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Strong Yen and the Japanese Economy[1]

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Immediately following the natural disasters that devastated eastern Japan, the yen began to strengthen rapidly against the dollar. On March 17, it recorded the historic high of 76.25 yen to the dollar. Subsequently, the yen weakened temporarily due to intervention, and now six month later, it has settled in the upper 70-yen range to the dollar. There are concerns that, if this exchange rate level should continue, the profits of Japanese export industries will decline and the hollowing out of industries will be exacerbated as they transfer their production overseas, which will in turn hamper the rebuilding from the natural disasters and economic recovery. Hence, the argument goes, it should be the top priority of the new government to deal with the strong yen.

Let us take a step back and review the reasons behind the strong yen. Starting at the end of last year, concern began mounting about the American economic recovery. As a result, the view that low interest rates will persist for a protracted period became the accepted outlook, and the attractiveness of the dollar as an investment medium began to diminish. Sustaining a huge current account deficit means an oversupply of the dollar. The seriousness of the fiscal deficit was gradually revealed, and on top of this, the disarray in Congress over raising the debt ceiling badly eroded market confidence in the US economy, ultimately resulting in lowering of the credit rating of US government bonds. As a consequence, public and private investors around the globe are moving their dollar holdings into other forms of assets. However, since the euro and the British

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pound are seen to be in even more trouble than the dollar, the only options remaining are the yen, the Swiss franc, and gold. The yen is especially attractive because of continuing deflation in Japan which is causing the purchasing power of the yen to rise with considerable certainty.

The critical point to note is that a stronger yen is not something temporary. It is likely to continue for at least another year or two. Given that the cause is not temporary, a temporary countermeasure will be meaningless. During the past 40 years, Japan has been applying stopgap treatments consisting of dollar-buying interventions in the market. However, facing the fact that, during this time, the exchange rate spiraled upward from 360 yen to 77 yen to the dollar, I believe the new government should fundamentally rethink the way in which it deals with the yen-dollar exchange rate. Two basic tasks should be conducted for this purpose.

The first is to evaluate the current exchange rate level. The second is to review what kind of effect the current rate is having on the Japanese economy.

Let me begin with the evaluation of the exchange rate level. The yen, with the recent exchange rate to the dollar hovering around the upper 70s, is said to be overvalued. But, how overvalued is it? There are various ways to evaluate exchange rates. For example, there is a measurement called the real effective exchange rate, which calculates how much price competitiveness a currency of a country has compared to those of its trading partners. An increase in this figure indicates a decrease in competitiveness, and a decrease in the former indicates an increase in the latter. The real effective exchange rate of the yen has increased since the natural disasters, and competitiveness has deteriorated. In spite of that, the current level is about the same as the average rate during the 30 years since 1980. This shows that export competitiveness did not decline because of the rise in the nominal value of the yen against the dollar during the last 30 years.

There is another measurement called purchasing power parity (PPP), which is the exchange rate at which the purchasing power of the currencies of two trading economies are at parity with adjustment for relative export prices. Looking at the long-term fluctuation over five-year periods, the yen-dollar exchange rate moves close in tandem with the trend of the PPP. This shows that the PPP is the most significant of the long-term variables in determining foreign exchange rates. When we compare Japan and the United States, the PPP has almost consistently moved toward a stronger yen, reflecting years of deflationary tendencies in the Japanese economy. Recently, it has been in the 60-yen range against the dollar. Although we experienced a similar nominal exchange rate of the 70-yen range against the dollar in 1995, the impact of the current strong yen is far smaller from the PPP point of view.

Next, let us look at the effect of the exchange rate level on the Japanese economy. First, what is the effect on the international balance of payment? It is known that when a currency strengthens and its export competitiveness weakens, the trade balance will deteriorate with a one or two year time lag. However, in the case of Japan, despite the yen's tendency to rise against the dollar over the years, Japan's current account surplus has been a stable 2% to 3% of its GDP. This must be because, despite the rise in the nominal rate of the yen against the dollar, export competitiveness as measured by the real effective exchange rate has not deteriorated. Looking at the recent period, though exports decreased drastically after the natural disasters because of disruption in the supply chain, they have picked up since June, and yen-denominated export prices have been on the rise since the beginning of the year.

The more significant issue is the effect on individual companies. Without doubt, export-dependent companies have been dealt a blow by the stronger yen. These companies face a severe challenge in having to expand yen-denominated exports, cut costs, and strengthen non-price competitiveness. The media tend to focus on the automobile and electronics industries as they constitute a huge share of Japanese exports as well as having a major presence in the domestic economy. However, we do need to balance our views when we contemplate the effects of a stronger yen. Exports constitute only about 15% of Japan's GDP, and while a stronger yen hurts export industries, it does benefit import industries.

There is concern that the rise of the yen will lead to decreased profitability in domestic production, which in turn will stimulate relocation abroad and loss of domestic employment. There is no denying that there are such examples. However, it is also inevitable that companies move overseas when domestic markets are sluggish to begin with, and foreign markets are expanding. Furthermore, when the high labor, utility, and other costs are taken into account together with the considerable tax burden and the number of regulations in the labor market and elsewhere, it is evident that the stronger yen is not the only reason for moving overseas. The overseas production ratio of

Japanese manufacturers has increased since the 1980s and is now around 20%. However, that is still relatively low compared to approximately 30% for the United States and Germany.

I would like to reiterate that, since the factors strengthening the yen are not temporary, we need a more comprehensive approach to deal with the trend. Intervention in the foreign exchange market may stabilize market volatility, but it is not a fundamental solution for dealing with the situation. On the domestic policy side, we must first overcome deflation, which is creating the tendency for the yen to rise, and secure a growth rate equivalent to that of the United States. In addition, deregulation should be carried out more rigorously, and initiatives should be implemented for tax and financial support to develop and expand the manufacturing industries which still have non-price competitiveness as well as various service industries and agricultural areas in order to increase employment and earnings. It is also vital to secure productivity, markets, and natural resources overseas by utilizing the stronger yen and foreign exchange reserves.

The critical aspects of a foreign exchange rate are not the level itself but its stability and predictability. These aspects are the most important from the viewpoint of companies as well. Such factors enter into the category of currency diplomacy as part of overall diplomacy. I urge the new Japanese government to evaluate prudently the cards it possesses and use those cards to deploy forceful currency diplomacy with the United States, Europe, China, South Korea, and other trading partners.

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