Japan Needs An Economic Dunkirk

During the transition period between the Carter and Reagan administrations, Jack Kemp and David Stockman penned an op-ed piece in *The Wall Street Journal* entitled "An Economic Dunkirk." The imagery of the title was striking; it implied the economic mismanagement of the late 1960s through 1980 had been so bad that we metaphorically had to get off the beach under duress to avoid an even greater calamity.

Japan has been floundering around economically since the start of the 1990s. That it is still has the second largest GDP in the world is really an embarrassment for the rest of the world, as a nation accustomed to doing everything right following its defeats in World War II suddenly and continuously started doing everything wrong. Worse still, many of their problems appeared to result from the very same group-oriented society and culture that enabled so many of their previous successes.

Here's a prediction none of us will live long enough to confirm or refute: Several centuries from now, Japan's two-generation ascendancy in the latter half of the 20th century will be regarded in the same light as Portugal's brief heyday in the late 15th and early 16th centuries. The major difference is Portugal and Spain quite literally choked on the inflationary effects of their expanding gold and silver-based money supplies without going through any overt, never-ending and often counterproductive currency manipulations.

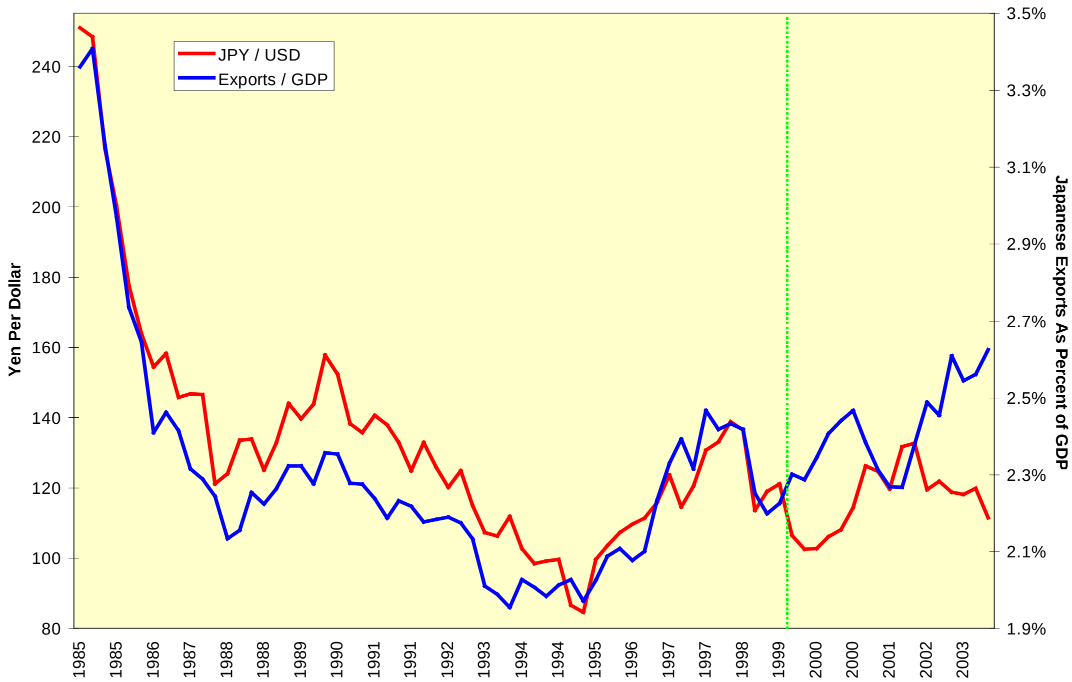
Don Quixote-San Tilts At The Yen

While the fictional Don Quixote tilted at windmills, the too-real Bank of Japan and Ministry of Finance have tied the fate of their policies to avoiding an appreciation of the yen. The presumptive theory is a weaker currency will allow Japan's export industries to remain competitive against those of China, South Korea and Taiwan, as if anyone can compete with China for the role of low-cost manufacturer. A core principle of international economics, the Hekscher-Ohlin theorem, states countries should devote resources to those industries wherein they have a comparative advantage; in Japan's case, this has been in the manufacture of high-value added manufacturing, not in low-cost production. In sum, a cheap-yen policy seems doomed to failure.

