Coping with Endaka

By Wakatsuki Mikio

Since the beginning of 1995, the yen has strengthened rapidly against the dollar, soaring from a level of around ¥100/dollar early in the year to the 70s (¥79.75/dollar) at one point in mid-April.

For 22 years, from 1949 to 1971, the yen rate was fixed at ¥360/dollar. For the following 24 years, it strengthened by 78% to ¥80/dollar. When the world moved to the generalized floating regime in 1973, great hopes were placed on the ability of the floating exchange rate to balance international payments. It was thought that instead of placing the burden on domestic policy, the imbalance of international payments would be corrected by the fluctuation of the foreign exchange rate.

The imbalance, however, did not correct itself as expected, and instead grew steadily larger among the major countries. The increased and prolonged imbalance of payments has the net outcome of many policy and structural problems. The long-term changes in the yen/dollar rate stem from overdue and inadequate measures implemented by both countries.

Below, I will outline the background and characteristics of the current surge in the yen's value, its impact, corporate strategies to diminish that impact, an assessment of measures taken to encounter the yen's surge, and the mid- and long-term outlook.

Background

At the beginning of the year, it was generally accepted that the U.S. economy would steady itself and interest rates would continue to rise; Japan would experience a moderate economic recovery with interest rates remaining low; and interest rates in Europe would fall. All this would lead to a stronger dollar against the yen and the German mark. But the devaluation of the Mexican peso threw a wrench into this scenario.

The subsequent fluctuations dampened the emerging market boom, and the so-called "tequila effect" spilled over to Latin American and Asian countries as well. The market fluctuations also spread to Italy, Spain and other European countries that finance their deficits with the inflow of foreign capital. Foreign capital flowing from these countries sought the mark or the yen as a safe haven, putting upward pressure on those rates.

The U.S. administration experienced a loss of credibility when President Clinton's first Mexican aid package became tied up in Congress. It also became clear that the existing safety net would not be enough to head off an international financial crisis. Pressure to sell dollars thus increased.

While the political and economic situation in Mexico remained unstable, the international contingency system and adjustment mechanism increasingly came to be seen as unexpectedly precarious. In addition, the markets continued to be influenced by basic problems: the continued international imbalance of payments between the U.S. and Japan, and the existence of economic divergence among European countries where there are plans to create a unified single currency.

The U.S. current account deficit reached a peak in 1987, after which it began to fall. In 1991 it rose again, and in the decade from 1985 to 1994 the cumulative deficit ran to $1.1 trillion. Japan's current account surplus reached a low point in 1990, and quickly began to rise again. In the same 10 years, Japan had a cumulative surplus of $630 billion. For the last 10 years, the Japan-U.S. trade imbalance has averaged roughly $50 billion per year.

Because neither country is undertaking sufficient measures to counter this continuing basic imbalance, distrust of the markets has increased, thus promoting the strong yen/weak dollar. Further fueling this trend is the perception that both governments, the G-7, the IMF and others are unable to effect an end to this drift. The loss of their credibility has been a major cause of the fluctuations since March.

Viewed from a different angle, the currency fluctuations are international sea changes spurred by deregulation and the globalization of finance. The growth of institutional investors and innovative finance techniques such as derivatives have led to "Americanization of finance," such as money games, which creates market volatility due to policy failures and shortcomings.

The liberalization and globalization of finance have been promoted in the "free world" since the end of World War II, and have provided great benefits. The problem is that there has been no parallel development of a public mechanism to keep things under control.

Because deregulation was allowed to proceed without strengthening the ability of major countries to monitor this phenomenon—building a co-ordinated supervising system, or securing an international financial safety net—a situation was created in which public international institutions are powerless to the vagaries of the flow of capital across borders.

Characteristics of the current strong yen

Since the 1985 Plaza Accord, the yen has been on the rise. And since 1991, when the movement towards the strong yen was established, the ratchet effect has ensured that there would be no turning back. The sudden surge in the yen's value in March this year was not, however, a continuation of past yen trends, but marked the start of a new phase.

To begin, it is impossible to predict the extent to which the exchange rate will accelerate. When the fixed exchange rate regime ceased to function, it was said that the world was sent out on uncharted waters, but the IMF and G-7 played the role of compass and pilot. The role of the IMF and the G-7 in the current currency turmoil, however, has been negligible —in fact, there is friction within the G-7.

Their role in directing the market has been passive, allowing the market to be so turbulent that in one and a half months the Japanese currency strengthened by ¥20.

