A gamble with Japan and OPEC

The U.S. Treasury deficit can't be financed without laying hands on petrodollars. Will Japan be an intermediary?

Paul Volcker has come up with a new scheme for gaining petrodollars to finance the growing U.S. government deficit. It's called "defending the yen." Getting Saudi funds directly will become more difficult because of a combination of factors including the Saudi 5-year plan to use $270 billion for projects at home, and the political fiasco surrounding the U.S. vote in the U.N. Security Council on Israeli settlements. Volcker hopes to obtain the funds by means of a route approvingly labeled the "pact of Tokyo" in the Swiss financial daily, *Neue Zuericher Zeitung*.

Potentially the most important of the yen defense measures announced by Japan March 2 is a provision for attracting billions of dollars worth of OPEC and other investment in domestic Japanese yen-denominated assets. Hitherto, Japan had tightly restricted foreign investment in order to maintain the disciplined system of government regulation of credit that fueled the postwar miracle economy. Under the new plan, interest rates on foreign nonresident holdings of yen assets, known as "free yen" would be free to rise to whatever level was needed to attract funds, despite continuing restrictions on other instruments.

In buying yen assets, the foreigner would first have to take his dollars to the exchange market to swap them for yen. At that point, hopes Volcker, the capital inflow beyond that needed to finance the trade deficit would pile up as Bank of Japan reserves, i.e., Japanese holdings of U.S. Treasury notes. This is why the March 3 London *Financial Times* praised Japan's plan for emphasizing the capital account rather than deflation.

Up to now Japan's yen problem has also hurt Volcker's deficit financing efforts. On March 3 and 4 alone, the Bank of Japan sold off $2 billion worth of U.S. Treasury bills in order to support the yen in the market. This caused the U.S. interest rate on the Treasury notes to rise a one-day record of 1 percent to 15 percent. The mammoth intervention restored the yen to 246 from its February nadir of 252—but only temporarily. As rumors hit Wall Street of a new U.S. discount rate hike, the yen fell back a point despite direct support operations in New York of $100 million or more by the U.S. Federal Reserve Bank. In such circumstances the $5 billion swap arrangement between the U.S. and Japan—the other major component of the March 2 package—could be blown in a week.

Despite Prime Minister Masayoshi Ohira's proclivities for aiding the Carter administration, Japanese economic reality makes it more sensible for Japan to use whatever capital inflow it garners not to bail out Carter's budget, but to restore Japan's export markets by gearing up loans to developing countries.

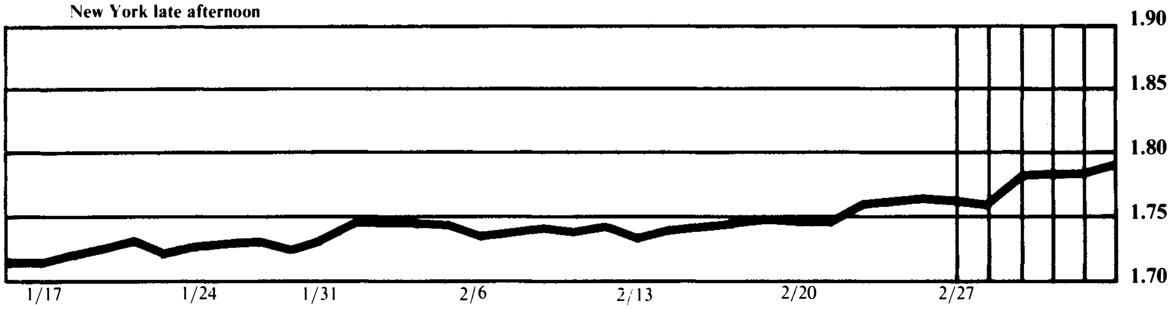
Japan is depending on a mild revival of exports in fiscal 1980 to provide the bulk of stimulus for growth. According to Yamaichi Research Institute, in 1980 the majority of projected 3.8 percent real GNP growth will be provided by a renewed trade surplus. In contrast, in fiscal 1979 the overwhelming majority of an estimated 6 percent growth was provided by domestic consumption and private capital formation.

