

A Hard Row

By Kenjiro Horikawa

Even though it will soon be one year since the yen started its sudden appreciation, Japan's trade surplus shows no signs of shrinking. Quite the reverse is true, as customs-clearance figures announced by the Ministry of Finance for the first six months of 1986 showed a \$34.1 billion surplus, well above the July-December 1985 surplus of \$28.4 billion. This \$34.1 billion was an all-time high for a six-month period.

Many economists attribute this to the J-curve effect—that phenomenon whereby currency appreciation inflates the dollar-denominated value of exports before the higher dollar prices depress export volume. The second reason suggested for Japan's record surplus is that imports have fallen by value—down by 0.2% in the first six months of 1986—with the collapse in oil and other commodity prices.

But it would be a mistake to assume from the continuing trade surplus that exports are still going strong. Export volume dropped 3.8% from the previous quarter in the January-March quarter of 1986, and this was the major reason for Japan's first full-quarter minus growth in real GNP in 11 years. Likewise, Japan's June 1986 export volume was down 2.3% from June 1985.

Nonetheless, even as the yen has appreciated 50% (from ¥240/\$ in the fall of 1985 to ¥160/\$ in the summer of 1986) exporters have by and large succeeded in maintaining volume by: 1) cutting their production costs and thus holding down their export price increases; 2) increasing overseas production and procurement of parts and products; and 3) enhancing market competitiveness in advanced technologies, automobiles and the like. It also helped that consumer spending in the United States was firm and the European and Southeast Asian economies were expanding.

Small firms hit hardest

Although Japanese exports are generally holding up well under the impact of the yen's appreciation, this is not true for all export company sizes and industries. Hardest hit are small exporters and subcontractors who supply parts to the larger export companies, since they are in no position to refuse when their major clients request price cuts. A leading automobile manufacturer is attempting to cope with the yen's appreciation by streamlining internal operations, forcing subcontractors to cut their prices on parts, and raising the prices of exports—

each of these three measures are expected to absorb about one-third of the yen's rise.

The Tokyo Chamber of Commerce and Industry recently surveyed 1,985 export-oriented small businesses capitalized at ¥100 million or less on the effects of the appreciated yen. More than 80% of these companies spoke of fewer export contracts, with 14% complaining that new contracts had totally dried up. This has been devastating for profits: 55% of the companies reported declining profits in fiscal 1985 and 67% forecast profit slippage in fiscal 1986.

The Chamber also asked its respondents what the minimum exchange rate was they needed to turn a profit. The most common answer was ¥180-189/\$, followed by ¥190-199/\$, ¥200-209/\$ and ¥170-179/\$ in that order. Only 10.4% of the companies said they could survive with an exchange rate of less than ¥170/\$, and a mere 3.5% said they could live with under ¥160/\$ (Table 1).

Even here, however, there were considerable discrepancies among different industries and even among companies in the same industry. For example, in manufacturing, the steelmakers and chemical companies were concentrated in the ¥180-200/\$ range, but machinery companies were mainly in the ¥170-190/\$ range. While the materials industries appear less vulnerable to yen appreciation than the processing and assembly industries, individual corporate strength is also a factor as answers ranged from ¥150/\$ to ¥220/\$ even within a single industry (electrical machinery).

It should be noted, however, that companies tend to be pessimistic in their replies to surveys such as this, probably out of anxiety at the unprecedented yen appreciation. In October 1985, just after the yen started its dramatic rise, the Sanwa Bank asked the leading companies in 16 major export industries if they would be able to maintain profitability at ¥200/\$. Thirteen said that their operations would be in the red at this



With the yen's appreciation, import displays encourage customers to take advantage of lower-priced foreign goods.

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Table 1 Maximum Appreciation at Which Profit Can Be Made

Exchange rate	Percentage of companies
Less than ¥130/\$	0.6
¥130-139	0.3
¥140-149	0.3
¥150-159	2.3
¥160-169	6.9
¥170-179	10.7
¥180-189	28.3
¥190-199	15.9
¥200-209	15.3
¥210-219	3.2
¥220-229	2.8
¥230-239	0.1
¥240-249	0.3
Over ¥250	0.1
No reply	12.8

Source: Tokyo Chamber of Commerce and Industry survey of 685 export-oriented small businesses

rate, two that they would still be making a profit, and one that it would be touch-and-go. The companies predicting deficits at ¥200/\$ were in tires, shipbuilding, steel, synthetic fibers, bicycles, machine tools, copying equipment, construction machinery, agricultural machinery, telephones, ICs, electrical appliances and plants; the profit-anticipating companies were in automobiles and computers; the borderline company was a magnetic tape manufacturer.

Yet as the yen has risen, companies have further rationalized their operations and made other efforts to cut their costs. As a result, they have managed to absorb another ¥20-30/\$ rise. When the Shoko Chukin Bank surveyed 622 small-business exporters this April, ¥182/\$ was the average break-even line. Nor is this survey an isolated exception. Mitsubishi Bank has done a number of surveys of exchange rates and profitability. In 1978, companies said they would not be able to make a profit if the yen went over ¥201/\$. In 1986, this figure was ¥171/\$—up ¥30/\$ in eight years.

