

Yen-Dollar Exchange Rate: Moving Toward a Stronger Yen

By Teruhiko Mano

Sources of the Dollar's Strength

A review of the international currency situation in 1982 shows that after a brief decline early in the year, the U.S. dollar remained strong against all other major currencies until early November. Nor was the dollar's strength limited to 1982. In terms of average value, the dollar remained strong for two years beginning in the autumn of 1980. As just one example, the International Monetary Fund's effective exchange rate indices (1975 = 100) stood at 125.1 in November 1982, up 32.4% from the 94.5 average recorded in the last quarter of 1980.

Since mid-November 1982, however, progress has been made on foreign exchange markets in correcting the strength of the dollar. The yen's exchange value vis-a-vis the dollar has generally moved in the opposite direction to the above-mentioned movements in the dollar's average value.

What, then, accounted for the dollar's strength up until November last year? It seems to me that there were the following three factors:

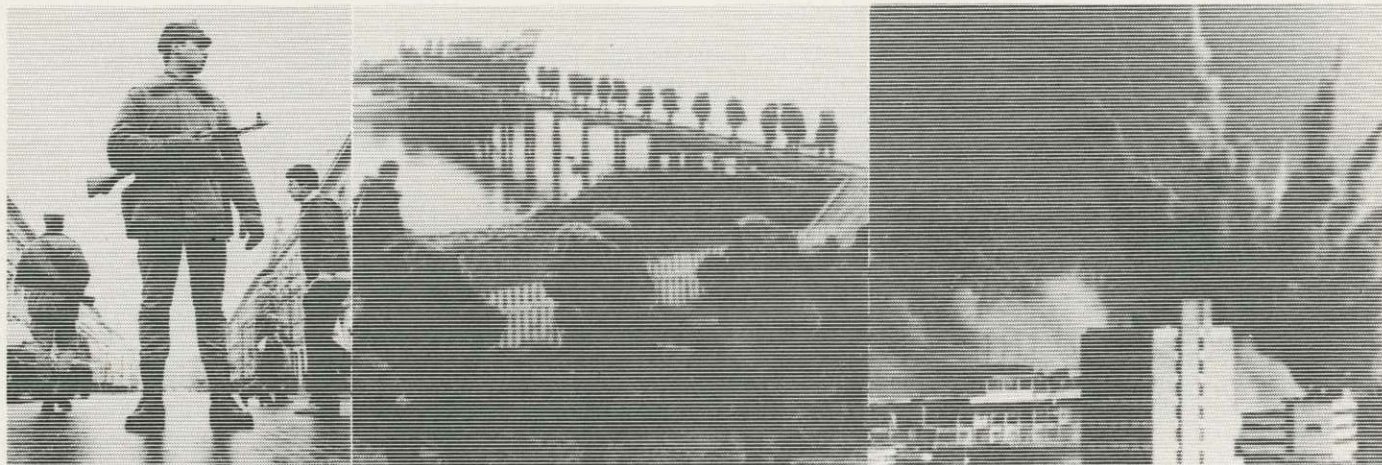
The first was the high interest rates in the United States. The fiscal reforms instituted by the Reagan Administration through tax and spending cuts, coupled

with an increase in military expenditures, so expanded U.S. fiscal deficits that the war on inflation could only be waged by tightening credit. For about three years until mid-1982, the Federal Reserve rigorously curbed growth in money supply. As a result, U.S. market interest rates rose sharply, with both long-term and short-term interest rates at one stage reaching nearly 20%.

Under the floating exchange rate system, most short-term capital movements tend to be covered by swap exchange deals, and short-term interest rate movements do not have such a serious effect on exchange rates. On the other hand, the differentials in long-term interest rates between the U.S. and other countries in favor of the U.S.—differentials caused by the abnormally high U.S. interest rates—attracted large amounts of long-term capital to the U.S. and, by extension, to the dollar. Comparative analysis of interest rate differentials between the U.S. and Japan in terms of secondary market yields of national bonds shows that in the period from mid-1981 to mid-1982 U.S. interest rates were 5% to 7% higher than in Japan. Under the new Foreign Exchange Control Law, which came into force in December 1980, life insurance companies and other Japanese institutional investors hoping to benefit from the interest rate differentials made huge investments in U.S. bonds.

A second factor behind the dollar's strength was a widespread belief that the dollar was the currency to rely on in an emergency. This encouraged the flight of international funds into the United States during times of international political and financial unrest. The declaration of martial law in Poland, the dispute between Britain and Argentina over the Falkland Islands, and the aggravation of the Palestine problem due to strong measures taken by Israel each touched off dollar buying sprees. In international monetary affairs, the problem of the huge external debts of East European and Latin American nations came to the surface as the world economy wallowed in stagnation. This led to renewed recognition of the United States' key role as the supplier of what has become the world's international currency.