A second characteristic is that there is little sense of crisis from the U.S. side at the dollar's dramatic fall. There seems to be benign neglect of the dollar's role as the principal reserve currency. U.S. industry seems to welcome the advantages of the weak dollar for export, and Congress is more interested in pushing through tax cuts than in curbing the budget deficit.

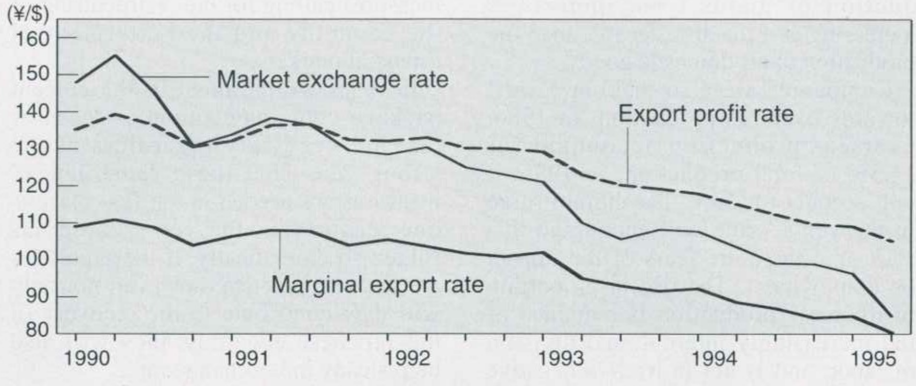
A *New York Times* editorial entitled "Let the Dollar Drift" is typical of widespread journalistic sentiment against protecting the dollar. With domestic inflation low, the economic slowdown, and the buoyancy on Wall Street, the U.S. economy is generally in good shape. To date there is no evidence of negative fallout from a weak dollar.

Despite the U.S.' benign neglect, the international role of the dollar will remain largely untouched. There is simply no currency that can replace it as the world key currency. However, the privilege of making international payments in one's own currency is accompanied by a responsibility to maintain that currency's value. Neglecting this responsibility is stimulating a shift towards the Deutsche mark and the yen as the reserve currency in dollar-based Asian countries.

Impact of the strong yen

The yen's value rose so quickly that it is still unclear at what level it will stabilize. Though the impact on the economy cannot yet be estimated, it will be severe if the yen stays in the 80s. The Japanese economy has experienced a gradual recovery since last year, but the sudden strengthening of the yen will deeply cut into the profits of exporting companies, put a damper on recovering interest in capital investment, and will encourage the shift towards overseas production. The Japan Research Institute, Ltd. estimates that if the yen stabilizes at ¥90 to the dollar, down from ¥100, the GDP in 1995 will fall by 0.5%; if the yen stabilizes at ¥85, the GDP will dip by 0.8%.

Yen/Dollar Exchange Rate, Export Profit Rate and Marginal Export Rate (Manufacturing Export Departments)



Notes: (1) The export profit rate is the exchange rate at which profits are zero; the marginal export rate is the exchange rate at which the price of fluctuation equals export sales.
(2) The second quarter of 1995 is calculated as the average of rates for April 3-12.
(3) First and second quarter export profit and marginal export rates are estimates of the Japan Research Institute, Ltd.

On April 14, emergency economic measures to deal with the strong yen were announced. In addition, the Bank of Japan lowered the official discount rate by 0.75%. These two actions will probably prevent serious damage to the economy. But depending on the concrete measures that are to be used to stimulate domestic demand and when they will be implemented, business could experience a downturn. Then, our original projection of 1.9% growth for 1995 may prove difficult to attain.

Turning to the impact on the corporate world, it is reported that Toyota loses ¥10 billion in profits for every yen lost per dollar on the exchange rate; Matsushita loses ¥2 billion. The effect of the strong yen on corporate profits is severe. According to our estimates based on the corporate business statistics published by the MOF, the export profit rate has dipped from ¥140 in 1990 to the recent level of ¥105 (see chart). Due to rapid changes in the market rates, the two rates vary widely. The marginal export rate is currently calculated at ¥80. If the market rate settles there, export companies will have to decide whether to stop exports or cut back on employees.

To date, businesses have taken five different measures to combat the strong yen: raising export prices, rationalizing, increasing quality of export goods, procuring parts from overseas, and shifting production overseas.

Since 1990, companies have dealt with rising prices by exporting more semiconductors, LCDs and other goods which are competitive regardless of price. They have also experienced firm demand due to the recovery of the world economy. The result of these two strategies was an increase in the cumulative export price as of the beginning of 1995 which covered 82% of the yen's appreciation, much higher than the 48% experienced in 1985-1987 during the surge of the yen. The dramatic strengthening of the yen and increasing discrepancies in prices since March, however, makes it difficult to increase export prices in tandem.

