Foreign Exchange by David Goldman

The hype goes sour

A turning point has arrived: new oil revenues' flow into other currencies will actually hurt the dollar.

The dollar's strange behavior on the foreign exchange markets during the week of Aug. 4 made fools of a large number of commercial bank economists, led by Morgan Guaranty's Rimmer de Vries, who had predicted that the previous week's runup of the dollar on the foreign exchange markets heralded a new era of dollar stability.

On Friday, Aug. 1, the dollar closed above 1.79 to the West German mark, or a respectable 2.5 percent higher than two weeks previously. By Aug. 6, the dollar had fallen back to DM 1.76. This occurred despite the announcement by Mr. de Vries and many other respected voices that the dollar was showing its real strength.

A more thorough appraisal shows that although some short-term bank deposits changed currency as American interest rates rose, virtually no long-term investment moved into the dollar. During the last several weeks' runup in American stocks, European investors sat on their hands, largely due to fear of foreign-exchange risk in switching funds into dollars. In the bellwether Eurobond market, the dollar sector remained on strike with very few new issues appearing in July or announced for early August. However, the German mark sector of the Eurodollar market has remained very strong indeed.

What is especially interesting in the souring of the dollar hype is a political sidecurrent that ran through the European markets the morning of Aug. 4. According to a story circulated by continental foreign exchange traders, the dollar was supposed to have risen because President Carter's troubles would guarantee the election of Ronald Reagan and ensure conservative management of the U.S. economy.

From an economic standpoint, tnat is a silly notion, and no major investors in Europe believe that Reagan will have any more success in managing the American economy than Carter, judging from his advisers' current policies.

What is worrisome for the dollar is the shift in the structure of the international market, through the diversification of the investment pattern of Arab countries. Previously, *EIR* has tended to downplay the possibility that large-scale Arab currency "diversification" would badly impact the dollar. However, if Mr. Carter is returned as his party's nominee at next week's Democratic Convention, there is no reason to suspect that diversification of Arab investment into state-to-state deals (see Special Report) will *not* hurt the dollar. The Carter administration is pushing toward a political break with most of the rest of the world. The extreme degree of the deterioration of relations with Europe and the Mideast will impact the dollar before the year is out.

Any stabilization of the net of agreements now being woven between Europe and the Gulf countries will tend to lower the dollar's value. In all fairness, the relative increase of the oil price during 1979 has had a great deal to do with the stability of the dollar, such as it has been, during the past year, for the simple reason that higher oil prices create demand for dollars to pay for oil, which is priced in dollars in international trade. Even a stabilization of the oil price—and the market is quite soft for both crude and refined products—for any period of time would produce substantial pressure on the dollar.

The other traditional source of strength for the dollar, the instability of weaker European currencies, may not come to the dollar's aid. Under the existing European Monetary System framework, the Bundesbank will sell deutschemarks to buy the currencies of those weaker EMS members. That tends to depress the mark against the dollar, for obvious reasons. However the doubling of the size of the pool of European Currency Units on which EMS members can draw gives the weaker EMS members virtually inexhaustible resources for currency support. This should make the entire system less subject to devaluations and more stable. The volume of ECUs available to individual members for foreign-exchange support is based on the members original gold contributions, valued at a formula linked to the market price of gold. Since the market price of gold has doubled or more since the founding of the EMS, support resources have increased markedly. Indeed, the success of the 1979-1980 EMS "Phase One" is a major reason for the relative stability of the European economies compared to nonmember Britain and the United States.