More important, however, is the breakdown in the stimulative effects of a cheaper yen on Japanese exports as a percentage of GDP. From the dollar's peak in early 1985 to the introduction of the euro in 1999, the connection between the yen-dollar rate and Japanese exports was direct. Once the euro was introduced and became a two-trade market against the dollar during the five years of its existence, the relationship between the yen and exports started to deteriorate. Even though the yen has remained firm, exports accounted for a greater percentage of the Japanese economy during the third quarter of 2003 than at any point since the second quarter of 1986.

It would appear as if Japan's export industries have adjusted to the stronger currency by adding value to their exports, just as theory says they should. Markets work when given a chance.

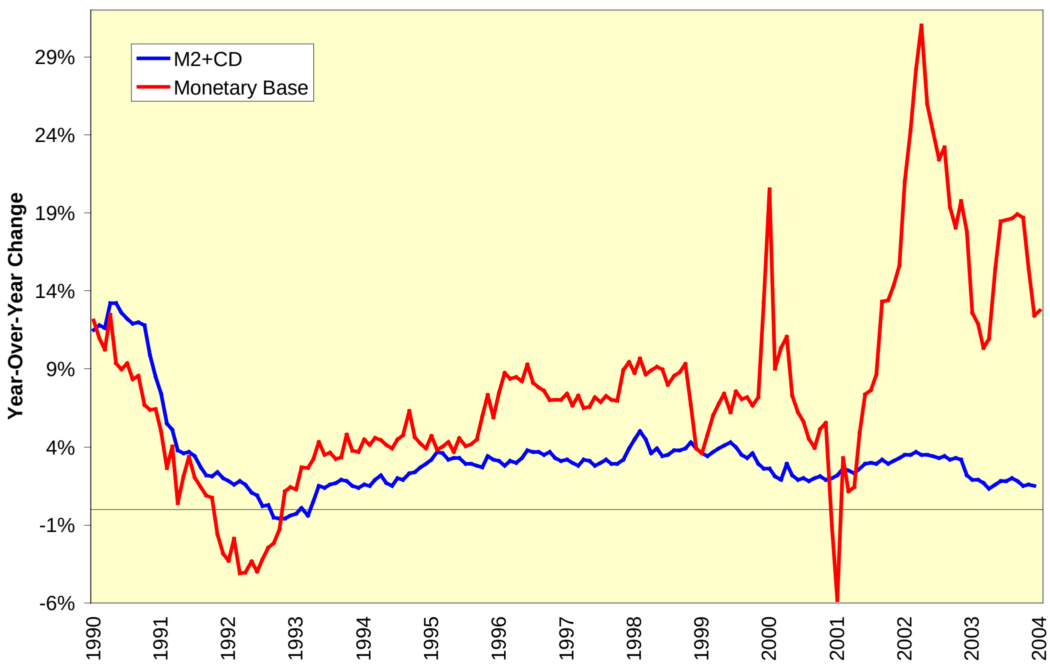
A Post-Euro Breakdown



Easy Does It

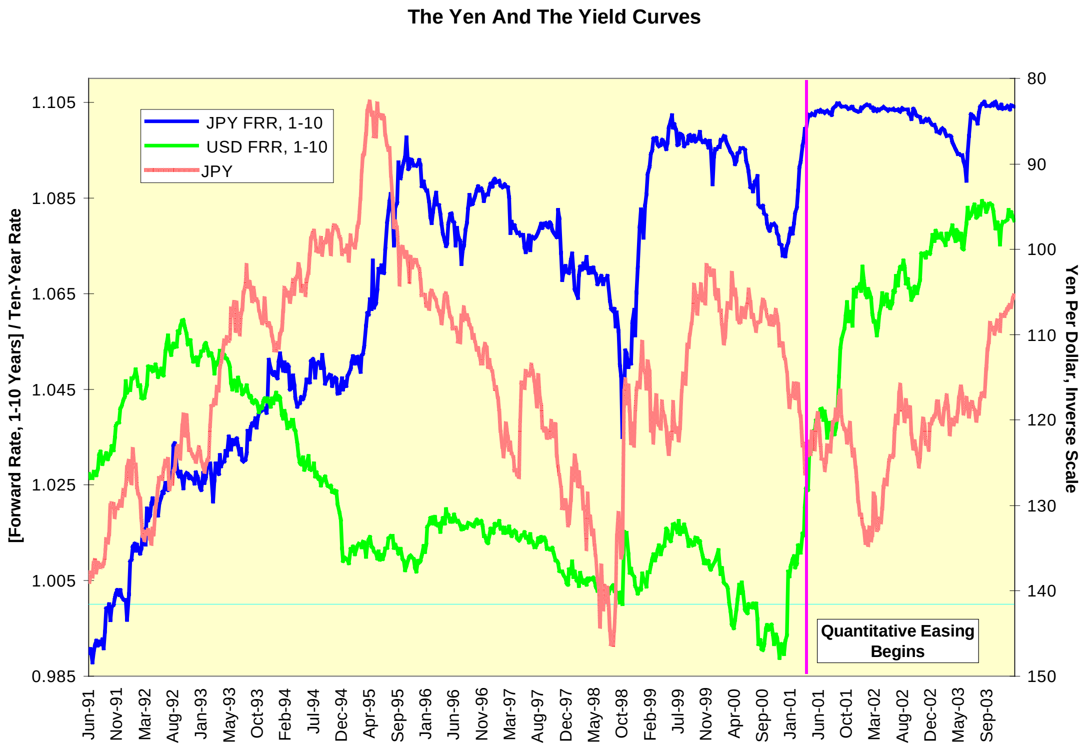
The inability of the U.S. money supply, however measured, to grow despite the Federal Reserve's repeated lowering of overnight interest rates is not as bad as the Japanese experience in this regard. The Bank of Japan has been pumping out monetary base, defined as currency in circulation plus current account deposits in the Bank of Japan, but the quantity of M2 plus certificates of deposit has scarcely been growing. As in the U.S., slack loan demand is to blame. As a result, Japan's persistent deflation, officially reported at -2.1% at the end of the third quarter of 2003, remains a problem. A holder of yen can earn nothing on a nominal deposit and still earn this rate of deflation in real terms, which represent an enormous reward to creditors and a concomitant penalty for debtors.

Base Is Growing, M2 Is Not



