The Yen's Appreciation and the Nature of Policy Debate in Japan

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On June 24, 1994, in an attempt to stem the fall of the dollar, President Clinton and Treasury Secretary Bentsen stated in no uncertain terms that the U.S. wants a stronger dollar, not a stronger yen. The U.S. monetary authorities made their presence felt in the foreign exchange market, intervening heavily in order to keep the dollar from falling further. The U.S. Federal Reserve also raised interest rates six times since the beginning of the year.

In spite of such concerted efforts by the United States, the yen-dollar rate failed to respond. This failure confirmed something very important: that the strong yen has little to do with the United States and has everything to do with Japan. After all, if the strong yen was master-minded in Washington as many were led to believe, such a clear statement from the White House should have been sufficient to turn the situation around. The fact that it didn't suggests that Washington had no bearing on the exchange rate from the very beginning, and that the causes behind the strong yen have always had their roots in Japan.

The Eighties and the Nineties

Up until the end of the eighties, the yen did not strengthen as much as Japan's mounting trade surplus had suggested. This was because Japanese institutional investors such as life insurance companies and pension funds were willingly buying dollars, absorbing the supply of dollars from Japanese exporters.

Japan's rush to acquire assets abroad started in December of 1980 when, for the first time in history, the government liberalized investment in foreign assets by Japanese investors. This period coincided with high interest rates in many foreign countries including the United States, and the subsequent rush to invest abroad by Japanese investors flooded the foreign exchange market with demand for dollars. This condition kept the yen from going higher in spite of Japan's mounting current account surplus.

In the 1990's, however, everything changed. Those investors who absorbed the supply of dollars from exporters in the 1980's have all dropped out of the foreign exchange market. There are a number of reasons for this.

First, over the past decade, Japanese investments in foreign assets have been nothing short of a disaster. It is estimated that the country as a whole suffered over ¥34 trillion ($320 billion) in foreign exchange losses since 1985. Losses of this magnitude are enough to discourage anybody from trying the market again.

Second, unrealized capital gains on domestic stocks which reached astronomical
figures in the 1980's as a result of the boom in the Tokyo stock market are all gone in the 1990's. But it was these gains that allowed Japanese investors to take so much risk abroad the previous decade. Indeed, nearly two-thirds of the above mentioned foreign exchange losses were incurred when the dollar fell from ¥240 to ¥120 after the Plaza Accord. In spite of such losses, none of the Japanese institutional investors actually posted losses at the end of those fiscal years: they were all able to realize the unrealized capital gains in their domestic stock portfolios and use the proceeds to offset losses from abroad.

Following the collapse of the Tokyo stock market in 1990, however, that luxury has no longer been available to Japanese investors. This reduction in Japanese investors' ability to take risks is forcing them to be far more cautious than they were in the 1980's.

Third, foreign interest rates have come down sharply. The fall in foreign rates has reduced the incentive for Japanese investors to go abroad.

Fourth, re-regulation of insurance companies is underway. A new capital adequacy requirement applied to banks is now being introduced. The new rule is requiring considerably higher capital provisions for investment in riskier assets such as foreign bonds and equities.

The above four developments, none of which were in place in the 1980's, are forcing investors to be much more careful when investing abroad.

Price Versus Quantity Adjustments

As though that were not enough, the Japanese government declared in February 1993 during U.S.-Japan trade talks that there will be no more agreements of any kind on quantity. The government argued that arrangements on quantity will invariably lead to managed trade. This was in sharp contrast to earlier agreements ranging from auto exports to semiconductors where there were always some arrangements on quantity.

Since there are only two variables in trade negotiations, price and quantity, when the Japanese said "no" on quantity, the implication was that the entire trade imbalance will be addressed with price adjustments. After all, free-trade is a world of price adjustments. Since the price here means the exchange rate, i.e., the yen's appreciation, no yen-based investor in their right mind would buy dollars when their own government was pushing for a stronger yen (unwittingly though it might be).

As long as the Japanese government maintains its present stance, it will be difficult for Japanese investors, who already have enough reasons not to invest
abroad, to buy dollars. In other words, it was the Japanese government's own position on trade which triggered the yen's appreciation.

In order to stop this trend, the Japanese government must come up with drastic import expansion measures sufficient to convince Japanese fund managers that the yen's peak and Japan's current account surplus is indeed behind them, that it is safe to invest abroad again.

This task is not going to be easy. Fund managers were mobilized many times in the late 1980's to keep the yen from appreciating further by the government's promises of "market opening" and "import expansion", only to incur huge foreign exchange losses. Although they could afford to take losses in the 1980's, they can no longer afford to do so in the 1990's.