Corporate rationalization has proceeded as far as possible, and not much room is left for new rationalization measures to deal with the current rise in the yen's value.

Improvement in the quality of exported goods and exports of high-value-added goods have been accomplished: as a share of general exports, the proportion of high-tech goods such as computers and semiconductors rose from 30% in 1984 to 43.7% in 1994, while low-value-added consumer products dropped from 24% to 14%. Since 1990, parts are increasingly procured overseas; the production of goods from imports is increasing at a much faster rate than the production of all-domestic goods.

Companies are also making a shift towards overseas production. In 1986, overseas production accounted for 11.5% of total production; in 1995, it will account for 23%. The current surge in the yen's value will encourage this shift, and there are fears of the impact on employment. The rise in proportion of overseas production is evidence of the increasingly international division of labor, and is not in itself a negative trend. If it progresses at too fast a pace, however, adjusting the domestic employment market will pose serious problems.

Assessment and issues

On April 14, the government compiled a six-sector, 24-item package of emergency economic measures to cope with the strong yen. At the same time, the Bank of Japan lowered the official discount rate by 0.75% to an all-time low of 1%. However, the market's response was indifferent, and the exchange rate surged further in the middle of the following week to an all-time high of ¥79.75.

This cool market reaction was due to the fact that the "emergency" package was regarded as mostly rhetoric and short of concrete contents. Further, the measures were less geared to deal with the short-term effects of the strong yen than they were the much needed structural and economic measures to revitalize the Japanese economy. For instance, the package includes the compilation of a supplementary budget to aid in the recovery following the Great Hanshin Earthquake and the aggressive implementation of public works as policies to stimulate domestic demand.

But both measures would be necessary in any case under current economic conditions. Pushing deregulation forward and increasing imports have been called for repeatedly since the 1986 Maekawa report, and it is doubtful whether condensing a five-year plan for deregulation into three years can really be called an "emergency" measure against the strong yen. The same skepticism is in order for the "emergency" measures calling for the restructuring of the economy and the betterment of financial markets.

In other words, most of the current package contains economic measures that are necessary regardless of the strong yen. That these "emergency" measures are needed in the first place is one reason that the yen's value has surged so dramatically. If these policies are put into practice, however, not only will they contribute to the recovery of the Japanese economy, they will also help steady the exchange rate.

In any case, as I previously mentioned, since the current currency disorder stems from the absence of credibility in politics and policies, faith in the markets may be effectively restored by this attempt on the part of the authorities to demonstrate their ability to act decisively.

Mid- and long-term market stability

Credibility issues aside, the U.S. and Japan must make serious efforts to correct the more basic problem of the imbalance issue if the markets are to stabilize. The U.S. must make efforts to lower its budget deficit and raise its savings rate. Japan must increase domestic demand and shrink its current account surplus.

It must be realized that Japan's structural surplus is due to an imbalance of savings and investment, which in turn is connected to the rapid aging of society. It is of paramount importance to solicit public support and understanding that financial outlays are not simply a policy to increase domestic demand, but that they actually prepare for the needs of the elderly by putting current savings to good use. In other words, it is important that the goal not be simply to create public works projects like those embarked upon in the past, but to enrich social resources for the aging population by improving welfare, the environment, education, communications and urban development .

The promotion of the internationalization of the yen, included in the package, is of course not an "emergency" but a mid- and long-term measure. As the yen is increasingly relied upon for international holdings and transactions, the yen's ties to the currencies of Asian countries, with which Japan is deeply involved, will strengthen, diminishing the impact of yen/dollar market fluctuations. As more of Japan's international transactions become yen based, Japan will be able to avoid negative fallout from the fluctuations of the market. It will also protect Japan from the dollar's neglect of its responsibility as the key currency.

However, truly internationalizing the yen will require more than Japan conducting its international business in yen. Japan must deregulate its financial markets, and make it easier to use and procure the yen. Japan must also bring its laws, tax system and accounting system in line with international standards. Without such a comprehensive approach, the holdings and transactions of the yen will never be as internationally appealing as those of the mark or the dollar.

Space prevents me from going into much detail about reforms to the international currency system. Under the current floating exchange, one idea was to introduce a target zone of exchange rates, but as long as there is no sign of convergence of political and economic performance of the major countries, it is doubtful such a target can function appropriately.

Reforms that would call for the strengthening of G-7 and IMF powers of surveillance, the introduction of an international early warning system, and the creation of an international financial safety net would be a feasible plan. These items will be part of the general reappraisal of the postwar international monetary system. The problem is whether the market will be patient enough to wait out debates on long-term reform. JTI

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