

The Rising Yen, Price Busting and the Consumer

By Goto Motoi

This past June, the yen-dollar rate broke through the \$1.00 = ¥100 barrier and finally plunged to levels of 90-some yen to the dollar. As the exchange rate enters a new phase, referred to in the colloquial as the "double-digit era," we might also say that a milestone has been reached in the rising yen's continuing four-year race that began in the spring of 1990.

During the first half of last year the Japanese economy was also clobbered by the yen's abrupt climb, and to all appearances the yen is again following last year's upward course. But opinions regarding *endaka* have changed greatly in the past 12 months. When the yen strengthened last year, prospects for an economic recovery were slim. Debate focused on corporate results—starting with exporters—that were negatively affected across the board, and the rising yen served as the impetus for Japanese firms to move overseas, in short the "hollowing out" of industry.

To some extent last year's discussions are being repeated, but the emphasis has clearly shifted to the role the strong yen will play in structural adjustments to the economy and improved living standards. In other words, discussions this time have shifted away from theories that focused on the best way to conquer the shock produced by the rising yen and now revolve around how to actively utilize this situation, reflecting a qualitative shift in the debate.

Two factors have led to this change. One is the increasing contradiction in the continued expansion of internal-external price differentials with the rise of the yen since 1985. Another involves recent low price trends, referred to as the "pricing revolution" or "price busting."

Delving into this further, everything points to the fact that the global economy is entering a period of mega-competition, focused on pricing. With the collapse of the Cold War structure, China and other East Asian and Eastern European nations, as well as low wage nations in

Central and South America have entered global markets, riding on a wave of economic liberalization policies.

From the standpoint that imports became cheaper as export firms' profitability worsened, positive aspects naturally accompanied the minuses. However, since the effects of export-related minuses actually appear quicker than import-related pluses, the resulting time lag leads to an inevitable tendency to be distracted by the minuses over the short term.

Also Japan is a nation of limited resources, and with the post-Second World War economic recovery and accompanying growth there was an extended period during which acquisition of foreign currency was a categorical imperative. As a result, people ended up believing wholeheartedly in the mercantilist notion that exports were good and imports bad, encapsulated in the phrase "exporting nation."

Since the "Nixon shock" of 1971, the onset of each of the many strong yen phases has engendered shock, setting the historical basis for Japanese corporate strategies which have primarily focused on cost-cutting to overcome the strong yen, along with the general belief that this was natural.

On the one hand, import-related pluses took the form of stable commodity prices and this certainly benefited the nation's standard of living. In actuality, however, the benefits of a strong yen were only felt during overseas trips or when supermarkets hold discount sales.

Within Japan it is often said that the yen is strong overseas and weak domestically, demonstrating consumers' dissatisfaction at not being able to fully enjoy its benefits.

This time, the debate regarding the rising yen has centered on the desire to have its benefits function normally after continuing for so long in a distorted

Table: Comparison of Management Resource Costs by Region

Category	Japan	U.S.	Europe	Thailand	China
Annual interest	100	110	220	230	300
Land (factory site, per m ²)	100	8	4	1	10*
Construction costs	100	73	56	45	—
Personnel expenses (monthly)	100	65	32	6	4
Overland transport costs per 300 km (20 ft. container)	100	19	15	25	—
Ocean freight charges (export-clearance costs)	100	13	130	33	130
Warehouse rental (per m ² , per month)	100	20	10	20	20
Electric power (1 Kw per hour)	100	30	25	45	28
Water (m ³)	100	19	4	100**	1
Office overhead (as percent of profits)	100	45	35	50	20
Corporate taxes (base tax rate)	100				

Note: Indices based upon calculations for hypothetical typical local factory. From a Sharp survey. *Rental fees. **Estimate based upon transport by tanker truck.

Source: *Nihon Keisai Shinbun* (June 8, 1994 "Keizai Kyoshitsu")

state. Moreover, while previous theories about how to restore the benefits of the rising yen focused on consumer dissatisfaction, a major difference this time is that most domestic manufacturers have joined in the battle. This is based upon a perceived risk that Japanese manufacturers will not be able to cope with ongoing cross-border mega price competition if the various obstacles that stand in the way of the benefits trickling down within Japan are not eliminated.

