Yen Appreciation Compels Structural Changes

By Takahiko Ueda

The yen/dollar exchange rate has changed over 30% since last September's G-5 meeting of central bankers and finance ministers from Japan, the United States, West Germany, Great Britain and France. Having soared from ¥230/$1 in mid-September to ¥160/$1 in mid-April, the yen is clearly overvalued. As seen in Fig. 1, a comparison of real effective exchange rate indices shows that the yen at 160–170/$1 is more than 20% overvalued.

Short-term investment deterrent

This rapid appreciation is having a grave impact on Japan's economy. To halt the erosion in their yen earnings, exporters have had to raise their dollar-denominated sales prices. In doing so, however, they face difficulties both because noninflationary expectations overseas make the market unwilling to accept the full brunt of these price hikes and because their market advantage is seriously eroded by more competitively priced products from Korea and Taiwan. As a result, Japanese export volume was down from 1985's figures in March and again in April 1986, and the yen's appreciation has clearly been an export deterrent.

Nor has the impact been limited to exports, as yen appreciation has also begun to make itself felt in domestic demand, especially capital investment. Because companies are seeing their capacity utilization rates decline with the slump in export volume and their profits diminish with the deteriorating export profitability, they are putting off capacity-expansion investment and postponing non-urgent plant investment. A slump in manufacturing capital investment seems inevitable this year. As seen in Table 1, manufacturing capital investment is off 6.1% this year from last year's figures. With the yen climbing still higher since the survey was conducted in March, there is a very good chance that even these modest plans will be revised and cut back. By industry, all manufacturing industries except oil refining plan to curtail investments, and it appears that business' short-term response to the yen's appreciation has been to hold investment to ongoing projects, rationalization and other bare-minimum needs.

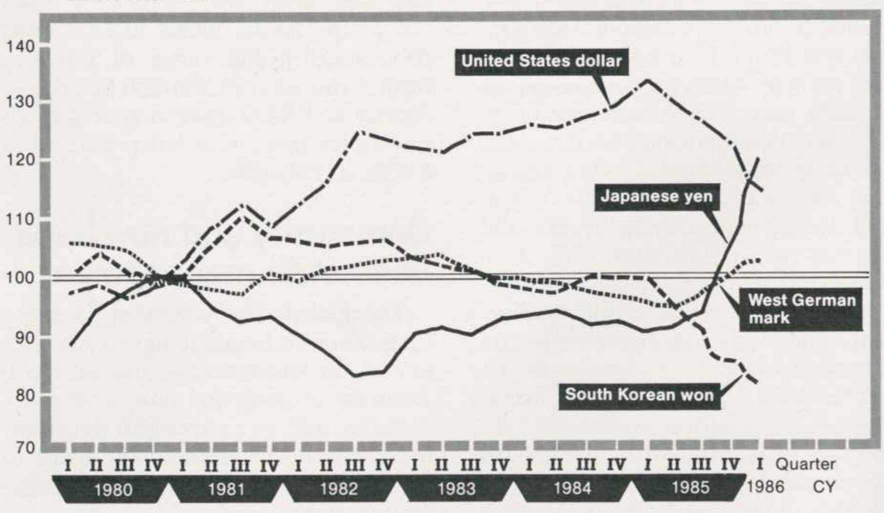
New forms of investment

Yet even as business is cutting back on capital investment in the face of deteriorating operating conditions, the yen's appreciation is dramatically changing Japan's relative position vis-à-vis other countries in terms not only of product pricing but also of personnel costs, production costs and the entire range of factors. As a result, not even rationalization can close the gap and it is more advantageous now to shift to overseas production of some products or to purchase parts from overseas sources, and these new competitive conditions are forcing companies to fundamentally reexamine their production and marketing strategies.

There are two directions in particular that companies will have to consider if they are to cope with the sharply altered environment created by the yen's appreciation: one being a shift to technology-intensive frontier industries and the other being a shift to overseas production and procurement.

In this regard, the two noteworthy areas in corporate investment are first investment for research and for diversification and second spending to expand overseas production and to acquire overseas partners. Of course, companies have long been fully aware of the need for a positive response along these lines to alleviate trade friction and to counter the

Fig. 1 Indices of Major Currencies' Real Effective Exchange Rate Fluctuation



Note: These real effective exchange rates have been derived by deflating the four countries' nominal exchange rates to compensate for inflation and then calculating weighted averages taking account of the importance of trade to their economies. Indices here have been calculated with December 1980 as the base of 100.
Source: Industrial Bank of Japan

Takahiko Ueda is an economist in the Research Department of the Industrial Bank of Japan.

