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Japan's Enigmatic Coexistence of Strong Currency and Trade Surplus

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Abstract

This paper shows that the economic policies of the US and Japan have led to disequilibrium in the pattern of trade. Both economies have built-in mechanisms tending towards equilibrium. However, with restrictive policies imposed by these countries, disequilibrium is perpetuated. The US "suffers" a trade deficit, while Japan "enjoys" a trade surplus. Although a trade surplus has a positive connotation, the prevailing strong yen hurts the Japanese economy. With a more integrated world, countries can no longer be concerned solely about their own economies. The recession in Japan is partially caused by this large imbalance in trade since the strong yen is driving out many Japanese businesses that can no longer compete. The large government deficit in the United States will also affect the exchange rate and the rest of the world, since the possibility of a default may raise the interest rates as well as the level of uncertainty. Countries must cooperate with each other in order to allow the world economy to reach its equilibrium. Intervention policies require that the citizens in each country actually trust that governments are committed to resolve the enigma of the strong Yen (**endaka**). Without strong conviction by the public that the policy would be seriously implemented, the exchange rates will not change in the desired direction.

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1. Introduction

The exchange rate between the dollar and the yen has been a much discussed topic ever since the great appreciation of the yen, which started in 1985 after the Plaza Announcement, accompanied by a large trade surplus for Japan. International financial theory predicts that a strong currency and a current account surplus cannot coexist indefinitely. Because as the yen appreciates, American imports to Japan should increase and Japanese exports to the United States should decrease. Thus, this process will eventually eliminate Japan's current account surplus. This paper will examine some of the reasons why Japan's strong yen and trade surplus have coexisted for so long.

2. The Puzzle

In 1985, the United States, facing an appreciating dollar, called for a meeting at the Plaza Hotel in New York City where the G 7 nations coordinated to lower the value of the dollar (Putnam and Bayne, 1988; Obstfeld, 1990). The United States was suffering from a trade deficit of \$122 billion and a Current Account deficit as well (Howard, 1989). Certainly, the theory predicts that a depreciation of the currency will reduce the balance of payments deficit. What is difficult is to determine how much the dollar has to depreciate to wipe out the trade deficit. Depending on the elasticities of exports as well as imports, the problem may be solved with a slight depreciation of the dollar. However, in 1985, Edward Mervosh in Business Week argued that the dollar must depreciate considerably more than the policy makers had expected in order to balance out the trade deficit. Ever since then, almost every article that has been written on the exchange rate between the dollar and the yen has blamed the large Japanese trade surplus.

3. Barriers to Trade: Japan

One reason the adjustment process has been slow is that there are barriers which block the natural flow of goods, services, and capital. While theories assume these items can move freely, in reality,

many nations including the United States and Japan make restrictions on their movement, some less explicit than others. Although the Japanese government passed the New Foreign Exchange and Foreign Trade Control Law, in December of 1980, there are still impediments for foreign direct investment. Since many Japanese companies own interlocking shares, it is more difficult for foreigners to invest in Japan (Ito, 1992, p.320). In addition, the constantly fluctuating exchange rate makes it even harder for capital movement because of a high level of uncertainty.

Industry and trade policies also adversely affect adjustment processes because they lead to inefficient allocation of resources. In Japan, the Ministry of International Trade and Industry (MITI) uses four basic policy tools. First, it can use specific laws aimed at specific industries, such as providing tax incentives. Second, the Foreign Exchange and Foreign Trade Law protects targeted industries from foreign competitors through government regulations. The third is **Gyoseishido**, or administrative guidance, which is governmental advice for the private sector. Although it is not legally binding, companies must obey MITI to avoid possible punishments. Lastly, subsidized loans by government organizations such as the Fiscal Investment and Loan Program and Japan Development Bank are used.

4. Barriers to Trade: The United States

Although Japanese policies are well known, the United States also has protectionist industry policies. Fred Bergsten and Marcus Noland (1994) list such measures as tax incentives, foreign aid tied to procurement of American products and military sales credit, input subsidies, R&D subsidies, and the Buy American Act which distorts consumption pattern. They claim that industrial policies are welfare reducing because they shift resources from high to low productivity uses (Bergsten and Noland, 1994, p. 69).