A third factor contributing to the strength of the dollar was an improvement in the fundamentals of the American economy, especially a marked decline in inflation and an improved current account balance. The inflation rate in the United States has fallen to 5% to 6% from a peak of about 20%, albeit at the cost of unusually high interest rates, prolonged business stagnation, and high unemployment. The U.S. current account registered a surplus of US\$3.2 billion in the first half of 1982, reflecting lower oil imports and a rise in interest revenue.

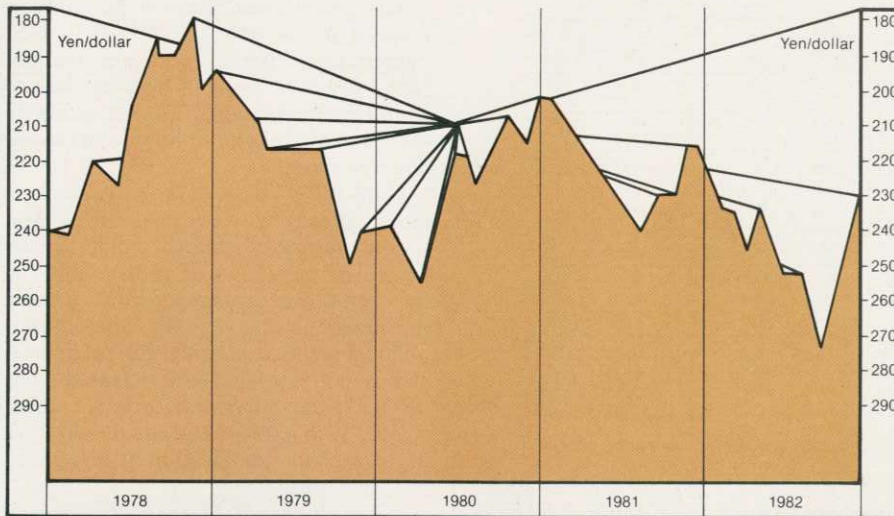


The declaration of martial law in Poland, the Britain-Argentina war over the Falkland Islands, and the Palestine problem all contributed to strengthening the U.S. dollar.

Photo: WWP

Yen-Dollar Exchange Rate

(Weekly Average of Closing Interbank Dollar Rates for Overnight Delivery)



Yen-Defense Measures

As the dollar rose against other major currencies, the yen-dollar exchange rate, which began 1982 at around ¥210 to the dollar, went into steady decline. The flagging yen adversely affected price stability in Japan and aroused fears that trade frictions with Western countries would be further aggravated. Measures to support the yen soon came in for discussion.

As Japan's current account was in the black, the principal cause of the yen's depreciation could be traced to a large net outflow of long-term capital. Most of the discussions on measures to defend the yen thus concerned how best to deal with this capital drain.

The measures discussed included the introduction of an interest equalization tax, adoption of a two-tier exchange market system, invocation of "emergency control" powers under the new Foreign Exchange Control Law (to place Japanese residents' investment in overseas securities on a permission basis), invocation of the Bank of Japan's "special official discount rate" (temporarily suspending the Bank's ordinary discount rate and introducing the higher central bank lending rate; sometimes compared with the special Lombard rate in West Germany), and powerful intervention in the foreign exchange market to support the yen by monetary authorities.

On the basis of these discussions, Japanese monetary authorities restricted investment by Japanese life insurance companies in foreign securities and urged Japanese securities companies to exercise self-restraint in domestic sales of foreign zero-coupon bonds. They also encouraged domestic short-term interest rates to go upward. Japanese monetary authorities, furthermore, continued their extensive market intervention, which resulted in a large sell off of dollars on a net basis,

although this intervention generally did not overstep the bounds of simple smoothing operations.

But despite these efforts, the yen continued to depreciate against the U.S. dollar, falling to nearly ¥280 to the dollar early in November 1982.