One method of dealing with the strong yen and worldwide price busting is to correct and eliminate the internal-external price differentials behind strong-yen based margin restitution theories. The point is how to resolve the productivity discrepancy that exists between trade commodities exposed to competition through international trade and non-trade commodities that are not. In plain terms, the issue is what to do with domestic industries with low productivity.

"Internal-external price differential" refers to the extent of the comparative disparities in countries' prices for purchases of like goods or services. For example, if the same commodity or service was purchased in the U.S. for an expenditure of ¥100,000 as compared to ¥170,000 in Japan, Japan's internal-external price differential would be calculated as 1.7 times that of the U.S.

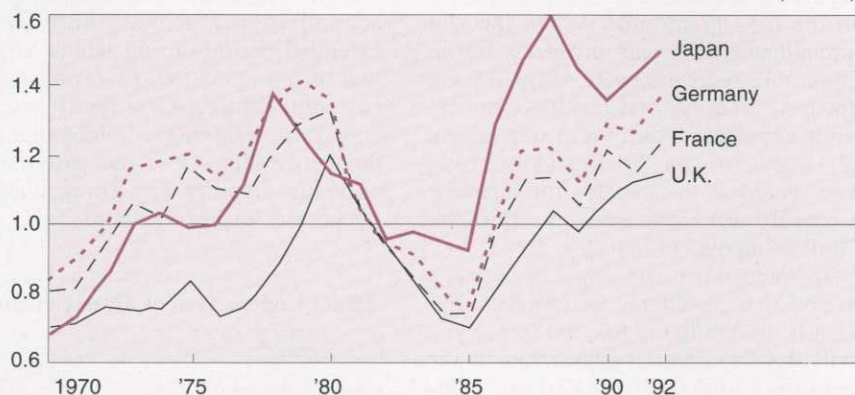
The graph shows developed nations' internal-external price differentials when the value for the U.S. is one. As of 1992 Japan was already at a level 1.4 times that of the U.S., a higher level than Germany, France or the U.K. According to newspaper reports, that differential is said to have widened to 1.7 as the yen continued to rise in 1993 and if the strong yen of 1994 is added on there is a strong possibility that this trend has further increased. If these price differentials are corrected as moves are made to eliminate them, the real income of Japanese will improve and, moreover, the national standard of living should improve that much more. This could also be a program for manufacturers to try to cut the costs of the relatively more expensive domestic raw materials, intermediate products, capital assets, and miscellaneous expenses they

Graphs: Trends in the Yen Rate and Major Countries' Internal-External Price Differentials

1. Real Yen-Dollar Rate



2. Internal-External Price Differentials



Source: *Economic Survey of Japan* (1994 edition)

have employed (see table).

However, correcting and eliminating these internal-external price differentials is easier said than done, which is to say that this issue has a great bearing on qualitative improvements in the Japanese economy. More than 35 years ago, in the mid-'50s, discussions revolved around the "two-tiered structure" of the Japanese economy. The discussions concerned ways of eliminating wage discrepancies between major corporations, where modernization was progressing and high wages were the norm, and the still existing premodern small- and medium-sized companies that retained low wages.

The issue of how to correct and eliminate internal-external price differentials is really the updated version of this theory. As I have already noted, relative disparities have arisen between items exposed to international price competition in the arena of trade and what would ordinarily be considered trade commodities but which have become non-trade commodities (no longer subject to commerce due to import restrictions and so on) as with most service industries that are not subjected to trade.

In Japan's case, the automotive, electronic equipment, and other typical export industries made efforts to improve productivity so that their products could

overcome international competition, resulting in the creation of expanded employment and rising incomes. In contrast, rice and other agricultural products, transport, construction, telecommunications, distribution, and other industry sectors (referred to as "regulated industry sectors" even in Japan) were safely cordoned off and kept from exposure to international competition through import restrictions. Productivity improvements lagged as a result.

