So is the drop in international oil prices, already threatening to turn into a crash. High oil prices have artificially increased demand for the dollar, and the quadrupling of oil prices in 1979 set the stage for the long rise of the dollar since. The reverse will place additional pressure on the dollar, probably by the fourth quarter of this year.

Wallich's conclusion is that there will be disaster unless the budget deficit is drastically reduced:

"If the dollar does decline substantially while the budget deficit remains unchanged, the external deficit will, with a lag, also decline. That would reduce the magnitude of the external deficit problem. However, it would also intensify other problems created by the budget deficit. With a return of the external sector toward balance [due to the falling dollar], foreign financing of the budget deficit would diminish. Ultimately, it would have to be financed entirely at home, absorbing a still higher fraction of scarce savings, thereby raising interest rates. The 'crowding out' resulting from the budget deficit, which is now partly offset by the foreign-trade related sectors of the U.S. economy, would then be directed fully against the other sectors of the economy. Thus, reduction or elimination of the external deficit, without a corresponding reduction in the budget deficit would only shift the impact of our nation's budget deficit problems without resolving them."

It may or may not be of interest that Wallich's article will appear in September, in time for the International Monetary Fund's annual conference; various players in the game, including the Soviets, reportedly believe that the dollar will go through the floor around October, in time to influence the November elections.