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Foreign Exchange by David Goldman

Dollar rise is temporary

Examining Europe's reaction to last-minute attempts to right the U.S. economy.

"It is unimaginable that Volcker would maintain the present high-interest rate policy for more than six weeks," said the chief of the international department at one of the Big Three Swiss banks Feb. 4. "Were he to do that, the American economy would go into an uncontrolled crash."

Hints and signals from the financial circles here and abroad who ultimately give orders to errand-boys like Paul Volcker now add up to a consensus that, by the end of March, the Fed will turn about-face and ease credit conditions, relying on the effect of a substantial rise in defense spending to bring the economy off dead-bottom in time for the administration to announce a "recovery" before the November congressional elections. No major recovery is to be expected, only a noticeable shift.

The factors that otherwise add up to a brutal beating for the dollar later this year would thus obtain the additional weight of a break in the interest-rate spiral that is now the dollar's only source of support.

West Germany, Japan, and Saudi Arabia, as we have emphasized recently, will probably be the only countries in current-account surplus by the end of 1982, while the price of oil, the major prop to the dollar in international trade, may fall significantly.

In this context, there might be a connection between Gordon Richardson's speech to the Overseas Bankers Club in London on Feb. 2, in which the Governor of the Bank of England predicted a stronger German mark and Japanese yen relative to the dollar, and a remarkable report from the International Energy Agency in Paris, issued the same day. The IEA reported that British North Sea oil was leading a fall in the spot price of oil, i.e., that the British were dumping onto an already-soft market. Some British traders have speculated that the oil price may come down to $28 per barrel this year. Meanwhile, Saudi oil is already selling at a $2.50 discount.

Such actions would seem to run against the immediate interests of the British, whose oil revenues have accounted for unexpected balance-of-payments strength during the last three years.

However, the answer to this apparent contradiction of interest may lie in recent agitation for Britain to join the European Monetary System, and in some even more interesting remarks recently by French President Mitterrand.

New York Times op-ed columnist James Reston, referring to the French leader, wrote on Feb. 3: "He was not judging President Reagan's economic policies, he said, for that was not his responsibility, but high interest and exchange rates were weighing very heavily on the economies of the allies. What could Europe do about this? As there is already a European Monetary System, he said, it would be a good idea if there were also a European system for rates of interest, and, he added, there would also have to be a system of control in order to avoid capital outflows from Europe."

West Germany rejected precisely such a French proposal when it was made before a Jan. 16 meeting of finance ministers; but the extraordinary turns of American policy may change this.

There is a survival mentality building in West Germany, based on the increasing conviction that the present U.S. administration is not capable of acting in America's most basic interests, after the double disaster of the administration's Polish bluff, and the open break on interest-rate policy, which West Germany initiated at the Jan. 16 meeting. After 18 months of attempting to persuade the Reagan administration to prevent Volcker from throwing the United States into depression, the West Germans are thinking of how they may insulate their economy from a U.S. depression.

Should Volcker either steer the United States into a monetary catastrophe, or seek to pump credit into the handful of economic sectors that stand to gain from a military program that is unlikely to impress anyone in the Kremlin, the dollar will be the first casualty on the financial front; a currency whose international deposit base has grown several times faster than world trade volume in the past 10 years, in that sense, has it coming. All the monetary defenses that have been proposed in the past year will cease to become a matter of choice, and turn into a fact of economic life in Europe.

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