Nonetheless, due to underlying labor shortages, incomes continued to rise in imitation of export firms that had achieved high productivity and as a result the prices of the goods and services produced by such industries increased, even though not supported by improvements in productivity.

Industries that would have retrenched or been obliged to try to improve productivity if markets had been sufficiently open, exposing them to international competition, were preserved without change and it can be said that as a result Japanese commodity prices were forced up to levels higher than the rest of the world.

When this is seen from the aspect of exchange rates, actual exchange rates reflect the strength of trade commodities and tend toward a strong yen. On the other hand, when industries lack international competitiveness and have been protected domestically without exposure to international competition, the result is that commodity prices do not drop and a disparity opens between the purchasing power parity that serves as the basis for commodity price levels in each country and real exchange rates, leading to an increase in internal-external price differentials.

Conversely, it could be said that Japanese on the whole have bought things that were much more expensive than in Europe and the U.S., guaranteeing incomes in low productivity sectors and maintaining employment. The wage disparity that was the central topic of the previous discussions of the two-tiered structure was resolved, but in its place Japan's economy has been encumbered with a new two-tiered structure, the strong yen accompanied

by increasing internal-external price differentials.

However, these types of contortions will no longer be permitted with the onset of a storm of price busting around the world. The expanding internal-external price differentials symbolized by Japan's high commodity prices will impede Japanese manufacturers faced with mega price competition and it would not be an exaggeration to say that this is now developing into a matter of life or death.

Backed up by consumer dissatisfaction, discussions regarding devolution of strong yen profits along with correction and elimination of the internal-external price differentials that have engulfed industry in this way has developed into a large ground swell. This ground swell will definitely not recede, nor would that be desirable.

One reason that it will not recede, as pointed out by Sharp Vice President Wada Hiroshi, is that, following the lessons learned during the bubble, Japanese consumer attitudes now more widely reflect purchasing intentions that could be described as "lower prices for quality products" and an emphasis on value that could be described as "paying what products are worth." (*Nihon Keizai Shinbun*, June 8, 1994). This means that price busting will not simply end up as a discount sale.

A second reason is that in order to cope with the consumer demands noted above and increasingly pricing-related mega competition around the world, Japan's manufacturers and other corporations are attempting to shift dependence on imports and switch to, or expand, overseas production. That Japanese companies have rapidly moved overseas since the rise of the yen last year is sufficient proof of this and the reawakening of the U.S. industrial sector, along with economic development in Asian nations, has become the foundation that supports a system of dependence on imports from the standpoint of quality.

If this move toward correction and elimination of internal-external price differentials was hindered for political or other reasons, low productive "regu-

lated industry sectors" would not continue to expand imports and as a result, the factors promoting the strong yen might increase.

If so, the hollowing out of industry will proceed apace and there is a strong possibility that only low productivity industries that cannot survive without protection will remain in Japan. In that case the exchange rate would naturally tend toward a weak yen, but a weakened yen after competitiveness had been lost would be no more than a large factor in inflation. Clearly, this would be a worst case scenario and not a desirable course.

As such the only path open to the Japanese economy is to increase imports of inexpensive overseas goods and services on the one hand while striving to ease regulations and improve the efficiency of service and other industries domestically, promoting price busting with a focus on the correction and elimination of internal-external price differentials. By doing this, commodity prices that are relatively higher than other countries' will come down, real incomes will rise, and the national standard of living will improve greatly. At the same time corporate production costs will drop and the excessive hollowing out of industry will be stopped. There is no other course.

However, inherent in this scenario are the thorny issues of deflationary phenomena caused by dropping commodity prices and the onset of employment problems in conjunction with structural reforms. These are troublesome issues in themselves and it goes without saying that thorough countermeasures will be required. However, the point that must now be emphasized is how best to resolve the problems. We should be fully aware that excessive apprehension regarding the pain that accompanies change places the wrong emphasis on the problem.

Goto Motoi, who worked for the Mainichi Shinbun for over 30 years until 1989, is professor of international economics at Tamagawa University in Tokyo.