Trade policies also have adverse effects on patterns of trade. A nation can protect an industry by imposing a tariff or by using other Non Tariff Barriers (NTB's), such as import quotas, voluntary export restraint, and structural restraints as in the Japanese distribution system. Japan and the United States have tried unsuccessfully to reach an agreement on trade barriers over many years.

The United States often asks for a greater share in the Japanese market, demanding specific

target numbers. In 1988, the Omnibus Trade and Competitiveness Act was passed aimed primarily at Japan. This act, which includes the Super 301 Clause, allows the United States Trade Representative (USTR) to name countries as unfair trading partners and to retaliate after unsuccessful negotiations. This strategy has been used in the past, usually over the automobile and automotive parts, the most recent example being the Japanese luxury car incident. Some argue that the Super 301 Clause is a violation of the multilateral trading frameworks such as the General Agreement on Tariff and Trade (GATT) or the World Trade Organization (WTO) because it is based on unilateral judgement by the USTR. Others think that it produces a credible threat to Japan and would open the Japanese market.

5. Informal Barriers to Trade

In addition to the welfare costs to society due to inefficient resource allocation, restricted financial and trade movements perpetuate disequilibrium. When the yen is strong, there should be a large increase in the imports in Japan. This in turn should increase the demand for dollar, leading to its appreciation. However, Japan is notorious for its rather closed market, and therefore Japanese imports do not increase by as much as would be predicted from the strong yen.

Even when Japan imports American products, the price advantage of the strong yen is often not reflected in the Japanese market. Sheryl WuDunn (1995) of The New York Times warns that the prices in Japan have not decreased to induce greater demand for imports, which is crucial to restoring the value of the dollar. Most companies, American or Japanese, do not pass on the low price to the consumers. This phenomenon is called Hysteresis, a situation when there is a resistance to change from the status quo (Baldwin, 1988).

While the exchange rate does not reflect the import prices in Japan as fast and as much as the adjustment process requires, it also does not reflect the export prices in dollars either. In addition, many Japanese companies try to keep the prices in the United States as competitive as possible to retain market share, incurring losses. Another reason the pass-through is incomplete is due to the existence of lags. Because the export prices do not change as fast as the import prices, with minimal change in the volume, an **endaka**, or strong yen, leads to a deterioration of the balance of

trade for the United States initially. The low pass-through rate causes an inverted J-curve (Meade, 1988; Dilip, 1993).

The balance of trade between the United States and Japan deteriorated because the Japanese exports did not fall (and imports did not rise) in proportion to the amount of the appreciation of the yen. Whenever there has been an agreement on the trade issue, the yen falls in value in the foreign exchange market, since the people predict that the more open market will allow more imports that help the yen go down. For example, in May, 1994, the yen depreciated a little, from 100 to 107 yen per dollar. The opposite news, that the trade talks were a failure, led to a depreciation of the dollar to 98 yen per dollar by August 1994.

Since the Japanese exporters are hurt by the strong yen because they have lost competitive pricing capabilities, many of them have moved abroad for production. Producing in Japan is no longer a competitive choice since labor is very expensive. To compete in the international market with a strong yen, the Japanese companies must reduce costs to avoid any further loss. While they would prefer to stay in Japan for nationalistic reasons of providing jobs and protecting technological advantage, they are now being forced to leave the country. Many “Japanese” products are no longer “Made in Japan.” Since less Japanese products will be exported from Japan, the demand for yen decreases, driving the yen to fall (Koo, 1994, p. 14-22). Less exports will lead to a balanced trade with the United States, however, under these circumstances, there will still be a Current Account imbalance. Since the profits made by Japanese companies in the United States will be included in the Japanese Current Account as a net income from abroad, the change in exchange rate will not improve the balance of payments as much as the United States would like.

