Rising Sun, Sinking Yen

Japan still is ranked as the world's second largest economy. How is this possible after all of the bad news befalling this country since its financial bubble burst in 1990? Last week, the once-mighty yen (JPY) moved to a three-year low on news that Japanese bankruptcies surged to their highest level since 1984.

The connection between corporate failures and a currency's exchange level is not obvious. One explanation proffered is that a weakening JPY will prompt foreign investors to pull funds out of Japan. A second explanation is a growing suspicion that the Koizumi government will seek a weaker yen as a method of economic stimulus.

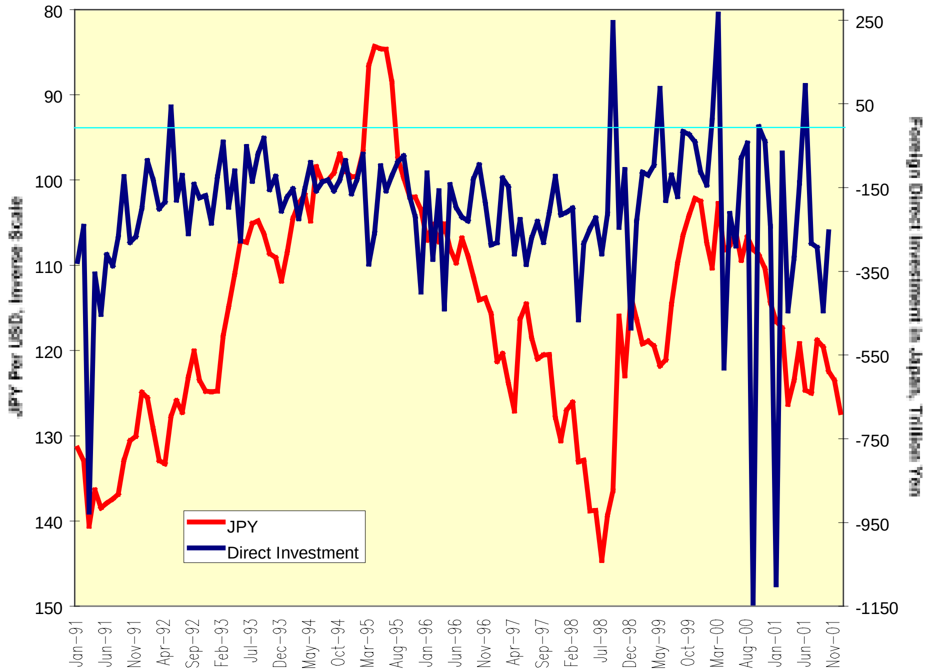
Both the fear and the alleged policy are nonsense. Or, as the noted economist and patron saint of corporate cost cutting Ebenezer Scrooge might declare, "Humbug!"

It's The (International) Economy, Stupid!

One of the more interesting and less discussed consequences of currency misvaluation is its effect on foreign direct investment. If a given currency is overvalued, it makes sense for holders of that unit to exchange the currency for someone else's plant and equipment. The strong U.S. dollar of the 1960s led to a rampage of American purchases of European assets and the 1966 publication of *The American Challenge*. The soaring yen of the 1980s led to such horrific national tragedies as the Japanese purchase of the Pebble Beach golf course and the publication of *Theory Z: How American Business Can Meet The Japanese Challenge*. Morning calisthenics and a rousing chorus of the company song, anyone? It also led to the Japanese making huge investments in automobile plants in the United States.

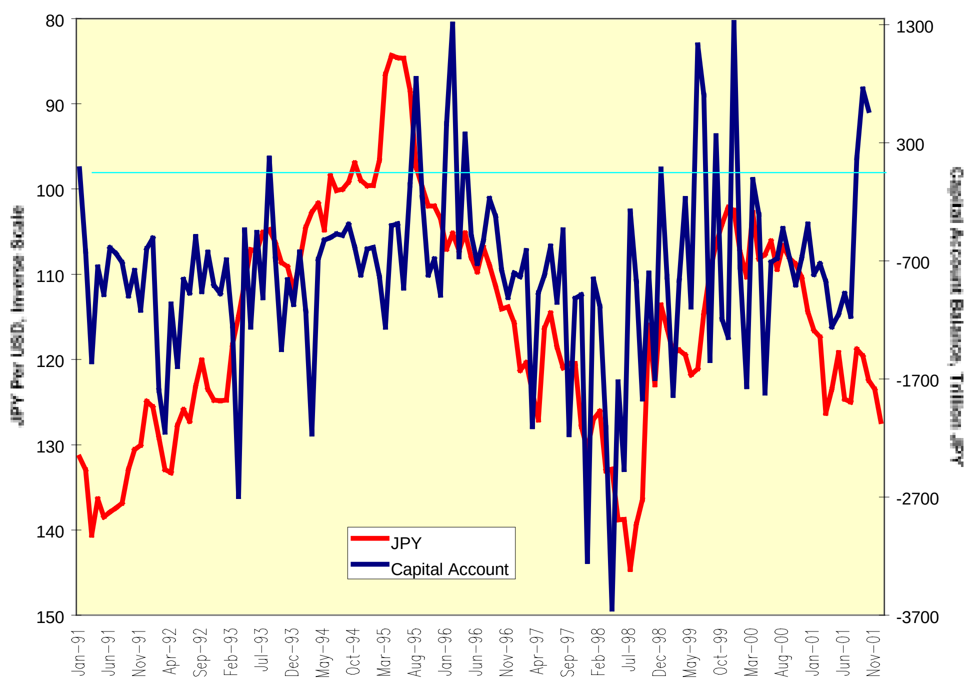
Over time, Japan has been a net maker, not a net recipient, of foreign direct investment. This is unsurprising on two counts. First, Japan is a notoriously difficult operating environment for non-Japanese entities. Second, the JPY has been chronically overvalued on an interest rate parity basis. The country's persistent trade surpluses mean that importers of Japanese goods must buy JPY to pay their bills regardless of how low interest rates on Japanese instruments go. That the current level of direct foreign investment by Japan is still so high stands as evidence that the JPY is still overvalued in the eyes of Japanese investors.

