

# Rising Yen Behind Deindustrialization?

By Naoyuki HARAOKA

## How Is Currency Value Determined?

What economic factors determine the value of a currency? This is a difficult question to answer. The simplest answer must be that it will be fixed by demand for and supply of the currency in the foreign exchange market. What factors influence the demand and supply of a currency? A nation expected to grow faster would produce more demand for its currency. However, *Chart 1 and 2* suggest there can be a negative correlation between the value of a currency and economic performance. Namely, as shown in *Chart 1*, stock prices fall when the dollar appreciates, and vice versa. *Chart 2* shows that when the value of the euro appreciates, the index of industrial production in the euro zone declines. The correlation between Japan's economic performance and the yen exchange rate is the same as in the United States and the European Union (*Chart 3*). This is perhaps to be considered in conjunction with a time lag. When the economy enjoys higher growth, the nation's currency value rises temporarily. However, a stronger currency discourages exports and encourages imports. As a result, the worsened balance of payments will have a negative impact on the rate of economic growth. The value of a currency is thus affected by economic performance and also simultaneously affects the economic performance.

The level of inflation is another important factor affecting the value of a currency. Deflation in Japan is often described as a critical factor contributing to raising the value of the yen since lower prices mean a stronger currency. A higher interest rate, together with a strong economy, attracts more demand for the currency of a country with the higher interest rate that is occasionally considered the outcome of high growth. Anyhow, these economic forces are clearly reflected in the market and the market determines the value of a currency. I believe that in this light, government intervention in the foreign exchange market would have very little impact upon currency value since the size of the global currency market is enormous and that would make government intervention less effective.

## Long-term Corporate, Gov't Decisions Have Little Correlation to Currency Value

Government policies such as structural reform to save the economy from a deflationary state or to strengthen competitiveness on the supply side of the economy, and thus achieve high growth in the long run, would work in favor of the stability of currency value. But its effects on the value of a currency must be limited to longer-run ones.

Assuming that the most important lesson from currency value fluctuations is that we do not have to worry about fluctuations but rather should leave them to the market forces of supply and demand, public economic policy should focus on a long-run perspective, irrespective of currency value. The business sector likewise focuses on a long-run perspective in the decision-making process to establish production or sales bases overseas. The flow of foreign direct investment (FDI) produced by such a decision is not much influenced by

the value of a currency, of which the impact on management is fairly limited in the short run.

According to a statistical survey on Japanese firms' activities taken by the Ministry of Economy Trade and Industry (METI), almost two-thirds of the companies surveyed consider the growth potential of the market in host nations as the most important factor in determining a production or sales location overseas. In contrast, the weight of the factor of sales prices possibly influenced by the value of a currency in this decision-making process is rather small. (Only 13% of the surveyed firms considered this the most important.) Accordingly, the majority of the firms polled picked Asia (specifically China rather than Japan) as a place to invest their resources in their future management strategy.

Another point to be noted in this survey is that more than 70% of the surveyed firms stated that their overseas subsidiaries' level of technology is the same as that in Japan. In comparison with past surveys, the proportion of companies citing technological equality between overseas subsidiaries and their headquarters in Japan increased from 50% in 1996 to more than 70% in 2008, and the percentage of firms saying the technological level of overseas subsidiaries is lower than that of their headquarters dropped from 40% in 1996 to 20% in 2008.

This means that the so-called inter-process division of labor, which is a horizontal and not a vertical one, has been promoted between Japan and the rest of the world, in particular with other countries in Asia. The inter-process division of labor is an outcome of strategic alliances among firms in the globalized economy and is brought about by long-term management decisions and not from a short-run perspective of management that could be influenced by the value of a currency. This is reflected in the continuous increase in the ratio of overseas production to total output or sales, irrespective of the value of the yen, as shown in *Chart 4*.

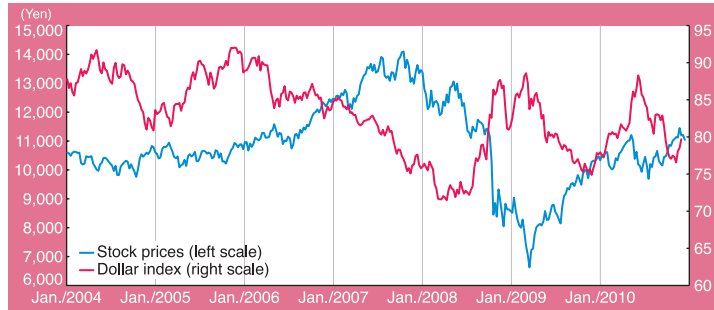
## How to Stop Deindustrialization – Possible Outcome of Long-term Business Strategy

The deindustrialization of the Japanese economy that some people are worrying about today is thus not to be seen in the light of currency value fluctuations but rather from longer-term managerial decisions. In order to stop deindustrialization as a possible outcome of such long-term management strategy, I have three suggestions.

The first is that we need to promote sales efforts for our final products in host countries, where in many cases parts and components exported from Japan are assembled as a result of the inter-process division of labor as mentioned above, and sold to their consumers. Our final products have to fit the needs of consumers in the markets of host countries or their neighboring countries. Business success in host-country markets achieved by meeting consumer needs there would eventually lead to expansion of the business of parent firms in Japan.

