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Foreign Exchange by David Goldman

Time of reckoning for the dollar

All options close off to prevent a disastrous fall of the U.S. currency.

Numerous analysts, including Irving Trust's Philip Braverman and Citibank's foreign exchange department, now project the U.S. July trade deficit at $16.5 billion or higher, i.e., an annual rate of $188 billion or more. That will crush the last flicker of credibility in the Reagan administration's prediction that the trade deficit will improve.

Huge amounts of central bank intervention have kept the dollar just above the yen 140 level (as of our deadline on Aug. 28), where it had fallen from over yen 152 only two weeks earlier. Japanese Finance Minister Miyazawa was quoted to the effect that the February "Versailles agreement" among the seven big monetary powers remained in effect, i.e., that central banks would cooperate to stabilize the dollar.

How long the central banks can maintain even the current dollar level, is uncertain. Their previous intervention this year generated a monetary bubble without precedent in the postwar period, for the simple reason that foreign central banks' support operations consist of printing their own currency, and using it to buy unwanted dollars in the market.

The result of the central banks' exercise in money-printing was a global boom in stock and related markets, spinning off the inflationary credit-bubble in the dollar sector. That is, in order to stall the collapse of the dollar's value, the other central banks had to debase their currency as well, and the debased, inflated currency flowed into speculative games in the London, Tokyo, and other stock markets.

Between December 1986 and July 1987, U.S. money supply (M2) rose at a 3% annual rate. But Japan's money growth rate stood at 10.5%; West Germany's at 7.2%; and Britain's at an incredible 26.1%. That corresponds to a $25 billion increase in Japan's dollar holdings during the first four months of 1987, corresponding to an equivalent amount of yen creation; and a corresponding $10 billion increase in West Germany's dollar holdings during the same period.

Some monetarists have argued that the differential rate of money growth explains the dollar's stability as of the second quarter of this year. That is nonsense; the differential money growth rates are the result of a cold-blooded decision by foreign central banks to inflate their own currencies, in order to approach the worthlessness of the United States dollar!

U.S. long-term Treasury bonds now yield 9.1%, the highest level in more than two years, a good index of the suspicion with which overseas investors view all but the shortest-term speculative dollar securities.

During the past several weeks, the central banks of Japan, West Germany, Britain, and Italy have all taken measures to halt the dilution of their own currencies and suppress the corresponding speculative bubbles in their home securities markets. They have no choice but to do this, if they want to protect their banking systems from the effects of a general American securities-market collapse.

Their decision has produced howls of protest from some Wall Street pundits, who complain that the central banks' protective action threatens the dollar's stability. The opposite, in fact, is true: The dollar's sham stability threatens *them*.

One such protest appeared Aug. 27 in the *Wall Street Journal*, from Morgan Stanley's James Fralick. He writes:

"The [West German] Bundesbank and the Bank of Japan—facing rapid money growth—have shown renewed interest in targeting the monetary aggregates. This attention on the money stock represents a major break from the recent past, when officials tolerated above-target monetary expansion because of good news on inflation and the need to support the dollar. And the dollar is suffering now as a result."

Fralick writes as if these central banks were directed by academic ideologues, who noticed, by chance, that money supply was growing out of bounds, and reacted according to the monetarist dogma.

That is complete nonsense. The point is not money supply growth, but the intentional debasement of other national currencies in favor of the dollar, and the consequences for national banking systems.

The dollar's recent tumble shows that the point has been reached, at which foreign central banks must leave the U.S. currency to its fate, as a matter of short-term self-preservation. Japan's central bank intervention of this week runs up against the same central bank's commitment to safeguard the Japanese banking system. It cannot go back to the massive intervention of the first and second quarters. Even if the Treasury attempts to hold the dollar firm, it is not likely that it can, even in the short run.

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