Another interesting effect is that Japan will experience **kudoka**, or the process of becoming “empty.” This new topic is a hot debate in Japan now, since many Japanese are concerned that the good and profitable, and therefore employment-driving, industries are leaving the nation, while protected industries that are inefficient, such as agriculture, remain in Japan (Koo, 1994, p. 236-244). The nationalists view this process as unfortunate, while others think that this is an extension of specialization that is to occur in a better integrated world. Japan tries to maintain the most sophisticated technological processes in Japan, while production that requires less skilled labor takes place abroad. The attention this topic is receiving in Japan may provide more incentive for

politicians and bureaucrats to open the Japanese market more than they would otherwise be willing to do. This, in turn, may alleviate the **endaka** problem.

Under the managed float, nations can intervene by buying or selling a large amount of a currency to maintain a desired level of the exchange rate. When the yen is too high, the Bank of Japan can buy dollars and thereby sell yen, or the Federal Reserve can buy back dollars and sell yen. According to the theory, when Bank of Japan purchases dollars without sterilization, the money supply in Japan increases through the bank multiplier, which then decreases the interest rate. This leads to capital outflow, with more Japanese people demanding the dollar to invest in the United States. Imports increase as well, because of an increase in the money supply. This increases demand for the dollar, allowing the yen to depreciate.

In addition, the supply of dollar in the foreign exchange market decreases at the same time because the low interest rate does not attract American investors. This adjustment process should improve the Current Account balance, but with so many restrictions at various steps of the process, the demand and supply curve shift will be delayed. The perpetuated disequilibrium leads to much speculation and uncertainty, which makes the rates fluctuate even more, repeating this cycle.

With intervention policies, it is important that the people actually believe that both nations are committed to fix the problem of the **endaka**. Without a cooperative and convincing policy, the exchange rates will not move in the desired direction. In 1987, for example, only two years after the Plaza Announcement when the concern was a strong dollar, the United States was puzzled by the weak dollar. The government could not come up with a good plan, so the dollar reached 144 yen per dollar from 238.54 yen per dollar in 1985. This was monumental since many thought in 1985 that the trade deficit would be effectively eliminated once the dollar reached approximately 200 yen per dollar (McNamee, 1987).

In August 1995, in contrast, the three central banks, Bank of Japan, Bundesbank, and the Federal Reserve acted firmly against the strong yen that reached its all time high of 79 yen per dollar in April. The weak dollar was hurting the already depressed Japanese economy as well as the German economy, which in turn can hurt the U.S. economy through foreign repercussions. The Japanese Ministry of Finance announced a large scale intervention of trillions of yen, selling the yen and buying the dollar. With the elections coming up, Washington also became interested in

intervening to shrink the notorious trade deficit. This credible strategy proved effective. The dollar appreciated 24 percent to 98 yen per dollar, and the Japanese trade surplus also decreased by 23 percent (Bremner, 1995).

As discussed above, various intervention policies helped restore the value of the dollar, which may help the economy out of the depreciating-dollar-spiral. However, the excess demand for yen (or conversely the excess supply of the dollar) still exists. One concern is that Japan, which needs to open up its market, may no longer feel the pressure to do so, since the trade surplus decreased in dollar terms due to a depreciation of the yen. Japan must restructure itself in a changing economy, where the strong yen is driving out Japanese competitiveness in the international market. The heavily protectionist policies will no longer be acceptable for a strong economic power with a large surplus.

6. Summary

In summary, this paper has shown that the economic policies of both the United States and Japan have led to a situation of disequilibrium in the pattern of trade. Both economies have built in mechanisms to balance themselves towards equilibrium. However, with restrictive policies imposed by countries, disequilibrium is perpetuated. The United States “suffers” a trade deficit, Japan “enjoys” a trade surplus.

Although a trade surplus has a positive connotation, the prevailing strong yen hurts the Japanese economy. With a more integrated world, countries can no longer be concerned solely about their own economies. The recession in Japan is partially caused by this large imbalance in trade since the strong yen is driving out many Japanese businesses that can no longer compete. The large government deficit in the United States will also affect the exchange rate and the rest of the world, since the possibility of a default may raise the interest rates as well as the level of uncertainty. Countries must cooperate with each other in order to allow the world economy to reach a global equilibrium.

Intervention policies require that the citizens in each country actually trust that both governments are committed to resolve the enigma of the **endaka**. Without strong conviction by the public

that the policy would be seriously implemented, the exchange rates will not change in the desired direction.

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