Correcting the Yen's Weakness and Dollar's Strength

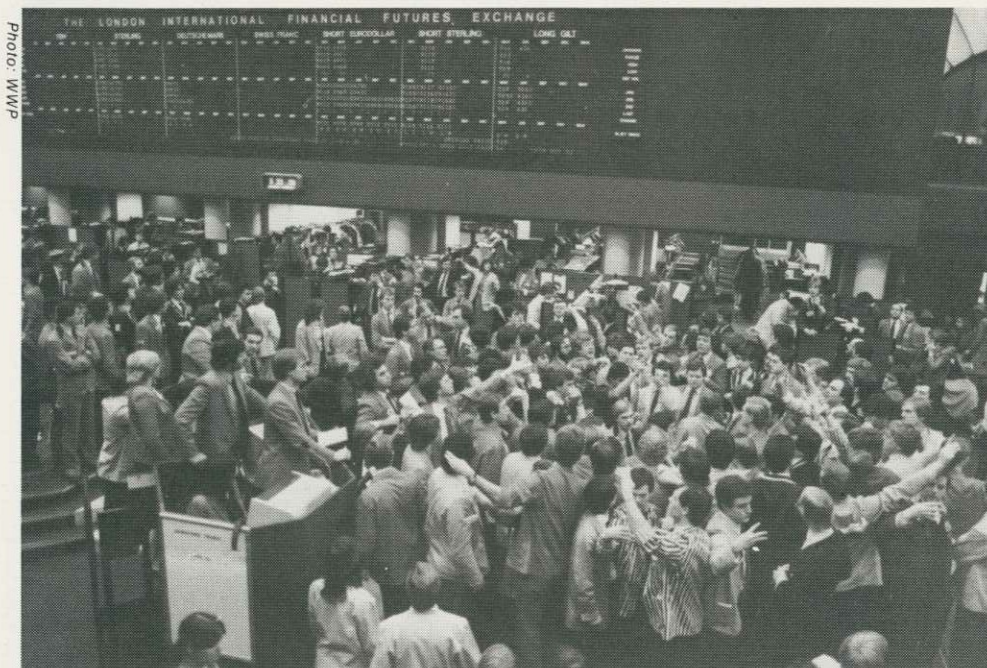
As business stagnation in the United States dragged on and concern increased over rising unemployment, an opportunity arose for a change in Washington's monetary policy. Late in July 1982, the U.S. discount rate was lowered to 11.5% from 12%. This was followed by repeated cuts of 0.5% that brought the discount rate to 8.5% by the end of the year.

Money supply growth was essentially left to its own devices and increased beyond the original target. Responding to such an easy-credit policy, both long-term and short-term market interest rates began to fall.

Spurred by the decline in U.S. interest rates, West Germany, Britain, the Netherlands, and Switzerland lowered their rates as well. Japan, meanwhile, moved very cautiously in order to prevent further depreciation of the yen. The result was that interest rate differentials between Japan and the U.S. narrowed steadily.

Nonetheless, the yen continued to depreciate against the dollar from August through October 1982. This was due mainly to persistent interest rate differentials of about 4% in favor of the United States. Another factor was increased demand for the dollar as a settlement currency as liquidity problems surfaced in Mexico and some other Latin American countries. Nor were matters helped by falling Japanese exports, despite the substantially lower value of the yen, and then Prime Minister Zenko Suzuki's declaration of "a state of emergency" in Japanese public finances, which gave rise to concern about Japanese economic fundamentals.

But change was in the offing. As Japan-U.S. interest rate differentials narrowed and the yen continued to depreciate, the flow of long-term capital out of Japan began to show a marked decline in and after September 1982. This reflected renewed recognition that the drop in U.S. inflation rates was due to severe stagnation in the American economy, and the remarkable deterioration in the U.S. balance of payments brought on by the appreciation of the dollar. These developments caused



London's newest exchange, the London International Financial Exchange, is already an invisible export earner.

