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Foreign Exchange by David Goldman

The D-mark rebounds

Even the markets recognize that fundamentals are what aid the mark, along with sturdy petrodollar inflows.

As the outlook for the dollar has started to darken, with the administration's budget fiasco unsettling the markets, the "fundamentals" of economic activity have started to reassert themselves for the German currency, which had lost 39 percent of its value to the dollar since Paul Volcker sent U.S. interest rates through the ceiling.

The Department of Commerce announced that it projects the U.S. trade deficit to hit $39 billion this year, $3.4 billion in excess of last year, a development it primarily attributes to the loss of competitiveness of U.S. goods denominated in a grossly overvalued currency.

There is more: the "aura of confidence" built earlier this year by the media around the Reagan administration's economic and fiscal strategy is being unraveled by the same media with a vengeance. The sharp drop in stock values, the collapse of the bond markets—the "process of generalized liquidation" referred to by numerous traders and portfolio managers—is combining with the administration's pathetic inability to get its figures right and the open bankruptcy of its strategy to remove most of the props that have kept the dollar artificially overvalued.

Only the Fed's high interest-rate policy has kept the dollar up. But as the Fed pumps large amounts of credit in the banking system to shore up liquidity-strapped financial institutions, and as the corporate sector is growing increasingly desperate in its quest for loans, the pressure for interest rates to soar once more is becoming irresistible.

Informed Wall Street sources expect the prime rate to move up several percentage points in the months immediately ahead, adding that the ensuing recession will then bring them down.

The conclusion, therefore, is that once the interest-rate prop is removed, a very significant depreciation of the dollar is ahead; a Bankers Trust source estimates that the drop will be 20-25 percent.

"In the last two or three weeks, there has been a remarkable change of mind concerning the deutschemark on the markets," the same source commented. "The trade balance is now nearly in black figures, and that trend is here to stay; labor settlements have been moderate; the government there has been grappling successfully with the budget deficit." In addition, the inflow of politically motivated Saudi and OPEC money has added to the slow momentum helping the mark.

More fundamental is the policy doggedly pursued by Chancellor Helmut Schmidt to make industrial investment the priority item in his 1982 budget. The perspective of the vast Siberian raw-materials development contracts already signed or contemplated by Germany and the Soviet Union is lending additional weight to the chancellor's strategy.

Would that be sufficient for the mark to withstand a new wave of U.S. interest-rate increases? That is what the market is reporting at present: "The 'fundamentals' have now cushioned the mark sufficiently. We expect that by the middle of next year, the DM will be at 2.20 to the dollar," the foreign-exchange manager of a major New York bank said.

Meanwhile, the currency outlook for most of the other European countries is bleak: the Danish kroner, a perennial foot-dragger inside the EMS, is expected by the *Neue Zürcher Zeitung* to be substantially devalued in the very near future; the pressure on the French franc is increasing with each measure taken by the French government—with a solid option for an 18 percent rate of inflation by year-end and more next year. The lira, which has been inflated by huge inflows of short-term Eurocurrency deposits, stands in immediate danger.

And the British pound "should be seen as a highly valuable currency, in spite of its recent losses," a foreign-exchange dealer said. This is confirmed by both the London *Times* and *Financial Times*, which report that the rapidly shrinking current-account surplus will further weaken sterling, and call for an early British entry into the European Monetary System to reverse that trend.

The prospect of a realignment of parities in the EMS also raises the possibility that Germany will grow tired of financing the budgets of its European Community partners through EMS support measures, and will dump the EMS wholesale, with the knowledge that their reserves will be bolstered by inflows of OPEC money.

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