What must be even more frustrating for the Bank of Japan is their yield curve has been steeper than the American yield curve for more than ten years. Steepness is measured here by the ratio of the forward rate between one and ten years, the rate at which you can lock in borrowing costs for nine years starting one year from now, to the ten-year rate itself. Once nominal short-term Japanese rates approached 0%, the Bank of Japan began a program of "quantitative easing," targeting the money supply rather than interest rates, in March 2001. The present program of creating yen to buy dollar-denominated bonds is part of that ongoing program.

However, Japanese quantitative easing ran smack-dab into the Federal Reserve's rate-cutting program, and by early 2002, the yen ceased falling against the dollar. Restated, our easing overwhelmed their easing, all of their frenetic interventions included. That, my friends, is one massive policy failure.



Get Off The Beach

To return to the historic analogy, Dunkirk was a massive dual military failure obscured by a moral victory. On the military front, the British got kicked off the Continent and the Germans, motivated by the quixotic hope of a separate peace, chose not to press for a complete victory, a bone-headed decision to be repeated in Iraq in 1991. The British euphoria from escaping to fight another day was so strong that many British today regard the whole affair as divinely ordained.

Japan needs to repeat the exercise of turning an admission of complete policy failure into a moral invigoration. No level of yen weakness will restore them to the world's lowest-cost punch-press operators, as if that is a laudable goal. The manic printing of money to buy U.S. bonds is distorting trade and capital flows worldwide and may be contributing to what some consider an echo bubble in financial markets. The time has come to accept a stronger yen, to increase the wealth level of their citizens by permitting this stronger claim on the world's output and to get about the business of adjusting to reality. The resulting euphoria from taking this risk and succeeding will be strong enough to preclude my forecast above of a long sunset into history.