Foreign Exchange by David Goldman

How long for the Japanese inflow?

A political deal over the Persian Gulf has temporarily boosted the dollar.

It appears that the Japanese government showed its gratitude to Washington for keeping the Persian Gulf oil lane open, by forcing Japanese financial institutions to buy dollar-denominated securities.

By the week of July 19, Wall Street appeared to have forgotten the days when bond traders programmed their desk-top computers to show the dollar-yen spot rate at all times, and bankers feared that a retaliatory trade bill might prompt the Japanese to reduce their purchases of U.S. securities, provoking a crisis in the U.S. capital markets.

Most analysts argued that the Japanese capital inflow would continue indefinitely, noting that the rising dollar of the month of July provides capital gains for Japanese investors' dollar portfolios, much as the falling dollar caused huge losses.

The dollar's rebound to a peak of DM 1.86 and yen 153, following the previous week's announcement of a huge $14.4 billion trade deficit, appeared to lend credibility to this argument.

But by *EIR*'s July 24 deadline, the yen had fallen to 1.49, and major New York banks warned their foreign exchange customers that Japanese institutions had turned into heavy net sellers of dollars.

One bank's commentary for foreign-exchange customers July 24 warned that "sentiment for the U.S. currency is weakening," noting that the dollar's steep fall in overnight trading was due to "active speculative selling by securities and trading houses." The securities and trading houses, it continued, "have turned from net buyers to net sellers after recent declines in the U.S. bond market."

Japan's monetary authorities had a double motivation for squeezing funds into the dollar during June and July. First, they were committed to shaking out a securities market bubble which had pushed price-earnings ratios on the Tokyo stock exchange into three digits. That shakeout was more or less accomplished early in the week of July 19.

Second, Japan was the principal beneficiary of American-British-French military action in the Persian Gulf. Japan receives 70% of its energy through the Gulf, and stands to lose the most from Iranian attacks against oil tankers.

A less immediately, but equally important aspect of Japanese-American military cooperation came to the surface the same week, when Defense Secretary Caspar Weinberger signed an agreement with Tokyo for cooperation in strategic defense research, ignoring the scandal surrounding the Toshiba firm's sales of technology to the Soviet Union.

It is emphatically not the case that Japan's nearly $100 billion a year of investible surpluses "cannot bypass the U.S. capital markets," as Treasury Assistant Secretary David C. Mulford bragged in a July 16 speech. The global capital market, which used to issue 80% of its paper in dollars, now issues 60% of its paper in non-dollar currencies, and the dollar's role as reserve currency is receding rapidly.

All that Japanese institutions need to do to make life miserable for the U.S. capital markets, in any event, is to "hedge" their dollar securities holdings, i.e., sell the same securities short in futures markets.

However, the Japanese have an extremely practical attitude toward the cost of their security, which depends upon the United States. To the extent that Weinberger's policy of protecting the Gulf prevails, they will assist the U.S. administration with its own problems—as Prime Minister Nakasone did by stabilizing the U.S. dollar days before the last November elections.

But the question remains: How long can this continue? Clearly, the Japanese will not compromise their own financial system in the process of supporting the dollar, as Bank of America learned when it failed to raise capital from Japanese institutions.

Japan's problem is how to deal sensibly with an administration whose existence is in visible jeopardy, and whose leading foreign-policy initiatives now compromise the most fundamental of Japanese strategic interests, i.e., the American nuclear umbrella over its allies.

Against growing domestic opposition, Japan's Prime Minister Yasuhiro Nakasone has bludgeoned the reluctant Japanese monetary authorities, who have bludgeoned the even-more-reluctant financial institutions, to maintain the flow into the dollar.

In the case of the current trade bill, the issue is not so much that Japan might retaliate against injury done by the U.S. Congress. Rather, the protectionist mobilization is viewed, correctly, by the Japanese, as an index of the administration's own collapse of credibility in the economic arena.