Effects of a Strong Yen

By Goto Motoi

The yen's rapid appreciation against the dollar since the beginning of the year has caused the issue of a strong yen to resurface as a major focus of attention. There is growing apprehension, especially among export industries, that a continued advance will hinder the nation's economic recovery.

What does a lofty yen signify? How will it have to change at this juncture? These questions are once again on everyone's mind.

This is not the first time there has been a sudden rise in the value of the yen. Graph 1 depicts the yen-dollar fluctuations since 1972, following the "Nixon shock" in 1971 which was the first postwar instance, and the measures taken, substantial at the time, to raise the yen's value. The rise was especially abrupt following the Plaza Accord in the autumn of 1985, to the extent that the yen's rate against the dollar doubled in the space of just over two years.

As denoted by the phrases "cats and dogs recession" and "strong yen recession," many people at the time believed that a high yen was equivalent to a serious recession, and memories of the anxious feelings that enveloped the country are still fresh. In reality, however, even though the economy slid into a temporary slump, the impetus provided by strong yen "crises" resulted in the successful creation of an even stronger economy, as in the case of the oil shocks. This has been praised as a demonstration of flexibility and ability to adapt to the environment, characteristics not noted in other nations. There are not a few people who are of the rosy opinion that the economy will exhibit the same qualities this time also.

But the latest raise in the yen involves a number of elements that have not appeared in previous situations and it will not be so easy to repeat these expectations in the future.

One difference is the level of the yen's strength. A glance at Graph 1 reveals that from January until June 1993 the yen rose 16.5% against the dollar. The pitch was indeed rapid, but such a pace has been previously experienced. Since the spring of 1990, a new type of appreciation has been coupled with previous rises in the value of the yen. It is easy to agree with a certain discouraged export company owner who said: "The strong yen is like a distant mirage—the more you chase it, the more it retreats."

Foreign exchange traders react to the quick rise of the yen at the beginning of August.

Moreover, with the confusion among European currencies in August, there were indications that the yen would strengthen even more when it set a record of ¥100 to the dollar on the Tokyo foreign exchange market. Exporters' concerns that a stronger yen would have a negative impact on the economy increased still further.

The second element is that the economy is in a different situation. This latest slump, the Heisei recession, is of a sort not previously experienced and is referred to as a compound recession. It goes without saying that the main factor was the lengthy business expansion, which people thought would surpass the Izanagi boom (57 months), and the resulting bubble effect. As a result of the bubble's collapse, surplus facilities and unsound assets have surfaced at the same time and the economy faces long-term adjustments. This is why "restructuring" has become the favorite phrase at most companies as they attempt to overhaul their operations.

Thirdly, since the first and second factors mentioned above overlap, corporate efforts to cope with the situation are much more difficult. Whether it was a high yen or an oil shock, previous economic crises in Japan were caused by external factors.

New responses needed

In the above situations, how best to cope with external environmental changes was the main point. In the case of a strengthened yen, it was cost reductions through rationalization; for oil shocks, cutbacks on energy usage. The aims were clear. This was precisely why both the government and the people struggled to achieve economic goals, and succeeded.

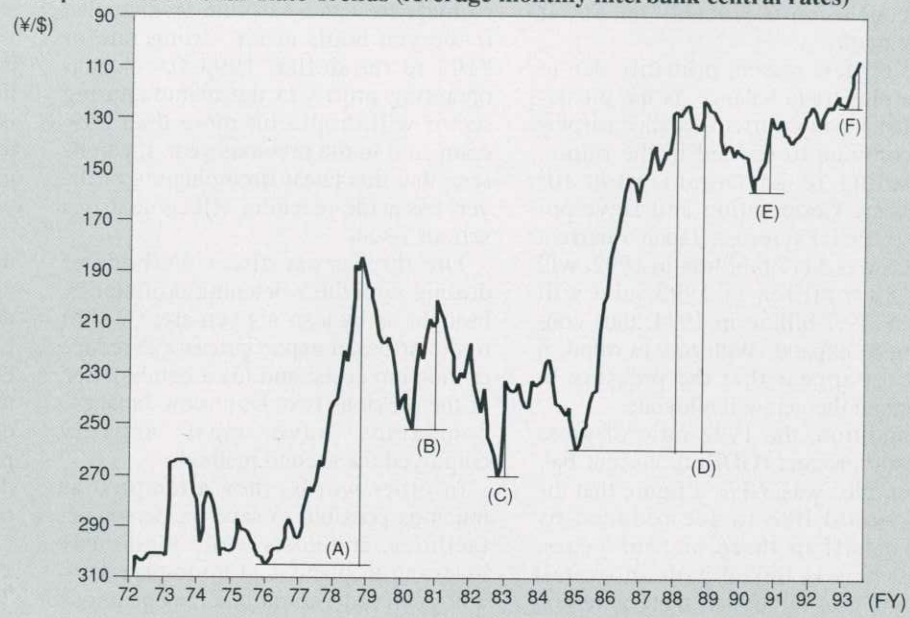
However, the current situation is different. The element of the strong yen and the aftereffects of the collapse of the bubble must be dealt with at the same time, and this is a totally new affair. In other words, it is like trying to cope with external changes while battling an internal disease, such as autointoxication. Doggedly coping with the outside world as in the past will not do the trick.