Japanese investors, like the U.S. government, are looking for concrete and measurable changes in Japan's import policy. They are not likely to be satisfied with pleasantries or abstract promises. In some sense, they are harder to convince than the U.S. government because the U.S. might agree to a trade accord not because of what is in it, but because of "other diplomatic considerations" such as promise of Japanese help in various troubled parts of the world.

But it is not in the job description of investors to look after democracy in Russia or rescue famine victims in Somalia. Their responsibility is to make sure that the funds entrusted to them by the Japanese public produce reasonable returns without too much risk. This means, even if President Clinton and Treasury Secretary Bentsen are satisfied, as long as Japanese investors remain unconvinced about the trade outlook, the possibility of the yen appreciating further against the dollar cannot be ruled out.

In order to convince these investors, therefore, a results-oriented approach, such as numerical targets, might indeed be necessary. Such a target need not be the one suggested by the Americans, but it must be convincing enough so that these investors will actually part with their yen and start buying dollars. The fact that these investors have not started buying dollars means that they don't trust the Japanese government's claim that the current approach will result in a significant reduction in Japan's trade surplus. And they won't be easily fooled. As such, the real war is between the Japanese government and Japanese investors, not between Japan and the United States. The strong yen is truly "Made in Japan".

Komiya Theory
Viewed in this light, it is alarming to note that virtually every arm of the Japanese government is still geared toward increasing exports and finding domestic substitutes for imports. One is hard pressed to find any group within the government that does not subscribe to these two goals.

For example, Japan's defense agency demands that weapons, even those developed abroad, must be built in Japan under license. Japan's space agency is spending billions of dollars of Japanese tax payers' money to develop "Japanese" rockets, hoping to put it on a commercial basis at some future date. Japan's notorious agricultural ministry continues to insist on no imports of rice while trying to increase exports on everything from Kobe beef to mandarin oranges.

Each and every ministry is staffed with highly educated and qualified staff armed to the teeth with theories and arguments on why they should reduce their dependence on imports while increasing exports. The problem is that, when all of these efforts are added, there is no one left in the country to absorb selling of foreign currencies by the exporters.

Furthermore, the Japanese government is prevented from addressing the exchange rate problem and investors' concerns by an economic theory created by Professor Ryutaro Komiya, an influential former professor of Tokyo University. The basis of this theory is the usual identity, S-I = Ex-Im, where S represents savings, I investment, Ex exports, and Im imports.

In the case of Japan, the left hand side of the identity (hereafter referred to as LHS) is the portion of excess savings not invested in the domestic economy, while the right hand side of the identity (hereafter referred to as RHS) represents the current account surplus. Being an identity, the two sides must be equal. From the viewpoint of the foreign exchange market, the current account surplus (RHS) is the amount of foreign currency that exporters will have to sell on the foreign exchange market.

The Komiya theory begins with the interpretation of LHS. Professor Komiya argues that any excess savings, i.e., that amount not invested in the domestic economy, must be fully invested abroad. That requires dollars because Japanese investors cannot buy U.S. Treasuries or the Rockefeller Center with yen. This means that LHS should represent demand for dollars from domestic investors.

Because S-I = Ex-Im, demand for dollars from investors on LHS must be equal to the supply of dollars from exporters on RHS. And this must be true to the last yen. But if the demand and supply of dollars is always in equilibrium, then the trade balance cannot explain movements in the yen-dollar exchange rate.

Here lies an important conclusion of the Komiya theory: trade balances have no
influence on exchange rates. No matter how large the trade surplus might become, because demand for foreign currencies will always equal supply, it will have no net effect on the exchange rate. Furthermore, if the trade balance and exchange rate are unrelated, then the trade talks should also have no bearing on exchange rates.

This conclusion has enabled the Japanese trade negotiators, virtually all of whom are true believers of Komiya's theory, to say "no" to outside pressure to open Japan's markets with the degree of conviction that they have up to now. The theory has completely prevented them from considering the possibility that their actions might actually be pushing up the yen. After all, if they thought saying "no" would drive up the yen, they wouldn't be so determined to hold to their negotiating position.

As for the actual movements in the exchange rate, the Komiya theory states that they are essentially the result of speculative investment flows. If that is true, then the appropriate policy response would be for the central bank to intervene in the foreign exchange market. It is this line of reasoning that has prompted the Bank of Japan to spend nearly $30 billion last year and almost as much this year in an effort to stop the yen's upward spiral against the dollar.

This theory, therefore, is the basis of the Japanese government's two-pronged approach on trade issues. On the one hand, they are determined to resist U.S. pressure, believing that it will have no effect on the yen-dollar exchange rate. On the other hand, they ascribe the yen's appreciation to pure speculation and respond to this situation by intervening, without apparent limits, in the foreign exchange market.