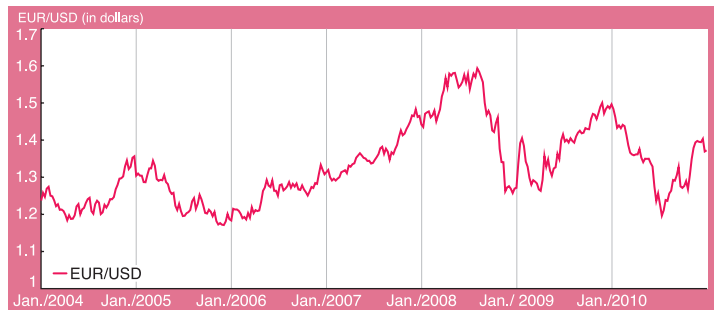
My second suggestion is that we should note and focus on our strengths in the manufacturing industry. That is the function of a wide

**CHART 1**  
**US stock prices & dollar exchange rate**



Source: GDP, Business Activity & Economy Site

**CHART 2**  
**Euro's exchange rate vs. US dollar**



Source: GDP, Business Activity & Economy Site

range of “services” such as recycling or after-sales service included in the manufacturing process. The quality of these “services” that could be interpreted as “Japanese hospitality” is considered very high in Japan. If we keep such high-quality services within the nation’s industries, we can maintain job opportunities.

Lastly, the most important way to avoid deindustrialization is to attract a wide range of professional and highly intellectual human resources from overseas. By doing so, we can maintain creativity, innovation and vitality in our economy. In the globalized economy, it is important to keep a diversity of talents to be competitive. Silicon Valley, for example, is a model region where you can find the highest level of innovation and entrepreneurship in the world, which serves as a locomotive for economic vitality and growth. A multiracial demographic structure is one of the salient characteristics of this region, where in particular the Asian or Asia-origin population in high-tech industries such as IT or biotech that are well developed in the region accounts for a significant portion of intellectual residents.

### Cultural Diversity – Key to Achieving Success in Globalized Age

The cultural diversity brought about by such a multiethnic population structure is highly instrumental in providing innovation through a melting pot of different ideas. Diverse ways of thinking create a synergy effect and thus a stimulus to produce new ideas. Since our world is undergoing a very rapid transformation of values and technologies, we need to constantly pursue creativity to be competitive. So, I believe cultural diversity is an essential source of competitiveness. Therefore, we need to be open to human resources from overseas and welcome new ideas or those that differ from typical Japanese ones.

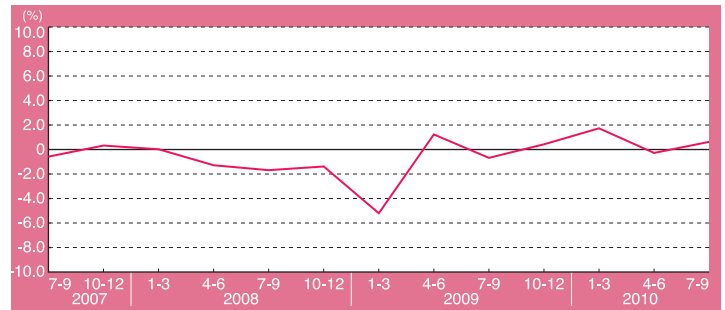
Today, some Japanese companies employ a few non-Japanese executives on their boards and hold board meetings in English. This is certainly a natural trend reflecting the reality of globalization. We

**CHART 3-1**  
**US dollar's exchange rate vs. Japanese yen**



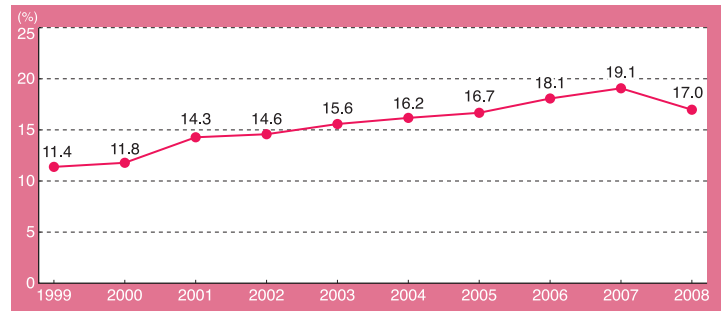
Source: Yahoo Japan (stocks/finance)

**CHART 3-2**  
**Japan's nominal GDP growth rate in recent years**



Source: GDP, Business Activity & Economy Site

**CHART 4**  
**Ratio of overseas output to total production**



Source: Ministry of Finance, Japan

should have more companies that hire non-Japanese executives on the board and discuss their managerial decisions in English. The editorial committee of *Japan SPOTLIGHT* recently invited two non-Japanese to become members, namely Mr. Niclas Ericsson, a Swede and chief editor of *Magazine Ambassador*, and Ms. Jillian Yorke, a British-born New Zealander and intercultural consultant. In order to enrich the contents of our digitalized *Japan SPOTLIGHT* in and after next May, we will invite more non-Japanese members to join our restructured editorial board and try to show our readers that cultural diversity leads to better outcomes. New ideas lead to entrepreneurship and new companies will be born and provide us with job opportunities.

These three suggestions could raise our competitiveness and thus avoid deindustrialization through firms’ long-run management strategy. In any event, the value of currency could provide us with an opportunity to think about this issue but has very little to do with deindustrialization.

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