YEN FOR A STRONGER YEN

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The significance of the role the Japanese yen plays in East Asia can scarcely be exaggerated. The importance the currency commands has much to do with the fact that Japan is the largest economy in East Asia and the second largest in the world. More specifically, Japan matters a lot to East Asian economies as one of the largest trading partners and one of the biggest sources of foreign direct investment. For some, Japan is also a major donor country, and for some others it is a major creditor country with yen-denominated loans running into billions, while Japanese yen has also been a major reserve currency for some.

To a considerable extent, the stability of regional currencies has been dependent on the stability of the yen in the foreign exchange market. In this sense, a strong and stable yen is good for other currencies in the region. A strong yen would mean more exports to Japan. It would also mean more tourist flows from Japan. And, what's more, it would mean more investments from Japan. Indeed, many countries in East Asia have benefited greatly from the strong yen after the Plaza Accord in 1985.

Prior to the Plaza Accord, the exchange rate for the yen was around 240 against the US dollar. After the historic currency realignment, the yen grew stronger and stronger, albeit with considerable volatility, reaching a peak of about 80 yen to the dollar in 1995. No doubt, the strong yen was hurting Japanese manufactured exports, which forced Japanese companies to go offshore in a big way, in an attempt to protect the market share of Japanese manufactures in the world market. Malaysia was a major beneficiary of this massive investment flows out of Japan, as more and more Japanese companies began to base their export-oriented operations abroad.

To Japan, the strong yen proved to be both a boon and a bane. It was a boon, as it boosted the purchasing power of the yen, resulting in enormous terms-of-trade gains. Although Japan's exports of finished goods suffered a loss of competitiveness as a result of the strong yen, the slack was taken up by increased exports of intermediate products to East Asia. The strong yen was a bane to the extent it caused a massive diversion of resources to speculative activities. A case in point was the powerful wealth effect driving property prices to dizzy heights, with disastrous financial consequences for the Japanese economy. Obviously, Japan has had difficulties in managing its meteoric rise.

Japan is yet to recover from the trauma, which calls for major banking reforms, deregulation and structural adjustments, which are politically painful to bring about. Since 1991, the Japanese economy has been stagnating, punctuated with negative or sluggish growth. It is in this sense that the nineties was a lost decade for Japan. The Japanese economy has been slumbering for too long. To stimulate the economy, interest rates have been driven down perilously close to zero without much impact. On the fiscal front, tax rates have been slashed, to lift up consumer and investment spending, again without much impact, prompting substantial increases in public spending through budget deficits and stimulus packages. All this notwithstanding, the Japanese economy remains sedated.

There are fears in the region that Japan would deliberately cheapen its yen so that it can export itself out of the doldrums. The logic for this is simple. Monetary policy is not working, as the economy is caught hopelessly in a liquidity-trap situation, while fiscal policy has been stretched dangerously to the hilt, with soaring public debt, one of the highest in the world. Hence the temptation to activate an exchange rate policy that would make Japanese exports competitive and divert demand away from imports to domestic products.

One must hasten to add that there is no evidence to suggest that Japan is consciously driving the yen down. The weak yen may simply be reflecting the economy's weak fundamentals. Last summer, the yen was actually appreciating against the dollar from about 125 to 120. Soon after September 11 last year, the yen strengthened further to a high of 115 yen to the dollar before falling to a 39-month low of nearly 135 yen to the dollar in January, down about 15 per cent.

It is not difficult to argue that all this is unsurprising for an economy that is stuck in a recession, fourth in a decade. Industrial output plunged 15 per cent in December year-on-year, the sharpest drop in 26 years. Unemployment in Japan increased to 5.6 per cent in December, the highest since 1953. It appears that the worst is not over for Japan, as many economists expect unemployment to exceed 6 per cent this year. The ballooning national debt, equal to about 130 per cent of national output, is particularly worrisome, as it will erode Japan's sovereign credit ratings. If the problem is not reined in quickly, the prognosis for the yen may well be unflattering indeed.

Japan's neighbours are understandably nervous about the weak yen, as it will eat into their own export competitiveness. This is not to deny that some firms would benefit from cheaper imports of components and parts from Japan. Nevertheless, the net effect of a weakening yen will doubtless be negative for East Asia. A weak yen will mean less exports, less tourist inflows and less foreign direct investments for these countries. Economies, which compete directly with Japan, are particularly vulnerable. South Korea and Taiwan, with an export structure somewhat similar to that of Japan, are deeply concerned. China, too, is quite uptight. There are fears that, if the yen depreciation is not arrested, there will be pressures on other regional currencies. The implications are particularly severe for those currencies which are pegged, like the Chinese yuan, the Hong Kong dollar and the Malaysian ringgit.

The Malaysian Prime Minister has recently remarked that the ringgit peg may have to be reviewed if the yen were to slide beyond 140 against the dollar. The trigger point may differ across currencies. China may have a higher tolerance level, as its capacity to make internal price adjustments in the wake of external pressures is significantly higher than that of some others in the region. Some observers are of the view that China may devalue its currency if the yen/dollar rate were to breach 150. Herein lies the danger of unleashing the forces of beggar-thy-neighbour competitive devaluation, which will bring nothing but disaster to the region.

Mercifully, the fears about the yen may well be apparent rather than real. Japanese officials are quick in denying any existence of a deliberate "cheap yen" policy. They are not unaware that a cheap yen is no panacea for the country's economic woes. It is certainly no substitute for structural reforms. Besides, a weak yen would increase the cost of imports into Japan, which is dependent on raw materials and oil imports. A saving grace is that Japan's external reserves are huge to the tune of over US$400 billion. What is more, Japan has accumulated about US$1trillion in overseas assets, which bring home annually an investment income of over 6 trillion yen, accounting for roughly 1.3 per cent of the national income.

It is not in the interest of Japan or the rest of East Asia to let the yen slip beyond 130 per dollar, which appears to be a fairly comfortable level in the near term. It is estimated, in purchasing power parity (PPP) terms, that one dollar is equivalent to only 110 yen in the traded sector and 160 yen in the non-traded sector (which incidentally shows how inefficient Japan's non-traded sector is). Japan has the means to intervene in the foreign exchange market to arrest the slide and stabilize its currency. To be sure, it has intervened in the past when the yen was "too strong" or "too weak". The last big intervention, with a US$ 20 billion tag, was in 1998 when the yen was hovering in the region of 147 against the dollar. One may wonder if that is the bottom line the next time around as well.

Be all that as it may, in the final analysis, it is fundamentals, not interventions in the foreign exchange market, which will guarantee the strength and stability of any currency. Seen in these terms, the sooner Japan puts its house in order, the better, not only for itself but also for the region as a whole. To be more specific, Japan must tackle structural reforms in three areas, namely banking, deregulation and fiscal consolidation. Cheap yen hardly has anything to do with any of these.