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Japan: The Undervalued Yen— What Can Be Done

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An Intelligence Assessment

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EA 83-10016
January 1983

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An Intelligence Assessment

This paper was prepared by an independent contractor under the auspices of the Offices of East Asian Analysis and Global Issues. Comments and queries are welcome and may be addressed to the Chief, Japan Branch, Northeast Asia Division, OEA.

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This paper was coordinated with the National Intelligence Council.

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Key Judgments

Information available as of 31 December 1982 was used in this report.

During the past year or so, one of the major analytical questions underlying US-Japan economic relations has been the perplexing weakness of the Japanese yen relative to the US dollar. This paper is a summary of a study of this question done under contract for the Directorate of Intelligence by a leading authority on international finance and exchange rates.

The study draws several clear conclusions. It adds to the growing weight of expert opinion that Tokyo has not purposely "rigged" the yen to increase Japan's competitive edge in world markets. The author argues that Tokyo's mix of fiscal and monetary policies, coupled with the impact of relaxed controls on international financial transactions, produced a surge in capital outflows that increased the supply of yen in foreign exchange markets. At the same time, major international wealth managers were less attracted to yen-denominated assets—because of high real US interest rates and a general attraction to US securities as a safehaven. International circumstances, particularly the US economic environment, were reducing the demand for yen while Japanese Government policies were increasing the supply.

The study implies that Tokyo is faced with a dilemma. The Nakasone administration is committed to the same mix of economic policies that contributed to the weak yen in 1982. Fiscal policy will remain tight while the Bank of Japan tries to maintain a relaxed monetary policy. Even though interest rates will probably remain low, most forecasts suggest private domestic investment will not be sufficient to sop up the large pool of Japanese savings. This will continue to push capital out of Japan, keeping downward pressure on the yen, as yen are converted to other currencies before being invested abroad.

The study suggests that Tokyo should reexamine its mix of economic policies with an eye to absorbing internally some of Japan's excess savings. One possibility would be to have the government pump up spending to spur aggregate demand. Conventional economics suggest that this policy would also stimulate imports and reduce exports because of higher domestic demand, resulting in a diminished Japanese trade surplus and, by reducing foreigners' needs for yen, cause a continuation of higher-than-desirable

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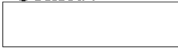

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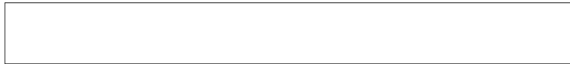
yen-dollar rates. The study argues that this does not have to be the case, because an expansionist fiscal policy could also increase demand for yen in Japan and reduce capital outflow. Indeed, in recent years, such financially motivated foreign exchange transactions have swamped trade-motivated transactions.



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Japan: The Undervalued Yen—What Can Be Done

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The Problem

A substantial appreciation of the yen is a prerequisite to reducing the disruption in the US economy and the political tensions caused by the imbalance in trade with Japan. Unless appreciation occurs, trade restraints are likely to become more comprehensive and more severe. The structure of the Japanese economy, however, is such that the country has a powerful tendency to run current account surpluses. From the overall financial standpoint, Japan's present surpluses are not troublesome. They are small in relation to the aggregate surpluses industrial countries must maintain if the developing countries are to meet their essential needs for development capital.

Nonetheless, the Japanese payments position causes grave concern to the United States and other industrial countries. Japan's competitive strength has enabled it to increase its share in industrial-country markets for automobiles, steel, and certain other manufactured goods almost as rapidly as it expanded production. The United States and Western Europe are not able to adjust the structure of production in their own economies quickly enough to avoid an extended period of loss of output and employment in the affected industries. Moreover, since mid-1981 the yen has depreciated while Japan has maintained its current account surplus. As a result, Japanese exporters are in a stronger competitive position.

Tokyo's Policy

The yen's weakness is not the result of deliberate Japanese policy. The charge that Japan is aggressively promoting undervaluation of the yen in order to maintain its large trade surplus with the United States is not well founded. The fact that the American automobile industry is demanding extension of the voluntary restraints on automobile shipments proves that the Japanese do not need a 265-yen exchange rate to be competitive in the US automobile market. The American industry complained loud enough to cause the Japanese to accept voluntary limitations when the yen rate was around 220. The Japanese do not need to cut the price of their goods if the demand for their product is so great they have to limit the quantity they sell.

The Bank of Japan did buy more than $1.5 billion to slow appreciation of the yen in January 1981, but since that time it appears to have sold $8.8 billion (through September 1982) in a vain attempt to stop yen depreciation. Since December 1981, intervention to support the yen has been frequent and substantial. The practice has not been used in an active effort to push the rate up, but only to slow or stop a further weakening. In central bank parlance, Tokyo was "leaning against the wind."

At times, however, when substantial amounts had been spent with little apparent effect, the Bank of Japan appears to have withdrawn from the market and let market pressures take over completely. At other times, most recently in late October 1982, the governor of the Bank of Japan has expressed great concern about the decline of the yen and has said the Bank would continue to try to "shore up" the yen by intervening in the currency market as well as by preventing a widening of interest rate differentials. These actions by the Bank of Japan lend credibility to frequent statements by Japanese monetary authorities that a stronger yen would be in Japan's national interest.