This theory is particularly convenient in that it absolves Japan of any wrongdoing on trade disputes and instead blames the United States for fabricating issues out of thin air. The Komiya theory even goes as far as to state that trade barriers have no impact on trade balances, citing countries that have trade barriers but which are still experiencing current account deficits.

The problem with this theory is that LHS is open to more than one possibility. The excess savings of a country will not necessarily be fully invested abroad. If investors think the dollar will weaken, they will reduce their overseas investments and instead park their surplus funds in low-risk instruments such as demand deposits. In the worst case, they might simply hoard their cash under mattresses.

However, because the dollars accumulating on RHS must eventually be sold, the lack of dollar buyers on LHS will force the sellers to lower their bids until all the
dollars are sold; in effect, lowering the value of the dollar vis-à-vis the yen. Once all the dollars are sold, supply will equal demand and the equation S-I = Ex-Im will hold true.

In other words, ex-ante, the equation does not necessarily hold. To give an example, let's say Toyota and Nissan were hoping to sell their dollars at ¥120, but found no buyers at this level. Since they had to accept whatever the market would bear, e.g., ¥100 to the dollar. Thus, ex-post (after the adjustment to the exchange rate is completed), RHS equals LHS.

If by chance RHS and LHS are equal ex-ante, the exchange rate will remain stable. But if the value of RHS ex-ante is greater than LHS, the yen will strengthen. Conversely, if the value of LHS ex-ante is greater than RHS, the yen will weaken. In the event the government is concerned about exchange rate fluctuations, the central bank need only intervene to make up which ever side is smaller.

Furthermore, LHS is not completely independent of RHS. If investors think the trade surplus will continue to expand, they will be cautious about investing abroad for fear the yen will appreciate further against the dollar, and vice versa. Even though many Japanese investors conveniently ignored the direction of the trade balance during the 1980's, that oversight cost them $350 billion in foreign exchange losses in the end. They are determined not to make the same mistake again.

What is worrisome is that the Japanese trade negotiators, so smug in their belief in Komiya's theory, seem completely unaware of the perspective of investors. They don't realize that their intransigence toward market opening may be scaring investors away from investing abroad. But without the counterbalancing demand for dollars that these investors provide, the yen will continue to rise as long as there is a current account surplus.

All of the bureaucrats sitting on Japan's side of the negotiating table are graduates of Tokyo University, and all of them are unwavering believers of the Komiya theory. Indeed, many of them studied under Professor Komiya. Furthermore, as a professor of economics at the prestigious Tokyo University, Professor Komiya has dominated academic thinking on trade issues in Japan for the last two decades. Arguing against his view is considered by many people in Japan as nothing short of blasphemy and academic suicide. Professor Komiya is currently the head of MITI's research institute, yielding considerable influence from within the government.
For all practical purposes, therefore, the Komiya theory is more than an academic theory; its influence on Japan's policy makers has almost religious overtones. And like so many religions in the world, it has to be fully discredited before a new idea is accepted. All this suggests that major changes in Japan's trade policies are still a long way off.

Trade Policy and Stages of Economic Development

Taking a slightly longer perspective, the problem Japan faces today can be viewed as a result of the failure to adjust trade policies to match Japan's economic development. Viewed in this way, one notices that there are basically two types of countries in the world. Those with competitive export sectors and open domestic markets, and those without competitive export sectors and relatively closed domestic markets. Those in the former group are usually called developed or industrialized countries, and those in the latter group are generally called developing countries.

And there is a good reason for the distinction. A developing country suffering from a chronic shortage of foreign exchange will want to make sure that the limited supply of foreign exchange available is put to good use. These countries typically have barriers to general imports in order to allocate the limited supply of foreign exchange for machinery and other needed imports.

When the expert sector of an economy achieves international competitiveness and the country begins to accumulate large current account surpluses, however, the country must change its course by doing two things: open its domestic market to imports and allow domestic investors to invest abroad. Without these two steps, foreign exchange earned by exporters will have no takers at home. Since exporters cannot pay their domestic employees in foreign currencies, their demand for the home currency will push it even higher.

This process will continue until the demand for foreign currencies matches the supply, that is, when the country’s trade imbalance is eliminated. If the domestic market remains largely closed, the imbalance can be eliminated only when exporters are priced out of the world market, i.e., when exports collapse to the level of imports. Today's industrialized countries have opened their domestic markets to imports precisely because they wanted to avoid such a prospect.

