

Weak Yen Conundrum

*Why Japanese households love
foreign financial assets.*

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Did it fall or was it pushed? The recent decline of the yen has led to speculation among non-Japanese observers that the Japanese government is orchestrating the currency's fall. However, yen depreciation is not a specific policy target. Rather, it is an inadvertent and inevitable result of a series of snowballing factors that can be traced back to the Bank of Japan's post-bubble monetary easing. The Ministry of Finance completely stopped its currency intervention practices in the spring of 2004.

In February 1985, just before the Plaza Accord was agreed, it cost 260 yen to buy one U.S. dollar. By April 1995, the Japanese currency had strengthened to 84 yen to the dollar—a gain of 211 percent. The currency has since reversed course, sliding back to 117 yen to the dollar as of November 2006. At face value, the yen depreciated by 29 percent over the past eleven-and-a-half years. However, during the same period, U.S. consumer prices increased by 33 percent, while Japan's consumer price index declined by 0.3 percent. In other words, relative prices in Japan came down by 25 percent compared to the United States. When the diverging inflationary trends are taken into account, the yen's real depreciation *vis-à-vis* the dollar between April 1995 and November 2006 was 46 percent. (In terms of the real trade-weighted exchange rate, the depreciation was 39 percent.)

Why has the yen weakened since 1995? The biggest drag on the currency was the Bank of Japan's monetary easing. Ten-year Japanese government bond (JGB) yields peaked at 7.5 percent in 1990—the height of the nation's real estate and stock market bubble. The yield fell below 1 percent at the end of 1998 and

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has hovered around 1.5 percent during the following eight years.

Similarly, the Bank of Japan's target overnight call rate, which peaked at 6 percent in 1990, had collapsed to zero by 1998. The target rate remained at zero until mid-2006, except for a brief period in 2000 when then Bank of Japan Governor Hayami tried unsuccessfully to raise rates. Japanese interest rates have been held close to zero—an unprecedented low—for nearly a decade.

The Bank of Japan undertook drastic steps to lower interest rates to save domestic banks and non-financial companies after Japan's bubble burst. Easing the interest-payment burdens of those entities was the most effective measure to rescue them.

The victim of this policy was the household sector. Their interest income was wiped out. After peaking in 1991 at 39 trillion yen in returns from 600 trillion yen in interest-bearing financial assets (mostly bank deposits), households' interest income has nose-dived to less than 5 trillion yen from 860 trillion yen in interest-bearing assets.

The redirection of households' interest income supported Japan's corporate restructuring and helped banks to write down and write off their glut of bad loans. Companies and banks were nursed back to health at the household sector's expense. Not only was their interest income erased, corporate restructuring also kept a lid on wage increases. (Globalization, which opened the door to abundant cheap labor in countries such as China, also constrained wage growth). Consumers' purchasing power has weakened as wages remained flat, interest income was lost, and the yen weakened. Thus, despite the fall in the household savings ratio from 15 percent in 1991 to 2.5 percent in 2006, Japanese consumption has been stagnant for more than a decade.

Zero interest rates also triggered a significant change among Japanese savers. An increasing number, who had

traditionally favored domestic bank deposits, are now looking abroad for better returns.

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Foreign bond funds came next. These funds were attractive not only for their higher yields, but also for their unique monthly dividend-payment schedule. This ingenious payout structure is particularly attractive to retail investors, who often require supplemental monthly income. In addition, deregulation made foreign bond funds—originally sold only by stockbrokers—easier to buy. Sales increased rapidly after banks were allowed to offer the funds.

Individual investors' latest foray into overseas markets is through foreign-exchange margin trading. Retail investors are now able to easily profit from global interest-rate differentials thanks to evolution in the foreign-exchange market. Take the yen-dollar rate spread of 5 percentage points. With 10 times leverage, retail investors can realize at least 50 percent annualized returns, assuming the exchange rate remains stable or the yen weakens. Such transactions are all the more attractive because of cheap trading costs.

In Japan's currency market, retail investors are believed to originate more than half of daily transactions. This shift of household savings from domestic bank deposits to overseas assets (foreign currency deposits, bond funds, leveraged currency trades, etc.) is now the biggest factor weighing down the yen.

Japanese households have some 1,500 trillion yen—triple the size of Japan's GDP—in financial assets (including the 860 trillion in interest-bearing instruments). The 15 trillion yen flowing overseas is just 1 percent of the total. Comparatively, Japan's current account surplus is less than 20 trillion yen. An important differ-

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An Overseas Party

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ence between households' capital outflows and those of institutional investors is that households don't have to worry about financial accounting, reporting calendars, or obligations. They can, in principle, hold onto positions indefinitely. Should this capital outflow accelerate, it will be very difficult to rein in.

