middle of May. Mexico will probably default on about $3 billion of amortization payments during the fourth quarter. One senior European official predicts that capital flight from France will force a French default later this year. Big debtors, including Egypt, Zaire, and Indonesia are already in default. Without an official refinancing capability of the magnitude of the proposed Witteveen Facility, the monetary system will break down sometime this year, probably no later than the end of the third quarter, possibly much earlier.

A European central banker attending the meeting warned that a confluence of defaults in the order of magnitude of $10 billion could create a panic, and "empty the Eurodollar market of $50 billion in deposits within two days." European governments, he complained bitterly, were "falsely optimistic," refusing to come to grips with the severity of the monetary situation.

Most of the burden of decision is on the West Germans. They do not have much time to decide whether they will patch together the U.S. private banking structure with their own hide, or find other ways of doing business.

— David Goldman

Japan Pushes Yen-Based Trade As Shield Against Eurodollar Crises

FOREIGN EXCHANGE

According to Japanese banking circles, the guiding feature in international financial policy at present among Japanese banks, the Bank of Japan, and the Finance Ministry is to shield Japan against the effects of what they see as a very possible Eurodollar crisis this year. One aspect of that shielding is Japan's steadfast resistance to the International Monetary Fund-Witteveen plan and similar proposals aimed at Japan's taking on some of the developing sector's insecure dollar debt.

Japanese banks are also now beginning to reduce significantly their dollar liabilities, which are presently estimated unofficially to be $30 billion. The means chosen by Japan's authorities to effect this reduction is shifting Japan's trade financing from dollars to yen. At present, 95 percent of Japan's imports and 75-80 percent of exports are financed in dollars, the rest in yen.

Seeking Protection

This policy and its motivation were revealed in a front page leak to the *Asahi Evening News* on April 23, in itself a striking development since the Japanese usually like to conceal their motives. According to the leak, the Finance Ministry welcomes the shift to yen-based trade and will aid it, "considering the reliance upon the dollar as a vestige of the past. . . . It is also concerned about the huge dollar-based external indebtedness of Japanese foreign exchange banks which could deal a tremendous blow to the national economy in the event of a credit crisis somewhere in the world."

Most of Japan's $30 billion external dollar debt is short-term debt, in which the principal is continually carried over and interest payments are maintained. Japanese bankers are worried that if a developing country defaults and advanced-sector bank failures produce tightness on the Eurodollar market, then the Japanese would find their existing loans called in, and have great difficulty in obtaining new loans. One Japanese banker reported that there is fear in Tokyo that such a situation might bring down one of the large Japanese international banks. Another recalled with a sudder the post-Herstatt bankruptcy situation in the summer of 1974 when he had to submit to 16 percent interest rates.

The strategy for reducing dollar liabilities is to shift trade from dollar financing to yen financing. When the Bank of Japan (BOJ) cut the interest rate two weeks ago, the cost of borrowing yen dropped below the cost of borrowing dollars for short-term trade purposes. Thus trading companies shifted to borrowing yen and then going into the foreign exchange markets to purchase dollars to pay for imports. This process would tend to continually lower the value of the yen except for the fact that the Bank of Japan now enjoys record high foreign reserves — up to $16.5 billion from about $12.5 billion in November 1975. The BOJ can release these reserves to the Japanese banks which in turn supply the foreign exchange markets. However, this can continue without unduly draining the reserves only so long as Japan continues to maintain a high balance of payments surplus, a very short-term prospect.

Therefore, as a more fundamental policy the financial authorities are now urging actual payments for imports and exports in yen rather than in dollars. According to banking sources, the countries from whom Japan buys have so far been reluctant to accept payments in yen. However, these same sources felt that OPEC and the Southeast Asian countries were likely to change their view in the near future. The sources noted that these countries have sharply increased their holdings of Japanese government yen bonds as foreign exchange reserves. Total holdings of yen bonds by foreigners amounted to $3.6 billion in September 1976 of which $2 billion was held by OPEC and the Asian countries. By December the level had risen to $4.4 billion and by the end of January to $5.0 billion (all unofficial estimates). The level steadied in February and March but there was another big purchase by Arab countries following the discount rate cut. As these countries increasingly use the yen as a reserve to hedge against a depreciating dollar, it is likely that they will then want to accept yen in payment. During the dollar crisis of the summer of 1973, the governments of Saudi Arabia and Abu Dhabi *initiated* discussions with Japan's International Trade Minister Yasuhiro Nakasone regarding yen payments for oil.

