

Foreign Exchange by EIR's Economics Staff

The dollar's brief respite

Japan's dollar-buying spree boosted the battered U.S. currency for a couple of weeks, but it has already given out.

A 2.4% decline of the dollar against the Japanese yen and German mark June 3 ended a two-week respite for the declining U.S. currency, during which it reached a peak of about DM 2.34 and 175 yen. Press accounts attribute the dollar's plunge to a wire-service report quoting U.S. Trade Representative Clayton Yeutter to the effect that the dollar's improvement was temporary, due to political factors in Japan. The Japanese central bank had intervened heavily, Yeutter argued, to lift the yen in advance of elections called by Prime Minister Yasuhiro Nakasone for July.

Yeutter's remarks were an excuse for major banks to resume short positions against the dollar. Most had been waiting for the appropriate occasion. In fact, Bank of Japan intervention was not the reason for the dollar's sharp rise during the previous two weeks, but, rather, a collective move into the dollar by Japanese financial institutions.

Previously, the Japanese had been unfairly accused of planning to withdraw investments from the United States, or at least reduce their \$50 billion-plus annual rate of purchase of U.S. securities. Nothing was farther from the truth; not merely Nakasone's political prestige, but the Japanese economy is on the line.

However, the Japanese have seen the value of their U.S. investments reduced sharply during the past year, as the U.S. currency has fallen much faster than the bond market has risen.

It appears that the Japanese insti-

tutions are determined to make up in trading profits, what they are losing on the currency side. As a major market player, they have the muscle to do so.

New York banking sources report that the Japanese took the major Wall Street houses for something in the range of \$50 million during the last week in May, when the Treasury conducted its last auction of long-term bonds. The secondary market for U.S. government securities has been doubling each year, and now exceeds \$20 trillion per year of total annual volume. With the wild swings in bond prices, most institutions are loath to merely investment in Treasury securities, which have turned from one of the safest, to one of the most speculative, of all financial markets.

A typical trading technique in this environment of multiply-hedged bets is a "straddle" between old and new Treasury issues. When the Treasury offers a new bond, it tends to trade at a premium against the old one, the institutions noticed. They proceeded to sell the old one short, while buying the new one, to make up a few basis-points' profit on the difference.

This time the Japanese came in with enormous amounts of cash, and bought the entire issue off the market. The American institutions were stuck with their short positions against the old Treasury bond; none were available for purchases to close out the shorts. Writhe as they might, the Wall Street houses could not extricate themselves without losing something

close to \$50 million.

Thus did Japan, Inc., avenge itself against a system which locks it into more than \$50 billion a year in a declining currency. The amount of capital deployed by the Japanese traders to conduct this operation was sufficient to reverse the dollar's downward direction. The dollar was at 164 yen before the Treasury-bond fracas, and moved up to 175 yen by June 2.

Of course, intervention by the Bank of Japan, as well as the liquidation of short positions against the dollar, pushed the U.S. currency up enormously. Given the staggering size of the 'secondary market, in which the annual volume of currency transactions is perhaps 50-fold the volume of world trade, what previously would have been a blip in the dollar rate turned into a major climb.

However, selling the dollar remains the long-term strategy of every major bank in the world. A securities-and-real-estate-market bubble, fueled by a 20% annual rate of debt expansion, cannot go on forever. Despite the extravagant claims of the Commerce Department, the U.S. economy turned sharply downward, in terms of physical parameters, during the first quarter of this year.

America's capacity to absorb the \$150 billion it requires to finance its trade deficit has depended on the securities-market bubble masquerading as "economic recovery." The speculative wolf-pack turned against the dollar in the middle of 1985, and the U.S. Treasury has been scrambling to preempt a run against the dollar by "talking the dollar down" in cooperation with other central banks.

The Japanese play on the Treasury market brought a brief respite. Most market participants do not, however, expect an encore in the immediate future.