It is not an exaggeration to say that this is the first time that the economy, which has always carried the day by labeling external changes as a "national crisis" and presenting a united front against them, has faced this type of adverse situation.

What path should the economy take now? As a prerequisite, the thorny question of the yen's future direction must be answered. It is often said that "it doesn't pay to forecast exchange rates or horse races because you learn the results right away and more often than not, you're wrong."

It is indeed difficult to forecast how much the yen will strengthen as a number of uncertainties are involved, such as the direction of the U.S. economy, the adjustment period needed for Japan's economy and and unstable political situation. In general, however, even if there is a temporary period of flucuation, it is predicted that the underlying tone over the medium- to long-term will be

Graph 1 Yen-Dollar Rate Trends (Average monthly interbank central rates)



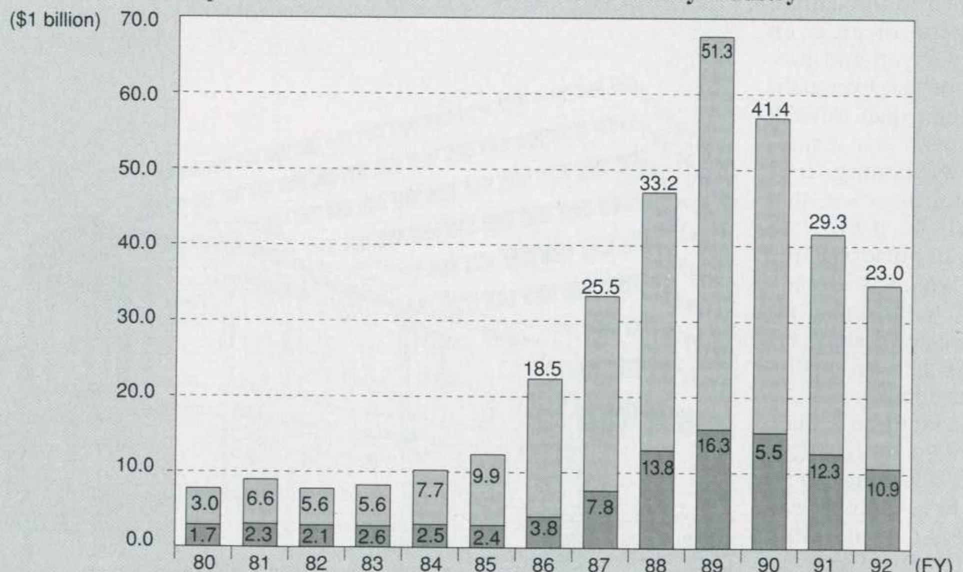
Note: Percent yen strengthened at each juncture (IMF formula)

A 72.12~78.10	305.60~181.58	% change 65.6%
B 80.4~81.1	252.18~201.91	24.9%
C 82.10~83.1	271.01~232.79	16.4%
D 85.2~88.1	260.24~127.56	104.0%
D 85.2~88.11	260.24~123.19	111.3%
E 90.1~90.11	150.47~129.08	22.8%
F 93.1~(93.6)	125.01~107.34	16.5%

Remarks:
1. Calculations use average values for monthly interbank central rates
2. Rate of change for effective rates derived from JP Morgan data

Source: *Economic Survey of Japan* (1993)

Graph 2 Japanese Direct Overseas Investment Trends by Industry



Remarks: Values for FY 1992 are equivalent to annual rate during the first half
Source: *White Paper on International Trade Japan* (1993)

Non-Manufacturing
Manufacturing

a continued strengthening of the yen. This conclusion is probably not so far off the mark.

The biggest reason, primarily due to the surplus trade balance, is the prediction that Japan's current balance surplus will continue to expand in the future. According to an Organization for Economic Cooperation and Development (OECD) forecast, Japan's current balance was $117.6 billion in 1992, will be $138.6 billion in 1993, and will reach $149.7 billion in 1994, thus continuing to expand. With this in mind, it does not appear that the pressure to strengthen the yen will alleviate.

In addition, the 1992 ratio of gross domestic product (GDP) to current balance surplus was 3.3%, a figure that the U.S. would like to see reduced by almost half in three or four years. Unless this is linked with an overall weakening of the dollar, there is reason to believe that approval for the continued strengthening of the yen and behind-the-scenes promotion efforts exist.

If this is the case, it is more realistic to be resigned to the current situation or an even stronger yen and prepare for that eventuality, rather than trusting in hopes for a temporary weakening. It is certain, however, that it will be a blow to most exporters if the yen, which is already at 100 to the dollar, the highest level since the end of the war, continues its climb.