Foreign Direct Investment in Japan As A Function of The Yen



The second reason the fear of foreign investors leaving Japan in droves is misplaced is that Japan has been a net creditor to the world ever since it began running persistent trade surpluses. This is a simple accounting identity in international economics: The current account surplus must be matched by the capital account deficit.

Japan's Capital Account As A Function of The Yen



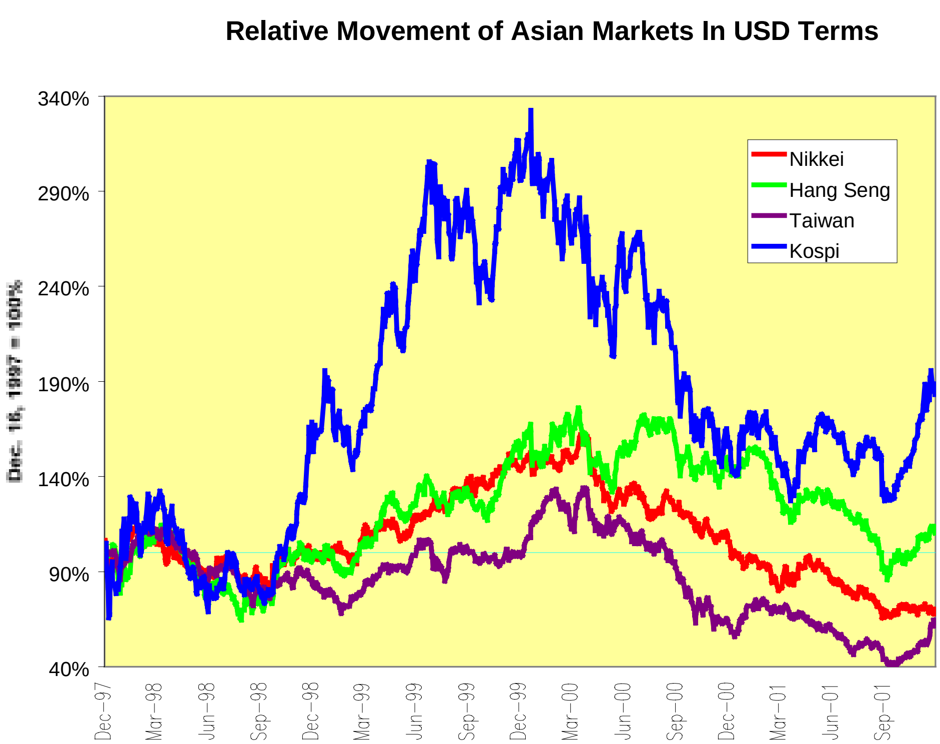
Japan's capital account lagged the JPY between 1991 and 2000, and this is consistent with theory. A stronger JPY should reduce Japan's current account surplus and therefore its capital account deficit as well. But this relationship started to break with the onset of global recession in 2001. Here the capital account moved into surplus even as the JPY weakened. This is a direct result of slowing global demand for Japanese goods.

A Bad Policy Trifecta?

Japan's policy makers have been giving incompetence a bad name. Their foray into Keynesian public works spending in a country where land is scarce has resulted in such absurdities as bridges with $40 tolls and parallel roadways. They would have been far better off building pyramids; the Egyptian experience indicates these are enduring tourist attractions. The Bank of Japan has shown that 0% nominal interest rates in a deflationary environment are no stimulus at all. The Japanese Diet has made a habit of raising taxes in a recessionary environment to pay for their profligate waste and a national debt near 135% of GDP.

And now they want to trash the JPY? If the world learned anything from the experience of the 1930s it was that beggar-thy-neighbor trade policies were a lose-lose proposition. They didn't have currency manipulations then, so they had to use tariffs. If Japan thinks that a weaker JPY – which we can restate as a reduction in global purchasing power for Japanese citizens – will solve anything, they are ignoring not only the entirety of the past three decades' experience with floating exchange rates but their own experience in 2001 as well. If export markets to the U.S. and Europe are weak, will a cheaper JPY alone make them stronger?

At one point, Japan was a low-cost producer in global manufacturing. They have lost this position to China, Taiwan, Hong Kong and Korea. The relative performance of selected East Asian markets in USD terms since the time of Korea's near-default in December 1997 demonstrates how Japan has performed far more as an emerging market than as a senior market over this period. Whatever they've been doing hasn't been working, and to threaten their neighbors with a competitive devaluation of the JPY is to place the world's trading system at risk.



Will the JPY sink further? Probably, the vaunted Japanese consensus has turned in this direction. Will it help Japan? No, at best it will impoverish Japanese citizens and deprive them further of the fruits of their labors. Will it lead to disinvestment in Japan? Probably not: At the rate this crowd is making a mess of things, Japanese assets will become cheap enough to attract buyers.

If this was the logical outcome of Theory Z or any other management gibberish that came down the pike during that era, I'm sure glad I forgot to pay attention.