## Foreign Exchange by David Goldman

# Volcker: dollar strength temporary

*Growing Treasury dependency on the Euromarkets will turn into nasty pressure on the U.S. budget in 1985.*

Speaking at the Arthritis Foundation dinner Nov. 29, Fed chairman Paul Volcker warned that a merchandise trade deficit running $130 billion per year and a current-account deficit at a $120 billion third-quarter annual rate have led to net financial inflows at a $120 billion annual rate during the third quarter.

"The hard reality is that for the moment we are addicted to foreign borrowings to reconcile our deficit and our investment needs with our limited propensity to save at home," Volcker said. "The U.S. is importing capital so fast that the largest and richest country in the world is well on its way to becoming the largest international debtor as well. Yet, we can't count indefinitely on the capital inflows," Volcker said, adding that an end to the capital inflows would bring higher interest rates and inflation.

As we have warned repeatedly since September, the dollar will not fall significantly during 1984, and, indeed, not fall until major adverse events in the banking system unravel the conditions under which the dollar has gained more than 50% in trade-weighted value since 1980. The dollar's recent rebound (to about DM 3.09 on Nov. 30) guarantees, for the moment, the dollar's first place in line among all international debtors. But the problems in the international banking system which will ultimately force the dollar down are likely to coincide with the greatest pressure for U.S. budget cuts early next year.

Sources at the Fed say that the dollar will keep rising in the short term, first, because inflation is so low that falling U.S. interest rates make no difference to foreign portfolio managers. A secondary factor in the short run, they add, is fear that a banking crisis might force a scarcity of dollars. However, Fed analysts admit, a major drop in U.S. dollar asset values, e.g., in the U.S. fixed-income securities and real estate market, or problems arising from collapsing Third World debt, could reverse the dollar rise fast.

Commodity prices, led by oil, are, indeed in a tumble. After rising by 21% between the beginning of this recovery in November 1982 and March 1984, the IMF's all commodity index fell by 10% during the next seven months. This provokes liquidity shortage and favors the dollar, the denomination currency of debt collection (ignore all the foolishness about "real interest rates").

However, the commodity price collapse—soon to be followed by commercial real-estate values—is the result of the flaking-off of the phony economic recovery, and threatens to undermine U.S. bank asset values. Apart from energy and real-estate loans, it threatens to reverse the $31 billion Ibero-American trade surplus for 1984 which has, thus far, permitted the major debtors to keep their arrears from growing.

The next shoe to drop will be in the Eurobond market, a major source of financing for the Treasury and related agencies; FNMA, the off-budget mortgage finance agency, announced last week it intended to raise $2 billion a year offshore, and the Treasury has been offering foreign bond issues abroad since September. All is not well on these markets, despite recent high issue volume. The *Neue Zürcher Zeitung* reported on Nov. 28 that there are "unmistakeable structural changes" in the Eurobond market, illustrated by the new Swedish $1.2 billion floating-rate issue; rather than LIBOR, it is priced at LIBID, or the London interbank bid rate.

"In Sweden's view, LIBID offers an advantage not merely because of lower costs . . . but presumably also as a better protection in the event of a banking crisis. In the Swedish debt management agency it is assumed that in a banking crisis, for example as a consequence of payments failure of a Third World debtor country, the interest differential between LIBOR and LIBID would rise appreciably and make LIBOR-pegged paper more expensive. The cheaper tie to LIBID can be defended in Sweden's case with the consideration that in the case of a bank crisis, state paper would carry less risk than bank notes and therefore attract more investor demand."

The rest of the world is not acting as if the dollar's strength is here to stay. The European Economic Community is already taking steps to force through the reserve role of the European Currency Unit, i.e., create a currency bloc at odds with the dollar.

The Japanese are also moving rapidly to make the yen an international reserve currency. Some New York bank analysts say that the yen may now be more important than the DM in Euromarket transactions; although stated figures show that Euro-DM are four times larger in total deposits than Euroyen, the net (of interbank) yen deposits is fast overtaking the DM.



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