A New Context

Up until about February of this year the Bank of Japan had resisted the so-called internationalization of the yen for the same reason that Chase Manhattan, the Brookings Institution et al. had pushed it: the yen would have thus served as a buffer for the Eurodollar market. Throughout 1976 as part of its strategy for a dollar-mark-yen axis, the New York banks had pushed yen-denominated trade. They urged the BOJ to increase yen credits to enable Japanese firms to increase imports for key debt-laden developing nations, even going so far as to suggest the government finance stockpiles of redundant raw materials. Then, the developing nations could take the yen income, exchange it for dollars and pay their debts. In effect, the Japanese banks would have taken a second mortgage on the insecure dollar debt of these nations, exactly the kind of scheme that Chase Manhattan is trying to peddle with its current Witteveen plan. Just as the BOJ opposes the Witteveen plan, so they opposed the internationalization of the yen *in that context* as inflationary and as likely to subject the yen to speculative hot money flows. In contrast, the Ministry of Finance was more willing to cooperate with the idea, as with Chase's and Brookings' reflation notions generally.

According to Japanese banking sources, this situation changed sometime in February. Intervention by Japanese bankers and industrialists persuaded the Finance Ministry to take a strong line against any kind of bailout for the New York banks. Assured that internationalization of the yen would not be used as a bailout, the BOJ then agreed to change its policy on yen-financed trade.

Record U.S. Trade Deficit Highlights Vulnerability Of Dollar

FOREIGN EXCHANGE

The Commerce Department's announcement that the U.S. economy ran a record monthly trade deficit of $2.4 billion in March sent shivers through the international foreign exchange markets last week.

The ever-widening U.S. deficit has awakened memories of the early 1970s dollar crises and forced foreign governments, in particular Japan and the OPEC nations, to rethink their present policy of holding the bulk of their reserves in dollars or U.S. Treasury Securities.

The U.S. trade deficit is feeding the Eurodollar market — already awash with funds without any profitable investment outlet. The flood of dollar deposits into Eurodollar banks is provoking a lending rate war between these international banks, who are now competing for business from a limited and tightening group of so-called prime borrowers.

At the same time, there is a continual threat of default by major Third World debtors whose credit lines have been cut. This combination of a mushrooming mass of footloose dollars and the specter of a major banking collapse is, understandably, encouraging governments and other investors to "diversity portfolios" by branching into other currencies and gold.

On Wednesday, April 27, immediately following the release of the trade figures, the U.S. dollar nosedived against most of the major currencies, and the Bank of England was forced to buy a substantial amount of dollars to keep the pound sterling below $1.72. The West German central bank was also enlisted in the dollar's support.

The flurry of dollar dumping allowed the Swiss franc to recoup its losses of the previous day, when news concerning the Credit Suisse financial troubles sent the franc sharply lower.

The British pound's strength, meanwhile, fed rumors that the Bank of England will slice its minimum lending rate once again, which could be a boon for the relatively stagnant British industry. The British central bank's rate has already been cut from a high of 15 percent six months ago — a draconian level which was set in order to brake the pound's then-precipitous decline — to 8.75 percent at present, as the Bank of England attempts to keep the pound artificially low to boost exports.

The U.S. trade deficit bears dramatic testimony to the failure of the Carter Administration's international economic policy — that is, a reflationary U.S. policy in conjunction with import-slashing austerity regimes in much of Western Europe and the non-oil-producing Third World.

The deficit for the first three months of 1977 totaled $5.9 billion, greater than the entire 1976 deficit and close to the record yearly deficit of $6.4 billion in 1972. While U.S. exports remained sluggish in March, failing to regain their December 1976 peak of $10.4 billion, imports surged to a new record of $12.5 billion. One-third of all U.S. imports in March, of $4.1 billion, were petroleum or petroleum products, reflecting restocking in the wake of this winter's cold spell.

"Diversification"

The current policy of the Japanese government serves as a leading example of the struggle by other countries to free themselves from the perils of the dollar.

Reflecting industrialist pressures, the Bank of Japan recently decided to deliberately encourage the internationalization of the yen for trade-financing purposes. According to one Japanese banker, the Japanese no longer look upon the creation of a yen zone as providing a "buffer" for the dollar but rather as a "safeguard" against future dollar crises.

Although the OPEC countries are not yet ready to consider the possibility of accepting large scale payments for oil in yen, Arab governments are definitely