Changes in Japan's Balance of Payments

| | 1980 | 1981 | P 1982 | 1981 1-3 | 4-6 | 7-9 | 10-12 | 1982 1-3 | 4-6 | 7-9 | P10-12 |
|-----------------------------|-------------------|-------------------|-------------------|------------------|------------------|------------------|-----------------|------------------|------------------|-------------------|-------------------|
| Current account | -10,746 | 4,770 | 6,896 | -2,076 | 1,455 | 3,531 | 1,860 | -912 | 2,582 | 2,924 | 2,302 |
| Trade account | 2,125 | 19,967 | 18,191 | 2,048 | 4,846 | 7,388 | 5,685 | 2,439 | 5,312 | 5,760 | 4,680 |
| Exports | 126,736 (25.2) | 149,522 (18.0) | 137,651 (-7.9) | 34,924 (30.7) | 37,451 (21.4) | 38,025 (16.4) | 39,122 (7.1) | 34,994 (-0.2) | 35,216 (-6.0) | 33,964 (-10.7) | 33,477 (-14.4) |
| Imports | 124,611 (25.4) | 129,555 (4.0) | 119,460 (-7.8) | 32,876 (12.2) | 32,605 (1.4) | 30,637 (0.8) | 33,437 (2.1) | 32,555 (-1.0) | 29,904 (-8.3) | 28,204 (-7.9) | 28,797 (-13.9) |
| Invisible trade account | -11,343 | -13,573 | -9,913 | -3,580 | -3,128 | -3,513 | -3,352 | -2,883 | -2,495 | -2,538 | -1,997 |
| Transfer account | -1,528 | -1,624 | -1,382 | -544 | -263 | -344 | -473 | -468 | -235 | -298 | -381 |
| Long-term capital account | 2,324 | -9,672 | -15,007 | -543 | -2,396 | -3,670 | -3,063 | -5,805 | -4,569 | -4,652 | 19 |
| Basic balance of payment | -8,422 | -4,902 | -8,111 | -2,619 | -941 | -139 | -1,203 | -6,717 | -1,987 | -1,728 | 2,321 |
| Short-term capital account | 3,141 | 2,265 | -960 | 4,039 | -3,250 | 928 | 548 | 865 | -2,851 | -74 | 1,100 |
| Errors and omissions | -3,115 | 493 | 4,100 | 1,004 | -378 | 585 | -718 | 2,561 | 1,458 | 1,729 | -1,648 |
| Overall balance of payments | -8,396 | -2,144 | -4,971 | 2,424 | -4,569 | 1,374 | -1,373 | -3,291 | -3,380 | -73 | 1,773 |

() : Percentage increase or decrease from previous year P: Preliminary (Source) Ministry of Finance

alarm in foreign exchange markets over the dollar's excessive appreciation.

The yen thus made a sharp turnaround in the period from late October to early November 1982. In all, it appreciated from ¥280 to the dollar to ¥235 by the end of the year, a rise of more than ¥40 in less than two months.

The Outlook for 1983

Reviewing the yen exchange rate in 1982, it is clear that international interest rate differentials have played an extremely important role in setting exchange rates in the open market following the removal of foreign exchange controls.

A look ahead would seem to suggest that U.S. interest rates will continue to decline, though gradually. Although U.S.

rates fell substantially in 1982 as mentioned above, the so-called real interest rate—representing the nominal rate minus inflation—is still quite high. The real interest rate in the U.S. ran even with or below the nominal interest rate immediately preceding business recovery during the postwar recession. Now it runs 3% to 3.5% above the nominal rate.

However, the U.S. fiscal deficit is expected to reach some \$200 billion in the current fiscal year (October 1982-September 1983) and again in fiscal 1984. A rapid easing of credit in these circumstances could rekindle an inflationary psychology and send interest rates back up beginning with long-term rates. We can thus expect to see efforts being made to ensure a steady business recovery, even as cautious attempts to ease credit and lower interest

rates without heightening inflationary expectations continue.

Japanese interest rates will probably be lowered in response to the fall in U.S. interest rates, but by a smaller margin. Interest rate differentials between the two countries should narrow further, although the gap may close more slowly than in the past few months.

If the differentials in long-term interest rates, already down to less than 3%, should narrow further, it would greatly lessen the possibility of sudden shifts in the yen-dollar exchange rate. Barring unforeseen events on the international political scene, it is likely that foreign exchange markets will show increased interest in U.S. and Japanese current account trends. Such a state of affairs should work in favor of the stabilization of foreign exchange markets.

It must be added, however, that we cannot preclude the possibility that large amounts of funds may flow into Japan in anticipation of an appreciation of the yen. Japan's current-account surplus is likely to grow while there is concern about possible deterioration of the U.S. current account. We should not forget the existence of huge amounts of highly liquid funds seeking profitable placement in financial assets now that international monetary integration has become a reality.

Seen this way, it seems likely that while the foreign exchange market will pivot around current accounts, capital flows will reflect market psychology based on various factors of the day. For this reason, exchange rate fluctuations this year will not repeat the ¥50-60 swings witnessed in the past three years. Rather, they are likely to follow a meandering course around the ¥220-230 level, with the basic trend being toward further appreciation of the yen. ●

The Bank of Tokyo's dealing room.



Photo: Asahi Shimbun

Teruhiko Mano is the general manager of the Economic Research Division of the Bank of Tokyo.

Mano, 49, joined the Bank of Tokyo after graduating from Hitotsubashi University in 1956.

He assumed various overseas posts with the bank, including assistant manager of the New York Agency, manager of the Foreign Exchange Department of the Frankfurt Office, and general manager of the Bank of Tokyo (Switzerland) before being appointed as acting general manager of the Overseas Administration Division of the bank's head office.

He was promoted to acting general manager of the Marunouchi office in September 1981 and to his current post in July 1982.