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8.8 percent in the second quarter of 1995 to 16.5 percent in the third quarter of 2006. The latest figure exceeds the previous post-war high of 15.3 percent reached in the fourth quarter of 1984.

Though large companies and banks have revived, small companies—which account for three-quarters of employment—have yet to bounce back. As small companies are predominately domestic-demand oriented, they would do better with a stronger yen, say, by reducing their import costs. To bolster the yen, interest rates should

be raised. Higher interest rates would also revive households' interest income. Greater household earnings would enable a pick-up in consumption: another benefit to small companies. However, the Bank of Japan has maintained its ultra-low interest rate policy, even though it has already served its original purpose of propping up banks and companies.

The extended zero-interest-rate environment has raised another problem—an additional liquidity surplus. Companies are extremely pessimistic about the prospects for domestic demand. Therefore, despite the increase in profits, they are reluctant to make any capital investments that are not tied to exports. The robust corporate profit growth with no accompanying domestic expansion has created a large pool of liquidity. This excess liquidity has led to two negative developments for Japan.

One is a surge in speculative real-estate activity. Even though Japan's population is projected to decrease by 30 percent in fifty years, aggressive real estate investment is taking place in both the commercial and residential sectors.

The other is an overactive yen carry trade. By borrowing yen with near-zero financing costs, hedge funds and private equity are chasing stocks, commodities, currencies, and real estate both inside and outside of Japan. Recent events in Thailand illustrate the negative trend. A huge inflow of capital, in the form of stock purchases by foreigners—most probably funded by yen carry trades—

pushed up the Thai baht, thus damaging the competitiveness of its export industry.

The Bank of Japan reduced interest rates to zero by increasing the monetary base, the aggregate of bank notes outstanding and current account deposits by banks. This forms liabilities on the central bank's balance sheet that match its assets, which are dominated by JGBs. With negligible interest rates on deposits, many savers have increased cash holdings. As a result, bank notes in circulation have increased from 40 trillion yen in 1995 to 75 trillion yen currently. That 35 trillion yen rise is equal to 7 percent of GDP.

Meanwhile, current account deposits increased from 4 trillion yen in 1995 to 35 trillion yen at the beginning of 2006. (These fell below 10 trillion yen after the Bank of Japan abandoned its quantitative-easing policy in March last year.) The rise in the Bank of Japan's liabilities to roughly 70 trillion yen by early 2006 was balanced by an increase in its holdings of JGBs. Such holdings increased from 30 trillion yen in 1995 to about 100 trillion yen at the end of 2005. The Bank of Japan managed to do this by underwriting 400 billion yen per month of new long-term JGB issues in 1997, and gradually increasing the monthly underwriting total until it reached 1.2 trillion yen by October 2002. The practice used to be taboo because of the spike in inflation in postwar Japan caused by such underwriting during the war.

The Bank of Japan desperately needs to get its house in order since the risk of severe monetary inflation is so high. The current monetary base of 86 trillion yen, or 17

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percent of GDP, is too large. Normally, the figure should be roughly 7–8 percent of GDP. Thus, long-term bond holdings should be eliminated and interest rates (short and long) be normalized. For the economy to achieve growth of 2–3 percent annually, short-term rates of at least 2–3 percent and long-term rates of 3–4 percent are

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necessary. This would not be an interest-rate hike in the conventional sense, but instead a normalization of the level of interest rates.

Household interest income would then revive and consumption start to rebound. As corporate sales begin to pick up, companies will be able to lift wages. Until a consumption-led economy emerges, Japan will continue to rely on exports and remain vulnerable to a global economic slowdown.

However, that is unlikely. The current government, led by the Liberal Democratic Party, will continue to oppose any move by the Bank of Japan to raise interest rates and the central bank is not strong enough to resist such pressure. They believe higher interest rates will cause problems for the corporate sector as well as government deficit financing. Moreover, yen appreciation would hurt large manufacturers.

As long as the Bank of Japan fails to lift interest rates, households' capital outflow will accelerate and further weaken the yen. Continued yen depreciation will eventually lift market rates, particularly yields on JGBs. Alternatively, as the global economy weakens, Japan's exports will plunge. That will push down capital expenditure and the economy will enter a recession. Then politicians will probably call for a renewed increase in government spending, creating a bigger budget deficit, while the resulting increase in JGB issues will raise bond yields.

Either way, long-term interest rates will pull up short-term interest rates. This creates a curious conundrum. Rising interest rates usually strengthen the yen. Yet given that failed economic policy led to this particular market-driven interest-rate hike, it is not clear whether the yen would strengthen or weaken. ♦