Foreign Exchange by David Goldman

Next phase of dollar collapse begins

The Paris agreement to set a floor under the U.S. currency collapses, along with central bank credibility.

Despite apparent record intervention by the U.S. Federal Reserve and other central banks, the U.S. dollar fell to a new all-time low against the Japanese yen on March 25. That marks the formal demise of the Group of Five's "Paris Agreement," which supposedly set a floor under the dollar.

The Reuter wire commented, "Foreign banks and Japanese central institutions sold the dollar down against the yen today as central banks of the major industrialized nations played a dangerous game of daredevil with the market. Dealers predicted that a failure this week by the central banks of Japan, the United States and Britain to keep the weak dollar above water would undermine their credibility in the eyes of the marketplace.

"Persistent intervention by the Bank of Japan, on top of apparent U.S. Federal Reserve and Bank of England action in support of the dollar overnight, did not stop dealers from knocking the dollar back during trading today to 149.05 yen."

The latest dollar slide occurred after Treasury Secretary James Baker III told a television interviewer on March 23 that the Paris group had set no specific floor under the dollar.

Baker's remarks meant little, since the central banks had never acknowledged a floor, but speculators took the opportunity to find out how serious the central banks were.

When the dust settled, the central banks had barely managed to prevent the dollar from crashing without control, and had still failed to bring it above 149 yen.

Stephen Marris, the former chief economist of the Organization for Economic Cooperation and Development, warned of a "hard landing" for the dollar in a study published last year by the Institute for International Economics in Washington. It is hard to tell, Marris now thinks, whether the dollar will go off the cliff now, or by summer.

Nonetheless, he emphasizes that "the central banks have certainly boxed themselves into a corner, by letting the idea get out that 150 yen to the dollar is the intervention point."

It is not even clear, Marris added, whether the Federal Reserve will obtain the authority it needs from the administration to continue intervening, given anti-Japanese sentiment which dictates that a lower dollar is better for the U.S. and worse for the Japanese.

A much more deadly side of the problem involves the effect on American credit markets. When the Federal Reserve intervenes in support of the dollar, it buys unwanted dollars off the market, in order to push the dollar's price higher.

That has the same effect as tightening credit. If the Fed continues to intervene in this fashion, U.S. interest rates will rise, and the administration's beloved stock-and-bond bubble will explode.

"What has held the dollar up so far," Marris adds, "is the Wall Street boom, because intelligent foreign investors have made as much in rising stock prices as they lost on foreign exchange; but that makes the eventual problem all the more dangerous."

America is now borrowing $200 billion a year or so from foreigners, paying for the enormous U.S. trade deficit, and financing the government's own budget deficit. A reversal of these investments by Japan and others would reduce American securities markets to a bloody mess.

Leading European circles are already preparing for the dollar's demise. In an interview with the London *Financial Times* on March 23, European Community President Jacques Delors called for strengthening of the European Monetary System (EMS), the protective currency mechanism set up by European governments in response to the Carter administration's "benign neglect" policy toward the dollar.

Delors will present a package in April at the EC Finance Ministers' meeting which calls for closer monetary cooperation, control of speculative flows and a "gradual, rather than radical reform of Common Agriculture Policy (CAP)." Delors warned, "Without a reinforcement of the EMS, we have not got the means to regulate what is happening in the capital markets." Delors also called for the full integration of Britain into these arrangements.

Stephen Marris adds, "The Germans have just woken up to their problems; they had convinced themselves that domestic demand would hold up, but in the last few months it completely collapsed. Growth slowed drastically in Japan and then Germany, even before they were hit by the adjustment in the U.S. payments balance. What will happen to them when the collapse of U.S. imports finally hits?"