According to a study compiled by the Economic Planning Agency this spring, exporters can maintain profitability at an average yen rate of 124 to the dollar. A mere 2.4% said the same if the yen was under ¥110 to the dollar. Furthermore, a survey by the private polling organization Nomura Research Institute predicts that if the yen holds at the strong rate of ¥102 to the dollar, 1993 fiscal year operating profits in the manufacturing sector will drop a bit more than 25% compared to the previous year. It can be seen that this latest strengthening of the yen has wide-reaching effects and is a serious issue.

The three most direct methods of dealing with the worsening profitability brought on by a strong yen are: (1) shift to dollar-based export prices; (2) reduce production costs; and (3) a combination of the previous two. Until now Japanese companies have most actively employed the second method.

In other words, they attempted as much as possible to save on personnel, facilities, and costs while vigorously investing in plants and up-to-date technology in order to rationalize operations and reduce the labor force, not raising local retail prices to the extent possible, and trying to maintain market share. This could well be called the Japanese corporation's classical, traditional strong yen strategy.

However, seen as a whole, a strategy of maintaining competitiveness by cutting costs does not tie in with reductions in the trade surplus and as a result leads to a vicious cycle in which even more pressure is applied to strengthen the yen. This is not a satisfactory method.

In addition, cost-cutting measures that do not touch upon the issue of employment have limitations and, considering that companies are burdened with surplus facilities and can not make additional investments in domestic plants, there is probably not much leeway to depend upon this method. We should probably conclude that the classical, traditional strong yen policies have reached their limits.

As such, numbers one and three above are the only direct measures left. There are not a few industries, such as the auto industry, which are already in danger of losing their price competitiveness after raising prices in conjunction with the strong yen. However, accord-

The Bank of Japan is concerned that the continued appreciation in the value of the yen will stifle efforts to reinvigorate the economy.

Photo: Kyodo News Service

Views are divided over to what extent a stronger yen will effect Japan's trade surplus.

ing to estimates in this year's *Economic Survey of Japan*, the price shift ratio (the rate of dollar-based price increases) accompanying the strong yen was at a level of about 50% for the country as a whole in fiscal 1991 and 1992. In other words, export price increases held at about half of the value of the strong yen. There is still room to raise prices.

Shift in emphasis

Of course, it goes without saying that price increases will require even more effort than before to boost competitiveness by adding extra value for improved quality and developing original products. However, this implies an export strategy shift, from Sony Chairman Morita Akio's credo, "Sell good products at low prices" to "Sell good products at high prices," or, to change the expression, from "emphasize market share" to "emphasize profits." Whether Japanese companies like it or not they will be forced to move in this direction in the future.

In addition to the kinds of schemes mentioned above, the most important aspect of this latest strong yen crisis will be the acceleration of the expansion of overseas production systems that have been promoted up until now, and the creation of a system of international operations. In May, color TV imports had already exceeded exports by about 30,000 units and it is predicted that this type of situation will extend to other sectors in the future.

Further, due to previous hikes in the yen, hourly wages are already 1.5 times higher than in the U.S. and five times more than in South Korea in dollar terms. As a result, there is no doubt that the shifting of production sites to overseas locations, temporarily interrupted during the "bubble" period, will pick up again as companies seek cheap labor.

Graph 2 shows trends in Japanese direct foreign investment. Direct foreign investment by the manufacturing sector grew rapidly following the 1985 Group of Five decision to boost the yen against the U.S. dollar and European currencies. The amount of investment in 1989 was seven times that of 1985.

It is likely that in the future there will be a shift on a scale equal to or larger than the one that occurred at that time. There are even some who predict that there will be an exodus to overseas production sites similar to the one that occurred during the strong dollar period under the Reagan administration.

Whatever the case, we can well state that enterprises are facing the "who?" will manufacture "how many?," "what?," "where?," and "how?" questions. This will entail a reappraisal of the full market entry doctrine that companies employ for any type of manufacturing and will also require an international vision for the reformation of the industrial structure.

There is also the argument that this is unsatisfactory because these trends will engender a hollowing-out of some industries. However, although the ratio of overseas production was high for cars, electrical equipment and some other industries, there was only an overall increase from 3% in 1985 to 6% in 1991.

This differs widely from the U.S., which, in 1985, had an overseas production ratio of 16.6% that grew to 25.8% in 1990. There are welcome aspects to shifting sectors that have lost competitiveness overseas in line with the market signal offered by the strong yen—the reform of Japan's industrial framework, reduction of the trade surplus, and expanded employment in developing nations, among other factors.

Finally, I would like to point out that the issue of employment is the most critical policy problem linked to the strong yen. In some cases, management is already beginning to expound upon the need to lower wages, using the high yen as an excuse. There is also the possibility that cost-cutting efforts and the reform of the industrial structure will make unemployment a fact of life. It must be said that special care will be required. JJTI

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