Even the limited projected trade revival is being bought at a heavy price. Japan's quantum index now shows a rise in exports and fall in imports, meaning that Japan is paying for oil by lessening other purchases and is selling more only due to a 35 percent loss of terms of trade because of the yen depreciation. The oil price rises and yen depreciation have led in turn to an annual 18 percent rise in wholesale inflation which the government is trying to clamp down on by increasingly tight fiscal and monetary policies.

Politically the world will not tolerate a repeat of 1977-78's performance of high Japanese exports of consumer durables due to a cheap yen. As a result, an export boom which is needed to revive the economy can only be obtained beyond a few months through restoring the kind of multibillion loan program to the developing countries that former Prime Minister Takeo Fukuda initiated in 1978. Might not Japan surprise Volcker by taking the petrodollars and relending them for export financing rather than placing them in U.S. Treasury bills? There will be a lot of business pressure on Ohira to do just that.

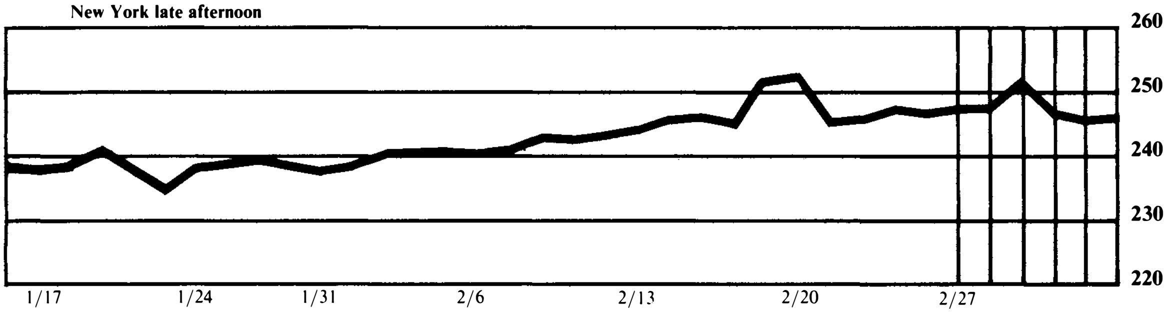
The dollar in deutschmarks

New York late afternoon



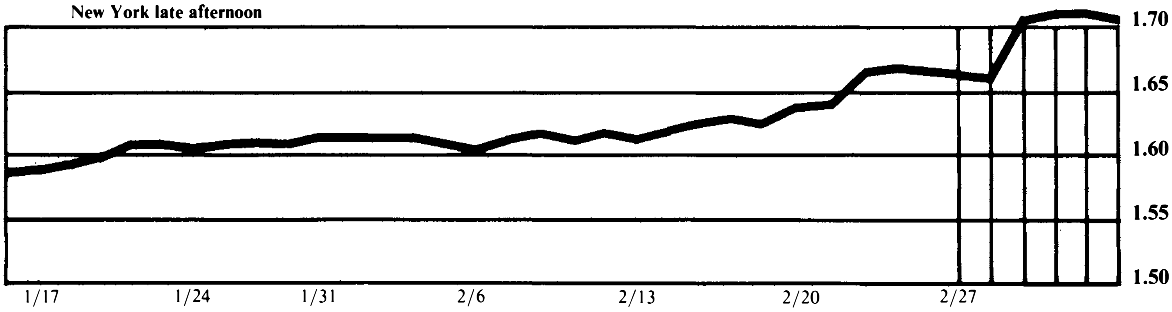
The dollar in yen

New York late afternoon



The dollar in Swiss francs

New York late afternoon



The British pound in dollars

New York late afternoon