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Swift BOJ action needed to check yen's sharp rise

Central bank ought to take aggressive forex, other measures amid growing economic risk, threat of currency's strength crushing exports

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In his most recent speech, U.S. Federal Reserve Board Vice Chairman Donald Kohn said the Fed has learned that the aftermath of a bubble can be far more painful than it imagined, going on to carefully examine alternative strategies for monetary policy to deal with asset price bubbles. However, he did not specifically discuss the potential role of foreign exchange rates in the aftermath of a bubble in supporting aggregate demand through their influence on exports.

In fact, a number of Organization for Economic Cooperation and Development countries that suffered domestic asset market declines in the late 1980s or early 1990s experienced large currency depreciations as a result of a loss of market confidence in their economies. The resulting strengthening of international price competitiveness led to a sharp upturn in exports and helped the recovery of overall output activity.

In contrast, the Japanese yen followed an uptrend even after the collapse of the bubble in the early 1990s. From the end of 1990 to April 1995, the yen appreciated against a basket of currencies of its trade partner countries by 64%. As a result, Japanese export volumes either declined or grew at a pace far below the growth of its markets each year, leading to a sharp decline in Japan's share in the world export market. Thus, net exports made a negative contribution to gross domestic product growth. Nevertheless, Japan somehow maintained positive GDP growth with fiscal and monetary support to domestic demand growth.

The recent sharp yen appreciation against the U.S. dollar, euro and other currencies including those of emerging Asian economies has considerably weakened Japan's international price competitiveness. With a 22% appreciation of the yen's real effective exchange rate from mid-2007 to October 2008, it is now more than 11% higher than the level of March 1973.

Meanwhile, big declines in the dollar prices of oil and other commodity prices, coupled with a sharp yen rise, have started to exert strong downward pressure on Japan's average import prices in yen.

Incoming data indicates that the Japanese economy has already entered its first recession in seven years, and that slack in the economy will most likely widen next year. Unless further expansionary domestic policy actions are taken and/or a significant yen exchange rate correction occurs, Japan will likely start to experience deflation much earlier than recently forecast by the OECD in its OECD Economic Outlook just published.

Indeed, what is striking in the OECD's new forecasts is the contrasting contribution of net exports to GDP growth between Japan on the one hand and the U.S. and European Union on the other. While the OECD expects a net positive growth contribution from net export volumes for the latter, Japan's net export volumes are projected to make negative contributions amounting to 0.7 percentage point of real GDP in 2009 and a further 0.4 percentage point in 2010. In other words, the projected increase in the OECD area's net export volumes in the coming two years will benefit essentially the U.S. and EU. Thus, Japan will stand alone as a country not benefiting from non-OECD market growth. Declines in its net exports will more than offset the positive GDP growth effect of domestic demand expansion, resulting in a 0.1 percent contraction of output next year.

The sharp appreciation of the yen against the dollar, euro, British pound and other major currencies reflects a considerable narrowing of interest rate differentials between the Bank of

Japan policy rate and those of the Fed, the European Central Bank, the Bank of England and other central banks - most of the latter reducing them far more aggressively and by larger cumulative amounts given their higher initial levels, while the BOJ limited its cut to 0.2 percentage point. At the same time, the BOJ started a system of paying interest on excess bank reserves held at BOJ accounts, thus effectively providing a floor to interest rates in the overnight interbank money market.

Actually, interest rates on term money instruments have risen since the cut in the BOJ policy rate, with a widening of interest differentials between overnight and term monies. This negates the policy effects on longer-term interest rates more relevant to borrowing costs of private enterprises and households. Moreover, availability of credit to the private nonbank sector is being reduced with the more cautious lending attitude of banks, whose capital bases have been weakened by declines in the market values of their equity holdings as well as the yen values of foreign currency assets.

Given all this, more aggressive action by the Japanese monetary authorities is urgently needed.

Time to move

First, the BOJ should stop the provision of dollar funding to banks in Japan in need of dollar funds. Instead, it should encourage them to borrow yen from the BOJ, letting them obtain dollar funds by selling yen in the foreign exchange market.

Second, the Japanese authorities should take appropriate direct action in the foreign exchange market, following the statement of Group of Seven finance ministers and central bank governors on Oct. 27 that specifically expressed concern about the adverse effects of recent yen movements.

Early last year, when the euro was rising sharply against both the yen and the dollar, I privately suggested to some key Japanese officials that they should publicly express concern about the excessive rise of the euro against the yen, and more generally should warn about the risk of large foreign exchange losses for Japanese investors attracted simply by higher yields on foreign currency holdings. Now that a very sharp turnaround has taken place, the authorities must not hesitate to intervene in the foreign exchange market as appropriate - in particular to smooth out volatile movements. There should be a clear commitment to reverse operations to net out their balances over a reasonable, but unspecified time frame as foreign exchange market conditions settle. Yen depreciation from current levels consistent with no changes in Japan's net export volume in the coming two years - rather than declines as projected by the OECD - would definitely be compatible with the shared goal of avoiding "beggar-thy-neighbor" policy.

Third, the BOJ should go quickly back to the earlier zero-interest-rate regime and "quantitative easing." Some simulations with econometric models suggest that the macroeconomic effect of moving to a regime of zero interest and quantitative easing, measured essentially through the term structure channel, is very small. However, quantitative easing may also influence foreign exchange and stock market conditions.

A change in asset market prices will change the market values of banks' equity holdings and the yen values of their foreign currency assets, thereby affecting bank capital adequacy, which can then influence credit availability. Macroeconomic effects via these transmission mechanisms can be significant, though it is not easy to incorporate the working of these mechanisms in econometric models.

As Kohn said, central banks need to improve their understanding of the workings of the financial system, its vulnerabilities, and its links to the real economy. The BOJ, however, does not have the luxury of waiting for the results of rigorous empirical work before taking action. Well-considered measures should be taken quickly as insurance, given the increasingly important downside risks to the domestic financial system and the real economy.

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