During this same period companies have buttressed their financial positions and raised their equity capital to 28% from 20%, and this is thought to be the main reason for their ability to cope with a higher exchange rate. Today's higher ratios enable companies to hold export price increases to a minimum and thus to minimize the drop in export volume. The Mitsubishi Bank explains that a 1.0% rise in the value of the yen caused a 0.5% drop



The trend for Japanese manufacturers to move their production bases abroad will accelerate with the yen's appreciation.

in export volume during the last major period of appreciation but the same 1.0% rise in the yen is depressing exports a mere 0.27% this time.

Export price rises modest

Almost no companies are raising their export prices as much as the yen is rising. Japan's Economic Planning Agency (EPA) announced that export prices have risen only 17% in the six months from September 1985 to March 1986 even though the value of the yen has risen 33%. Companies are passing on only 52% of the yen's rise, significantly less than the 78% passed on during the last yen appreciation. Obviously, companies are finding some other way to cope with appreciation with only modest price rises.

Even so, export-oriented Japanese companies will have a very difficult time of it if the exchange rate continues at ¥150-160/\$. Plant exports for fiscal 1986 are predicted at just under \$7 billion, a mere 40% of the amount recorded in the peak year of fiscal 1981. As the yen rises, Japanese companies are rendered less competitive and lose contracts to American, European and South Korean manufacturers.

The Ministry of Finance has reported that current profits for all industries in the January-March quarter of 1986 fell by 8%, with the biggest declines in steel (86%), electrical machinery (35%) and general machinery (25%), all export-oriented industries. For these companies, the slump in exports caused by the yen's appreciation more than offset the gains from falling oil prices and lower interest rates.

As if to substantiate this, one financial information service reported that there were 220 bankruptcies attributable to the yen's appreciation between October 1985 and June 1986, most of them in electrical machinery, general machinery, ferrous and nonferrous metals and other export-oriented industries.

The yen's appreciation is also being felt in employment. In April 1986, unemploy-

ment hit a record 2.9%, causing many people to believe that Japan is entering an age of 3.0% unemployment. The shipbuilding industry's decision to close down 20% of its facilities will put 16,000 people out of work, and 2,000 more people are expected to lose their jobs in the lumber and plywood industries. Companies in the aluminum smelting, spinning and cement industries are also planning personnel cuts. Even the automobile industry is feeling the pinch, and automakers are not planning to take on any seasonal workers this year.

Japanese workers are likely to be further hurt by moves to counter the yen's appreciation by shifting production overseas where costs are cheaper, since it is expected that this overseas shift will cause domestic shutdowns and layoffs.

Yet no one, neither government policymakers nor businesspeople, expects the exchange pendulum to swing back. While there will be some minor ups and downs, most people believe the exchange rate will stay in the ¥150-160/\$ range for the rest of this year and next. Some of the big banks are even predicting that the yen will break the ¥150/\$ barrier by early next year. Almost all of the American participants at the Japan-U.S. Business Conference held in Tokyo this July agreed that the exchange rate should stabilize at around ¥150-160/\$ for there to be any improvement in the bilateral trade imbalance. Most Japanese participants, by contrast, argued for stabilization at around ¥180-190/\$. However, Japanese businessmen realize that ¥180-190/\$ is wishful thinking, and they also expect that the exchange rate will be closer to the ¥150-160/\$ the Americans want.

Shifting strategies

Faced with the likelihood that the yen will continue strong for some time, Japanese corporations are being forced to effect major changes in their strategies. The Ministry of International Trade and Industry (MITI) recently asked 85 of

Japan's leading corporations what they thought the most important element in corporate strategy was. Although answers varied among different industries, there was a general consensus that domestic markets must be developed, overseas production increased, and technology exports promoted with the main emphasis currently on overseas production (Fig. 1).

Textiles, chemicals, ceramics, sundries and paper and pulp were particularly interested in developing domestic markets; electrical machinery, precision equipment, steel and nonferrous metals in increasing overseas production; and general machinery and transport equipment in promoting technology exports. Matsushita Electric, for example, has decided to transfer all production of cheap (under \$100) audio equipment to plants in Taiwan and Singapore and to produce its window air-conditioners in Malaysia.

This year has seen a rush of companies in electrical appliances, automobiles, office automation equipment, machine tools and other processing and assembly industries shifting production to overseas plants. One electrical appliance manufacturer claims that a ¥170/\$ exchange rate effectively made labor costs in Japan and

the United States the same, and that any rate over that gave the advantage to the U.S. There is also a trend to move production to Asian countries such as South Korea, Taiwan and Singapore, where labor is cheaper and whose currencies are linked to the U.S. dollar.

