City of London by Stephen Lewis

Global interest rate war likely

The clue lies in the fall in Japanese rates, even as U.S. rates began their ascent.

The surge in the U.S. dollar following release of the May U.S. trade figures made an international interest rate war all the more likely. One does not have to believe in the "U.S. economic miracle of 1988" to justify the current strength of the U.S. currency. Shifts in interest rate differentials are sufficient grounds for the dollar's recovery. There has been a significant widening in dollar/yen interest rate differentials since March, from 250 to 350 basis points.

This seems to have been deliberate. The clue lies in the fall in Japanese rates, even as U.S. rates began their ascent. It will be recalled that this was at a time when the Dukakis bandwagon was rolling in the United States: George Bush, though assured of the Republican presidential nomination, was in serious political trouble, to judge by the opinion polls.

The dollar was trading at 1.65 deutschemarks and 124 yen, not so far above the turn-of-the-year "lows," and looking to head down. A decision seems to have been taken, by the United States and Japanese authorities at least, to give the dollar a boost by widening dollar/yen rate differentials. Whether the German authorities were active parties to this policy initiative is difficult to tell from the record. German rates hardly moved in the four months from the beginning of February to early June.

The impact of the wider dollar/yen differential on the U.S. dollar was hardly electric. The best that can be said is that the move helped to prevent the dollar falling into a chasm. It stabilized at the 125 yen level.

The U.S. authorities' concern to curb domestic inflation expectations, and possibly their desire to see a firmer dollar to reduce import costs and for its own sake, was reflected in a continuous rise in U.S. short-term interest rates through April and May. Again, the U.S. dollar's response must have seemed disappointingly limited for Mr. James Baker and the Federal Reserve.

However, the U.S. dollar/DM differential, which had throughout the year been wider than the differential against the yen, had opened to more than 400 basis points by the end of May, and the deutschemark was beginning to slide.

It was at this point that the West German Bundesbank began to intervene on the foreign exchanges to support its own currency. This may be circumstantial evidence that the Bundesbank was not a party to the U.S.-Japan agreement on currencies at the end of March. The domestic effect of the Bundesbank's currency intervention was to drain funds from the money market, thereby driving interest rates up.

In the past month, the Bundesbank has maintained its opposition to further rises in the U.S. dollar, and even the Bank of Japan seems to have been willing to declare that enough is enough, to judge from the way the latest U.S. interest rate increase has been matched by higher Japanese rates. The point has now been reached where further U.S. aggression on interest rates could risk destabilizing international currency and money markets.

The U.S. Federal Reserve's judgment, which is probably correct, is that the most serious threat to the stock market and economic confidence ahead of the November elections is a possible collapse in the bond market. Such a collapse might stem from a rise in inflation expectations. This is why the Fed will be tempted to go on turning the screws in the money market.

Even so, it will be difficult for the Fed to persuade the markets that it is doing enough to curb inflation, simply because natural cynicism teaches the markets to suspect the Fed of taking an unduly soft line on inflation in an election year, for the sake of promoting economic growth. This basic misunderstanding of the Fed's objectives provides the motive force to power U.S. interest rates to yet higher levels in the months ahead.

Meanwhile, the Bundesbank's concerns about inflation will not allow it to stand aside as the U.S. dollar pushes up against the deutschemark. Continuous tightening of German monetary policy is a prospect as long as the deutschemark remains under downward pressure.

An end to dollar strength might come if the Bank of Japan were willing to narrow the dollar/yen interest rate differential through a substantial tightening of domestic monetary policy. The Japanese authorities, however, give every appearance of being content with yen/dollar stability around the current level. They do not seek a lower dollar. Furthermore, a substantial tightening of monetary policy runs counter to the domestic objective of sustaining economic growth. Consequently, the Bank of Japan is likely to play a passive part in any U.S.-German interest rate competition and, for that reason, the competition could well be prolonged.

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