

Foreign Exchange by Richard Katz

The dollar's strange stability

The dollar's much-vaunted stability is short-lived and strictly political...waiting for the Afghanistan crisis to cool.

The dead-center stability of the dollar following the Feb. 28 announcement of an all-time record \$4.7 billion U.S. merchandise trade deficit for the month of January has led some dealers to conclude that the dollar's position is inviolable, against all expectations. Short-term dollar rates at over 17 percent both in the Eurodollar and the Federal funds markets have been cited as incentive for investors to hold dollars. However, with the parallel rise of interest rates in all European money centers and in Japan, the lifting of Swiss and Japanese exchange controls, and the jump in the American consumer price inflation rate to 16.8 percent per annum during January, high interest rates are less of an incentive to hold dollars than ever before.

In fact, the dollar's surprising strength is neither inviolable, nor does it have anything to do with relative inflation or interest rates. This one is strictly political. Just retired West German Bundesbank President Otmar Emminger is saying privately that as soon as the current Afghanistan crisis cools, the dollar will collapse. That is not because European flight capital is seeking a haven 3,000 miles away from the Warsaw Pact's front lines, as some market commentators argue. European investors generally understand that Wall Street would be ashes the moment that a serious

confrontation began in central Europe.

Europe is supporting the dollar as a matter of NATO solidarity. Ultimately, Europe has no options without the dollar, unless the continent makes a full-scale economic agreement with the Soviet Union. West Germany's leaders are not happy their commitments to the dollar, at the expense of a 9 billion deutschmark balance of payments deficit during 1979 and a potentially larger one during 1980, serve to stabilize American government finances and permit a military build-up. However, a collapse of the dollar would only be useful to West Germany if it shocked Washington sufficiently to force the abandonment of the Brzezinski "arc of crisis" policy. Nothing of that sort will happen under present circumstances. As long as Western Europe is locked into the dollar reserve structure, a weak dollar would only mean more currency inflows into West Germany and other strong-currency sectors, more central bank purchases of these dollars, and more purchases of American treasury securities. In this case, the Europeans would end up financing the military budget directly.

The so-called European reserve currency option is thoroughly unacceptable to Paris and Bonn. It presumes the direct or indirect extension of European currencies

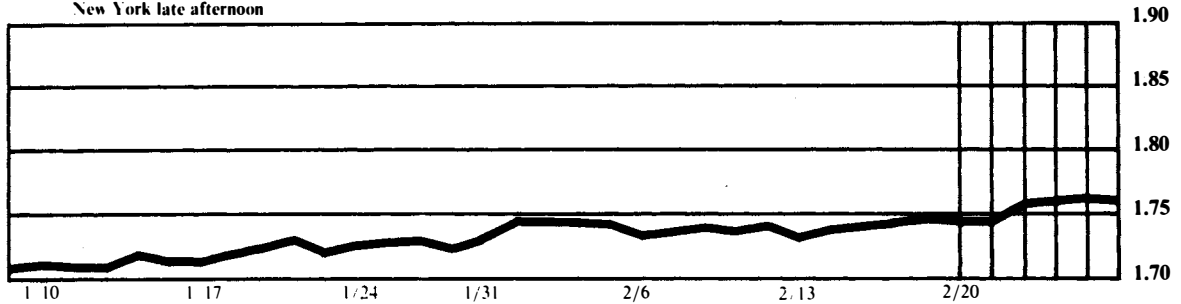
into a reserve role they cannot sustain. The problem is that the world's claims are still in dollars; Europe's principal assets are in dollars; Europe's trade and debt relations with the developing sector are in dollars; if the Washington Treasury makes the dollar unuseable, Europe is stuck.

However, Washington's strategic and economic policies are pushing Europe to a break. If Volcker accepts the advice of the *London Times* (see Special Report) and imposes a serious deflation, the dollar's usability as an international reserve currency will disappear. Europe will have no option but to freeze its dollar assets for all working purposes, and employ its gold and nondollar currency reserves to preserve its foreign trade, through a number of possible makeshift arrangements. And if Washington attempts to finance its current proposed military buildup the way it financed the Vietnam War, by unloading Treasury securities on European central banks, the Europeans will balk, and let the dollar go. Under the worst of circumstances, Europe could institute emergency payments measures on the strength of gold reserves, even if most international dollar accounts are frozen.

Worse yet for Washington, the European Monetary System could borrow several tens of billions of dollars through gold-denominated bonds, taking over the world dollar supply. In this case, the dollar would strengthen considerably. However, a major break downwards of the dollar's parity against the EMS currencies is virtually inevitable before any such arrangement would come into effect.

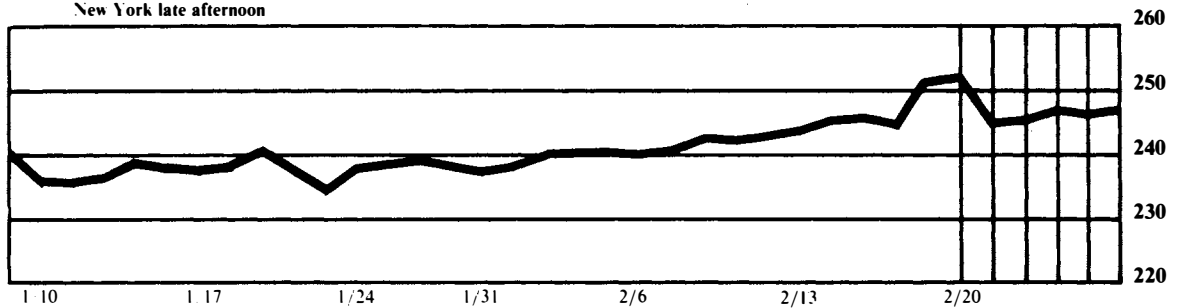
The dollar in deutschmarks

New York late afternoon



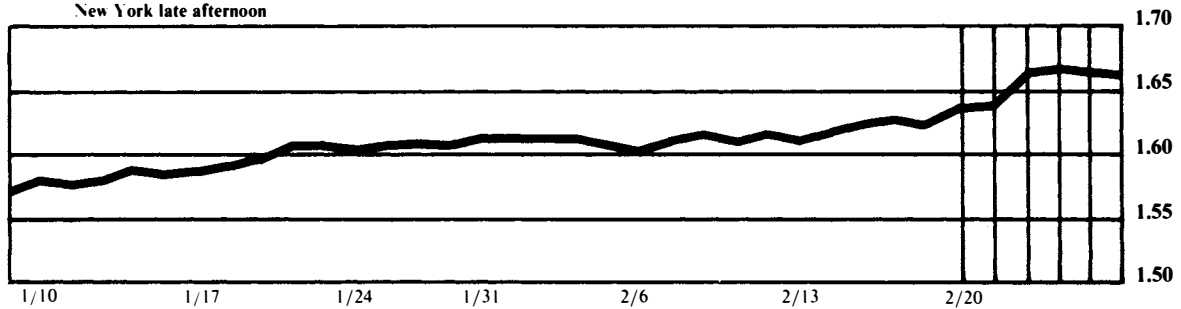
The dollar in yen

New York late afternoon



The dollar in Swiss francs

New York late afternoon



The British pound in dollars

New York late afternoon