This exodus of Japanese companies to foreign countries is having a dual impact. On the one hand it is helping to alleviate economic friction by increasing employment opportunities in the host countries, and on the other hand it is contributing to "hollowing" Japanese companies. Just as people have pointed to the deindustrialization of America as that country moves from manufacturing to services, so has it been suggested that Japan is taking the first steps along the same road. The yen's appreciation has clearly created serious problems for the Japanese economy.

Tightening belts

In addition to such long-term policy responses as increasing domestic demand and shifting production overseas, there are a number of short-term steps being taken to cope with the yen's appreciation. The most common are to economize on company expenses, import

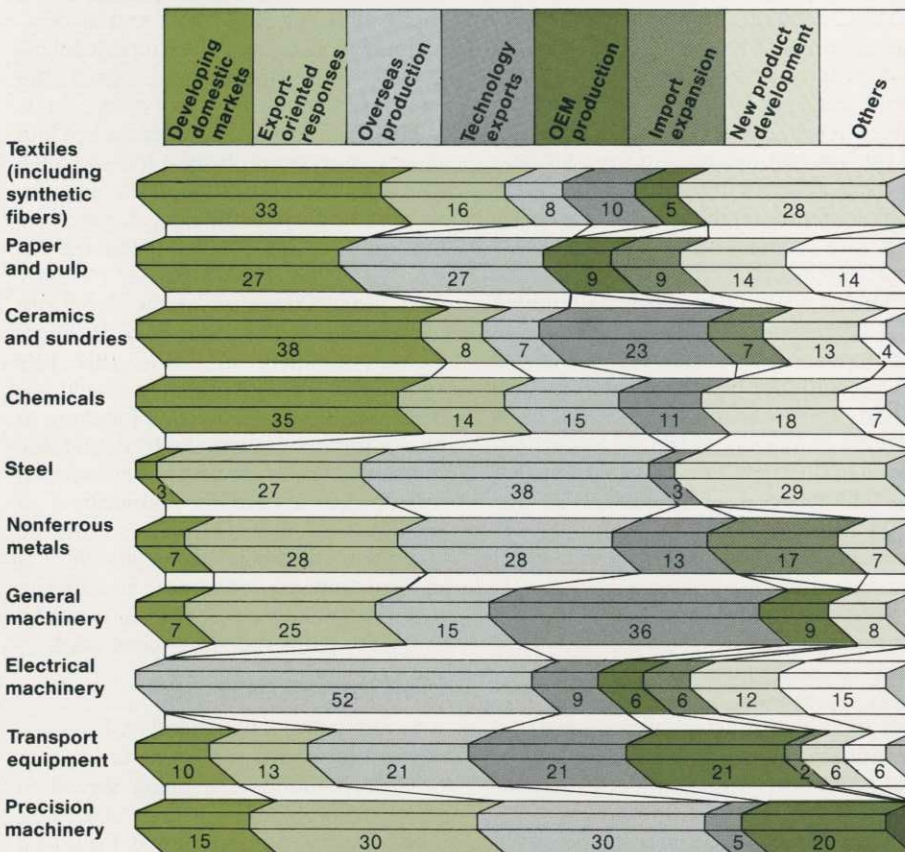
more parts to take advantage of the strong yen and get subcontractors to lower their prices. In reducing their own costs, almost all exporters are granting smaller annual wage increases, reducing overtime, encouraging early retirement and reducing the number of part-time employees. Companies such as Matsushita Electric and Sharp have decided to increase the use of imported parts by 20% over last year, while Canon is planning a major increase in its imports of office automation equipment parts from South Korea and Taiwan. Most of these additional parts are being supplied by the Southeast Asian countries.

Aside from cost-cutting, companies are moving to protect themselves by developing new and better products to maintain export levels in spite of the increased prices that appreciation mandates. According to a survey done by the Tokyo Chamber of Commerce and Industry, the most common steps being taken by export-oriented small businesses in the face of the yen's appreciation are: 1) developing new products, 2) cutting materials costs, 3) streamlining and cost-cutting, 4) raising prices, 5) putting greater emphasis on domestic markets, 6) shifting to higher-priced products, 7) going into another line of business, 8) expanding overseas production and 9) increasing parts procurement from overseas.

Going into another line of business is a last resort for companies otherwise unable to deal with the present exchange rate. Although the government has attempted to help small businesses that want to shift out of exports by offering them low-interest loans since January 1986, only three companies had availed themselves of these loans as of the end of March. Asked the reason for the unexpectedly low response rate, the Small Business Finance Corporation cited the example of a tile manufacturer that decided to abandon exports and switch to the domestic market but is now having trouble finding a domestic wholesaler to handle its distribution. Japan's distribution system is as big a problem for Japanese companies as it is for overseas corporations attempting to break into Japan's markets.

There is, of course, a thin silver lining to yen appreciation as the import-dependent petroleum, electric power and gas companies enjoy windfall profits, but this is not enough to overcome damage inflicted on an economy that exported \$60 billion more than it imported last year, and the future looks bleak for Japanese industry in the years ahead. ●

Fig. 1 How Companies Are Coping with Yen Appreciation (%)



Source: MITI survey of 85 companies in 10 industries