Some have asserted that Japanese monetary policy was being kept easy to promote yen depreciation. There has been an acceleration of the growth of the domestic money supply in 1982. Defined broadly, the money supply was rising 10 percent per year (seasonally adjusted) in the April-June period, almost twice the rate of increase of the previous three months. Narrowly defined, money was growing at an even faster rate. Consumer prices were unchanged or declining slightly during this period so that rates of growth of money in real terms were as large or larger.

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The Bank of Japan had announced a monetary annual growth target of 11 percent for the first quarter of 1982, consistent with expectations of 5.1-percent real growth and a 3.5-percent inflation rate. When growth prospects dimmed and prices leveled out, the Bank of Japan lowered the targets for the third quarter to 9 percent annually. Although these targets may not suggest a restrictive monetary stance, the posture cannot be characterized as one of unwarranted ease, given the condition of the domestic economy. The monetary stance may have contributed to yen weakness, but it appears to have been determined by the state of the domestic economy, not the desire to promote exports.

Japan's record of modifying controls over capital movements has also been cited as evidence of a longstanding Japanese policy of promoting undervaluation of the yen. The Japanese Government did "change the rules" on the capital movements a number of times during the 1970s to influence the exchange rate. In every case, however, the Japanese attempted to stop an exchange rate trend that had already produced a major rate change, and they acted to counter depreciation as well as appreciation. As with intervention, their actions were always "leaning against the wind," not aggressive manipulation. In the mid-to-late 1970s when Tokyo liberalized capital outflows to counter yen appreciation, they were acting with the full support of US authorities who were pressing for greater access to the Japanese capital market. Moreover, their current reluctance to return to capital controls to strengthen the yen is attributable in part to strong US pressure to open their capital market even further.

The Causes

The basic reasons the yen depreciated in 1982 can be summarized as follows:

- The nearly complete removal of comprehensive government controls over capital movements and the growing belief that they will not be reimposed, which have encouraged Japanese investors to build foreign portfolios.

- The existence of an interest rate differential between dollar- and yen-dominated assets that has been extraordinarily large for most of the year and remains substantial.

- Sluggish economic growth and lack of business confidence that announced government policies would stimulate revival, combined with expectations that the United States will soon resume moderate growth.

Deteriorating prospects for the Japanese domestic economy probably have played a much greater role than is usually assumed. Between 1981 and the first half of 1982 there was a swing of $5.5 billion (annual rate) in foreign purchases on the Japanese stockmarket—from an inflow of $3.6 billion to a net sale of $1.9 billion. Moreover, the decline in demand for investment funds within Japan has stimulated an outflow of Japanese capital that may be continuing even with the substantial reduction in interest rate differentials that has occurred in recent months.

Over the past decade the integration of financial markets throughout the world has increased to such an extent that trade in financial assets has come to dwarf the volume of trade in goods and services and, thus, to exert greater influence on the foreign exchange markets. The movement of exchange rates of major countries is now much more heavily influenced by the factors that affect the prices of financial assets than by those that influence the relative prices of merchandise.

There are no comprehensive data on the turnover in the combined foreign exchange markets of the world. US Treasury Under Secretary Beryl Sprinkel recently estimated the total to be more than $100 billion per day—$25 trillion per year. The International Monetary Fund has forecast total world trade in 1982 at $2.5 trillion.

The shift in the relative weights of capital movements and trade as a determinant of the exchange rate of the yen has been magnified by the fact that capital flows in and out of Japan, which were under strict governmental control in the early 1970s, have now been

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largely freed from formal governmental controls. Incomplete as they are, the data are impressive. In 1969 long-term capital transactions between Japanese residents and foreigners were less than $7 billion gross (net was $155 million). In 1981 the gross was $135 billion (net $6.5 billion). Gross volume of repurchase agreements was about $50 billion in 1981; these agreements were not permitted at all in 1969. The increase in the short-term assets of Japanese commercial banks during 1969 was less than $1.5 billion; in 1981 the increase was in excess of $38 billion. Obviously the sum of the individual short-term transactions was many times that amount. During the same period the sum of imports and exports of goods grew from $27 billion to $280 billion.

Capital Controls

The exchange rate probably could be significantly strengthened if the Japanese Government were to reimpose sharp limitations on Japanese loans to foreigners. Japanese sales of samurai bonds in 1981 were $2.6 billion; yen loans to foreigners were nearly $8 billion. If the new bond issues and new commitments of yen loans were prohibited, a significantly higher yen exchange rate might be needed to clear the exchange markets.

Going back to rigid capital controls is not a step the Japanese authorities would take lightly. US authorities have been almost as insistent on the opening of the Japanese capital market as on the opening of Japan's goods market. Under Secretary Sprinkel has assured Congress that the United States "will continue to encourage Japan to pursue the path of freer markets, both in the trade area and in the financial area."

