Japan's External Surplus Swelling Again; Foreign Exchange Policy only Recourse

By Sakamoto Sakae

In the spring of 1995, when the Japanese economy was in the grip of a serious recession, Japan was hit by the yen's runaway appreciation against the U.S. dollar, the Japanese currency appreciating beyond ¥80 to the dollar. Industry, fearing a decline in its competitiveness on the export market, was panic-stricken. Now, in the spring of 1997, with the yen's exchange rate nearing ¥130 to the dollar, the excessive swing in the yen-dollar rate in the direction of a weak yen is posing a problem the opposite of that two years ago. In a bid to halt the yen's decline, Minister of Finance Mitsuzuka Hiroshi told reporters and the Diet that "excessive weakness of the yen, like its excessive strength, is unwelcome." Thus, the monetary authorities' concern about the exchange rate has changed diametrically in only two years, pointing up the volatility of exchange markets.

A weak yen is welcome to the Japanese economy in that it helps Japanese companies promote exports. However, it hampers the government in it's efforts to structurally reform the Japanese economy, and causes a capital outflow from Japan, due to the market's dislike of a weak yen. Further, the prices of goods, which have been declining as a result of the lackluster supply-demand situation, come under upward pressure due to a rise in the prices of imported goods. Thus, the view of government policy makers is that from a long-term perspective, an excessive decline in the value of the yen is harmful to the Japanese economy.

Moreover, the second Clinton administration in the United States began warning, around March, about problems arising from a growth in exports from Japan and a consequent swelling of Japan's external surplus. Japan-U.S. trade friction, a frequent occurrence in the past, may make a comeback if the upward trend in exports persists. Such a change in Japan's external balance is another reason why the Ministry of Finance wants to halt the yen's excessive depreciation.

Five factors behind the yen's weakness

The yen's present weakness can be attributed to the following five factors:

The first is the difference in performance of the Japanese and U.S. economies. The stagnation of the Japanese economy and the strong performance of the U.S. economy brought about selling of Japanese yen and buying of U.S. dollars.

The second is the difference in Japanese and U.S. interest rates, which arises from the first factor. The difference in the case of long-term interest rates is five percentage points. While water flows from a higher to lower level, capital, on the other hand, flows to where interest rates are higher: in this case, to the U.S. market. Moreover, this trend is being encouraged by the conviction that the Japanese monetary authorities, fearing a mid-recovery stalling of the Japanese economy, will maintain interest rates at their present very low levels.

The third factor is that many market players are convinced that the U.S. monetary authorities wish the dollar to remain strong. While they once thought that a weak dollar was welcome because it would help U.S. companies promote exports, U.S. authorities now appear to take the view that a strong dollar is beneficial to the U.S. economy as a whole.

Fourth, the corrective depreciation of the yen in the past two years from ¥80 to ¥125 to the dollar has gathered excessive momentum, and just as the yen overshot when it was rising two years ago, it is now swinging rather excessively in the opposite direction.

The fifth factor is the vague but widespread unease in the foreign exchange market about Japan's financial and economic systems, which are heavily burdened with bad debts.

Pronouncements by the Japanese and U.S. monetary authorities that a further depreciation of the yen against the dollar is undesirable will not, however, be enough to halt the yen's decline: a change would have to come about in the above five underlying factors.

"The level of business activity in Japan will not deteriorate seriously hereafter." "The U.S. economy hereafter will not remain so buoyant as it has up to the present." These observations represent a growing consensus among Japanese and U.S. economists. If these forecasts prove correct, the difference in the performance of the Japanese and U.S. economies (the first factor contributing to the weak yen) and the difference in the two countries' interest rates (the second factor) will gradually diminish. Regarding the widespread unease about the Japanese financial system (the fifth factor), the situation appears to be changing for the better, as indicated by the scheduled merger between Hokkaido Takushoku Bank and Hokkaido Bank, and the drastic restructuring of Nippon Credit Bank and the bank's tie-up with Bankers Trust. But unease will remain, as the problems afflicting the banking industry have now spread to the life insurance industry, with the recent bankruptcy of Nissan Mutual Life Insurance Co.

