Foreign Exchange by David Goldman

Rollercoaster for the dollar

The United States has caught the British disease. Short-term dollar gains won't help the economy.

Widespread fear of a third skyrocketing rise in U.S. interest rates due to the policies of Paul Volcker's Federal Reserve has prompted a new belief that the U.S. dollar may be a great deal stronger than anyone expected.

First with the line on the dollar's new lease on life was the Organization for Economic Cooperation and Development (OECD), the economic think tank which runs NATO and created the Club of Rome to promote negative economic growth. At a Paris meeting of OECD's Working Party Three on money and financial markets the first week of January, OECD Chief Economist Dr. Sylvia Ostry announced that the NATO group now sees only a gradual weakening of the dollar as the U.S. economy falls. In fact, Ostry stated, there may be a "perverse lift" in the value of the dollar during 1982.

The Fed, Dr. Ostry announced, will at all costs stick to its tight money policy, even as the U.S. slides into recession. This means that recession won't slacken credit demand much, though normally it would lower U.S. interest rates and thus weaken the dollar. Further, she stated, the huge U.S. budget deficit will mean that "any upturn in the U.S. economy will set off another interest rate explosion, perversely lifting the dollar."

So far this has indeed occurred, as the dollar got a lift in the first week of January when Fed interest rates began to rise as predicted. The dollar strengthened to 2.26 deutschemarks from 2.24 the week before, as Volcker pushed the federal funds rate up from its December average of 12.4 percent to over 13.5 percent. The Polish crisis also benefits the dollar, as European "scare" money flows into the United States.

But Like the geriatric British pound sterling, which ended its days as a world reserve currency some time ago, the U.S. dollar cannot long be kept afloat merely by high interest rates. Given that Volcker is destroying the U.S. economy as fast as the Bank of England did Britain's earlier this century, at a certain point in the not too distant future the dollar may snap. Rising interest rates may hit the U.S. economy so hard that bankruptcies and other economic crises cause panic runs.

No New York bank economist will tell you this, for most believe firmly that Volcker's tight money plan to fight inflation can keep the paper dollar attractive as long as interest rates are high enough. Even Rimmer de Vries, the chief economist of Morgan Guaranty Bank in New York, who had thought a growing U.S. trade deficit would topple the dollar in 1982, now believes that, "It is not at all unlikely that interest rate differentials will again move favorably for the dollar during 1982."

Similarly, Dr. C. Fred Bergsten, Jimmy Carter's Treasury International Affairs chief, who now runs the German Marshall Fund's International Institute for Economics in Washington, had been predicting a "dollar collapse" for early 1982 since September. This week, aides to Bergsten told a reporter that, "Maybe we were wrong." Commenting on the fears expressed this week in Washington by Chancellor Helmut Schmidt about "world depression" and high U.S. interest rates, Bergsten's aide was hopeful: "Maybe it will be the German economy and the deutchemark that will collapse, and not the dollar. Maybe that's what Schmidt was afraid of."

Only in the short or medium term. The dollar's prospects may now be compared to the state of the British pound just before its massive devaluation from $2.50 to below $1.70 in 1976, an event which effectively removed sterling as a world currency. This happened *even though British interest rates were then rising sharply.*

The fact was, the pound had been kept high artificially for years by high interest rates. Meanwhile, the British industrial economy was being shut down by a fatal combination of high rates and huge government deficit borrowing, which crowded all industrial borrowers from the markets. The demand for British Treasury debt and for sterling on the part of foreigners created an artificially high currency.

This is precisely what is happening in the U.S. today—down to the last detail of industrial closure and government borrowings on the order of over $100 billion a year. The U.S. economy is on the edge, and investors are beginning to realize this. One more interest rate shock could send the dollar over with the rest of the economy.

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