Table 1 Planned Plant and Equipment Investment by Industry

Industry	Number of companies surveyed	Percentage change from previous year	
		FY 1985	FY 1986
Iron and steel	108	10.7	-2.7
Nonferrous metals	77	-7.8	-10.0
Electric machinery	129	-8.0	-10.1
Shipbuilding	22	17.5	-12.2
Automobiles	106	38.8	-0.8
General machinery	170	9.3	-8.1
Oil refining	36	0.4	21.1
Chemicals	283	9.3	-6.4
Textiles	79	12.2	-7.1
Pulp and paper	59	25.8	-27.6
Ceramics	104	11.5	-9.8
Food	95	7.9	-2.3
Other manufacturing	165	3.1	-1.8
Manufacturing subtotal	1,433	7.9	-6.1
Mining	40	-34.2	-30.7
Gas	46	3.9	2.7
Construction	95	-6.3	-11.8
Real estate	169	15.9	-1.2
Land transportation	157	11.7	3.6
Marine transportation	141	-6.3	-13.8
Department stores and supermarkets	75	27.2	-5.4
Leasing	89	22.9	17.8
Other nonmanufacturing	613	20.5	8.3
Nonmanufacturing subtotal	1,425	17.1	9.5
Electric power	37	3.7	11.2
Total	2,895	11.2	4.7

Source: March 1986 Industrial Bank of Japan Survey of Plant and Equipment Investment Trends

Table 2
Manufacturing Sector R&D Investment and Spending in FY 1986 (%)

	Planning to increase capital investment from FY 1985 level		Planning to reduce capital investment from FY 1985 level	
	Planning to increase	Planning to decrease	Planning to increase	Planning to decrease
R&D investment	85.2	14.8	72.9	27.1
R&D spending	86.4	13.6	79.2	20.8

Source: March 1986 Industrial Bank of Japan Survey of Plant and Equipment Investment Trends

competition from the newly industrializing countries. The big companies have built new research facilities to beef up their basic research, and diversification has been proceeding rapidly over the last few years with the emphasis on new materials. Likewise, the Japanese automakers have been investing heavily in local production in the United States. While the yen's appreciation may accelerate these trends, it will certainly not dampen them.

As seen in Table 2, among the manufacturing companies which plan to cut back on plant investment in FY 1986 over 70% of companies said they will expand research and development investment. There is clearly a strong will to invest in areas perceived as crucial to a company's survival.

In overseas development, in fact, the trend over the past few months has been for increased investment as a result of the yen's appreciation. Major electrical equipment manufacturers have been expanding local production capacity in Singapore, Hong Kong and other sites for direct exports, taking advantage of the competitive export profitability they offer. In another industry, almost all of the major Japanese automakers have expanded capacity in the United States where production costs are lower. Some automakers have also entered into tie-ups with firms in the United States and Korea for horizontal integration and cross-supply of parts.

Too much too fast

So far, Japanese companies have refused to bow down in the face of yen appreciation and have instead worked hard to respond positively to these altered circumstances. Over the long run, this is expected to contribute to reducing Japan's current account surplus by reducing exports and boosting imports.

However, things could change if the yen's rise goes unchecked and it breaks through ¥170/$1 to stay. There is, after all, a limit to what the companies can do in the short term, since all of these policy possibilities will require time to take effect. If the yen's ascent is gradual, companies can formulate plans for medium-term structural change and respond positively. Yet the yen's recent abrupt rise has left companies little time to reflect or plan.

Granted that industrial restructuring is essential for rectifying the external imbalances and that some yen appreciation and dollar depreciation has been needed since last year to encourage this industrial restructuring, excessive yen appreciation threatens to make companies unnecessarily cautious and to slow down domestic reflation and corporate adjustment. Thus, the painful deceleration from runaway yen appreciation could well outweigh any current account rectification advantages and work to the ultimate detriment of the Japanese and world economies.

At the risk of belaboring the obvious, it is unreasonable to expect to rectify short-term external economic imbalances with currency exchange adjustment alone. Rather, the important thing now is to move vigorously to restructure the economy by stimulating domestic demand and further improving market accessibility. In effect, the trick now is to encourage economic trends and corporate behavior to move in the right directions, and the tactical emphasis on exchange rates should not be allowed to get in the way of these strategic goals.●