Japan's export industries achieved international competitiveness by the late 1970's. The government responded by promptly deregulating capital movements across national borders in December 1980. What it forgot to do, however, was to open the domestic market to imports.
Helped by higher interest rates available abroad, the deregulation of capital flows in December 1980 unleashed a buying spree of foreign assets by Japanese investors and kept the yen weaker than suggested by Japan's trade performance. This allowed already highly competitive exporters to do even better, resulting in an explosion in Japan's trade surplus.

The problem with this situation was that when those countries receiving Japanese investments tried to export their goods to Japan, they found that the Japanese market was largely closed to them. This meant that they could not pay back those investors in yen because they were unable to earn yen by exporting to Japan.

But as long as Japanese investors continued their foreign purchases, the appreciation of the yen was held in check. Once those purchases stopped, as has been the case since the collapse of the Tokyo stock market in early 1990, all hell broke loose.

If this trend is left unchecked, Japan's best industries, the manufacturers, will have no choice but to move abroad. This will leave the least competitive industries in Japan, such as rice farmers, which have been protected by various import barriers.

The moral of this story is that if an investor's country has a highly competitive export sector and its domestic market is largely closed to imports, that investor should not invest abroad because the currencies of those countries receiving investment cannot appreciate against the investor's home currency.

In retrospect, the deregulation of capital flows in December 1980 and the subsequent rush to invest abroad postponed by many years the yen's inevitable appreciation and widened the trade imbalance that much more. In effect, Japanese investors were subsidizing Japanese exporters by keeping the yen artificially low.

The U.S. and U.K. Experiences

There was a time in history when the United States and the United Kingdom also ran large and persistent current account surpluses. The difference between those two countries and Japan today is the fact that both the US and the UK opened their markets to imports at the time they were running large surpluses.

As a result, those countries that received U.S. investments after World War II, such as Western Europe, Japan and Taiwan were able to export their way out of their debt by selling goods in the U.S. market. Thanks to the U.S. market, these countries not only grew rapidly, they also managed to turn their initial trade
deficit problems vis-à-vis the United States into surpluses. In the process, the asset prices and currencies of these countries appreciated rapidly, bringing in huge returns to these countries.

The success of U.S. investors in Japan and the failure of Japanese investors in the United States is simply due to Japan's failure to open its democratic market. Japan is suffering from a strong yen precisely because it has forgotten to open its market to exports. Now that Japanese investors are beginning to realize what they are up against, they will be even less inclined to buy dollars in the future.

Purchasing Power Parity

Another way of looking at this same phenomenon is from Purchasing Power Parity (PPP). There has been much talk about the vast discrepancy between the yen's actual exchange rate relative to its PPP. In fact, many investors both in Japan and elsewhere have bought dollars and sold yen in anticipation of the yen weakening to the level of its PPP. All of these investors are now facing huge foreign exchange losses.

Although the yen is clearly overvalued in terms of PPP, for the PPP to provide a reasonable guide to the exchange rate, one condition must be met: that country's market is reasonably open to imports so that the arbitrage opportunities created by the exchange rate deviating from its PPP can be exercised by importers and exporters. In other words, demand for imports should increase in a country where the exchange rate is overvalued relative to the PPP. The increase in demand for foreign currencies stemming from the increase in demand for imports should bring the home currency back to a level closer to its PPP.

Viewed from this perspective, one notices the extreme difficulty foreign manufacturers are facing in penetrating the Japanese domestic market where a large portion of retail industry is dominated by established domestic manufacturers. Under such circumstances, the supply of foreign currencies earned abroad by the exporters will meet a very limited demand for foreign currencies from the importers. The net result will be a strong currency well beyond anything that resembles PPP.

In other words, the yen is strong precisely because imports are not coming into Japan in sufficient quantities. And unless this condition is rectified, it makes no sense to talk about the PPP with regard to the Japanese yen.

Whether the yen will continue to defy the PPP or come to terms with it all depends on the extent of market opening measures by the government and
industry. If those measures remain marginal, as they have up to now, there is no reason to expect the yen to come anywhere near its PPP levels anytime soon.

A National Crisis

As a stop-gap measure, the Bank of Japan has been buying dollars heavily through foreign exchange interventions. In 1993, the Bank of Japan added $26.5 billion to its foreign exchange reserves, the largest addition since 1986. In 1994, the Bank of Japan purchased a total of $18.0 billion up to August. In addition to official interventions, it is said that public sector institutional investors are also mobilized to provide demand for dollars. In some sense, therefore, it is the taxpayers who are now being mobilized to subsidized the exporters. But this cannot go on forever.

The current situation is nothing short of a national crisis, and the boldest market-opening measures must be taken to reverse the trend. The strong yen is the logical conclusion of an economy composed of a highly competitive export sector and a largely closed domestic market. The massive foreign investments of the 1980's were able to postpone the inevitable, but could not stop it. Global capitalism has finally caught up to Japan.

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