Although they may not acknowledge it publicly, many Japanese officials would probably admit privately that the limits on the purposes for which Japanese banks could extend foreign loans and the formal quantitative ceilings on loans and samurai bonds were removed to accommodate pressure from US officials. Knowing that any increase in the opportunities to take advantage of existing financial incentives for capital outflow tends to cause further depreciation of the yen, the Japanese were baffled by the US request. Although the request was consistent with the basic American principle of free market trade, the Japanese cannot understand why it was pushed so vigorously when the immediate practical impact would be to weaken the exchange rate, worsen the bilateral trade imbalance, and aggravate the political tensions.

In any event, the Japanese have now publicly announced the liberalization measures. In his announcement prior to the summit in mid-1982 of actions to open up the Japanese goods market, then Prime Minister Suzuki included the statement that Japan would "pay due consideration to further facilitating foreign borrowers financing in the Japanese financial market." Unless the United States reversed its position, the Japanese would find it extremely embarrassing to reverse their position on the capital controls at this time.

As a long-run principle, the Japanese authorities agree with Under Secretary Sprinkel. The Japanese economy is the second largest in the non-Communist world. Its long-term growth rate is higher than that of other industrial countries and its domestic savings rate is still the highest. It makes no sense for the Japanese to be using variable quantitative ceilings on capital outflow as a standard tool for influencing the exchange rate.

Although the capital market in Japan may not be highly developed compared with those of the United States and the United Kingdom, it is large compared with the markets of other nations. The domestic market is also large in relation to the volume of international movements, even at current rates. It is logical that the Japanese capital market be accessible to borrowers in other parts of the globe. International use of the Japanese capital market cannot fully develop, however, if the government continues the on-again, off-again approach to foreign access that has characterized the past decade.

Both the securities dealers and the large banks in Japan have publicly argued against any return to exchange control restrictions. They want to develop long-term, continuing relationships with foreign borrowers. Borrowers also want a reliable source of funds. The tap has been opened and shut so frequently

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over the past few years that another shutdown would seriously damage the credibility of the market and make it difficult to rebuild.

Moreover, if US interest rates were to decline enough to wipe out the differential between the rates in the two countries, the pressure for movement of funds from yen to dollars could be expected to decline quite naturally. The Japanese would not want to gear up for a costly return to controls only to have the need for such action erased by a fall in US interest rates, as has been predicted.

Finally, the continuing rapid evolution of the institutional banking and financial system throughout the world is making it increasingly difficult to prevent capital movements when the financial incentives are large. Foreigners who have invested in Japan cannot really be prevented from withdrawing money they have brought in—not if a country wants to attract new foreign capital at some future date. Yet as the gross volume of foreign capital invested in Japan grows, the potential for sudden withdrawal also grows. Much of Japan's problem today is just that—foreign investors are withdrawing money.

Government controls could be used to block the major channels for outflow of domestic capital and to impose significant costs on other techniques for Japanese investment abroad. The greater the volume and variety of transactions, however, the easier it is for investors to evade government restrictions. Although the Japanese have a reputation as a disciplined people, leakages could be expected to be sufficient to affect the exchange rate. It would, therefore, be necessary to impose severe restrictions on virtually all types of capital flows.

In other words, it is not practical for the Japanese authorities to return to exchange controls short of a grave emergency. The question then is does the present situation constitute such an emergency? Imposing exchange controls may be the only feasible method through which an adequate degree of appreciation could be produced in short enough time to ward off the application of quantitative restrictions. The temptation to resort to trade restrictions to preserve jobs in stagnant economies is becoming increasingly irresistible the longer stagnation and high unemployment continue. The additional surge of imports of Japanese goods, which must be anticipated in the light of the exchange rates of the past six months, together with weakening domestic demand in Japan, is likely to prove too much for either US or European governments to accept.

If Japan attempted to curb capital outflows by bringing contractionary pressure on the economy to drive interest rates up, the domestic economic impact could be far reaching. Weaker growth prospects and a downward trend in the Japanese stock market could induce further withdrawals of foreign funds. Deterioration of economic prospects in Japan would tend to divert domestic production to export markets leading to even greater penetration of US and European markets.

In theory, Japan—by increasing the fiscal deficit—might be able to achieve higher interest rates without an overall contractionary effect. The new political leadership may make it possible for the Japanese to continue with a large fiscal deficit, but probably only for the purpose of injecting new domestic stimulus. Although the application of fiscal stimulus to the Japanese domestic economy would bring conflicting pressures on the exchange rate, it seems likely that reduced incentives for capital outflow would prove to be the dominant effect. Combined with a modest change in market psychology, such a reduction could have a significant effect on the exchange rate. Thus, domestic stimulus might be both in Japan's direct domestic interest and in its broader interests internationally.

Domestic growth might be the principal contribution Japan could make to easing the economic and political concerns of the United States and Western Europe in the short-to-medium term and minimizing the retreat into protectionism. The prospect of improvement in domestic economic conditions and a higher growth rate than has prevailed over the past year—even if not high by postwar standards in Japan—would alter investment psychology, reduce the net capital outflow,

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and strengthen the exchange rate. If at the same time US interest rates should decline further, the US economy revive, and fears about the stability of the international banking system simmer down, the yen rate should return to a level more in keeping with purchasing power parities.

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