The most important factors at present are the third (Will U.S.monetary policy change?) and the fourth (Will market sentiment change?). In this regard, statements made by the U.S. government, particularly the Department of

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Where does the yen go? U.S. Secretary of the Treasury Robert Rubin and Prime Minister Hashimoto

the Treasury, deserve special attention.

A message from the U.S. Secretary of the Treasury

U.S. Secretary of the Treasury Robert Rubin made a speech in Tokyo in early April, in which he stressed the importance of Japan "achieving strong domestic demand-led growth and avoiding a significant increase in its external surplus," "continuing to take steps to strengthen its financial system," and "building on Prime Minister Hashimoto's commitment to deregulation" as the principal challenges the Japanese government now faces. From this, it is clear that he wished to emphasize in particular the importance of Japan achieving "strong domestic demand-led growth and avoiding a significant increase in its external surplus" through implementation of "a macroeconomic policy stance consistent with those objectives," adding that "Current account balances will rise and fall. But it is critical that Japan's current account surplus not rise again to a level that is detrimental to global growth, that causes trade frictions with Japan's trading partners and that could fuel protectionist sentiments in other parts of the world."

In this speech, Rubin did not mention any change in foreign exchange policy. However, around the time of the meeting of the Group of Seven finance ministers and central bank governors held in Berlin in early February, the U.S. Department of the Treasury's foreign exchange policy changed from an outright welcome of a strong dollar to a cautious stance toward it. The communique issued by the G-7 at the end of the Berlin meeting may be considered an indication of a slight change in policy by the U.S. Department of the Treasury, having stated that the gross disequilibrium in foreign exchange markets, mentioned in the G-7 communique in April 1995, had been corrected and that it had been agreed upon that foreign exchange markets should reflect the economic fundamentals of the countries concerned and that excessive fluctuations were undesirable.

"Lure" of foreign exchange

Further, the U.S. Department of the Treasury, in response to a statement made by Minister of Finance Mitsuzuka Hiroshi in which he had expressed concern about the yen's decline, issued a statement to the market from Rubin, in which he said that concern about the yen's exchange rate voiced by Japanese monetary authorities was shared by the U.S., because it could affect Japan's current-account surplus. Whereas the concern voiced by Rubin in his Tokyo speech about the swelling of Japan's external surplus was primarily intended to urge the Japanese government to promote imports and curb exports by stimulating domestic demand, it was nevertheless a veiled warning that the U.S. government would, if necessary, make use of foreign exchange policy again to settle trade problems.

What is certain is that concern about Japan's swelling external surplus will intensify hereafter in U.S. export-oriented industries and in Congress. However, what the Japanese government can do to stimulate domestic demand is limited regardless of what fiscal or monetary measures it takes. On the fiscal side, the government is launching an all-out endeavor to cut the budget deficit toward the year 2000. On the monetary side, the policy-based interest rates are at the lowest level in history, and the interest rates on bank deposits are almost zero. Therefore, the government will have to resort to a third course, a foreign exchange policy, to stem the expansion of Japan's external surplus—guiding the yen-dollar rate in the direction of a stronger yen to curb exports and promote imports. The Ministry of Finance, which considers the rehabilitation of public finances to be its top-priority task, wants to refrain from stimulating domestic demand by way of a method that would defeat the Hashimoto Cabinet's effort to cut the budget deficit.

Rubin, though saying that the U.S. government shares the concern about the weak yen, reiterated that a strong dollar serves the U.S.' interests. The Secretary of the Treasury, who comes from Wall Street, knows only too well the disastrous side-effects of using "exchange" as a tool for the implementation of trade policy, as it would accelerate the dollar's decline and this in turn could bring about a crash in the bond and stock markets, thereby ending the current U.S. economic upturn. Probably for this reason, unlike former secretaries of the treasury, he couldn't state openly that the U.S. government welcomes a strong yen. Thus, the U.S. government's delicate position in this regard lessened the impact of the G-7's Berlin communique on foreign exchange markets. JJTI

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