The Asia-Pacific Journal: Japan Focus
In-depth critical analysis of the forces shaping the Asia-Pacific...and the world.

Japan, Financial Stability and the World Economy: Two Perspectives

Thomas I. Palley and R. Taggart Murphy

How Japan fuels financial instability

Thomas I. Palley

New York. Over the past several years, much attention has focused on the role of China's trade surplus in creating today's global financial imbalances. But too little attention has been paid to the role of Japan's policy of near-zero interest rates in contributing to these imbalances. As global financial uncertainty rises, it is time for Japan to change course.

Japan's ultralow interest-rate policy was initiated in the 1990s to put a floor under the economy following the bursting of its asset price bubble. However, over time these ultralow interest rates have promoted a highly speculative financial "carry trade": Speculators borrow yen at low interest rates and then buy dollars and other currencies that are invested in higher-yield assets elsewhere.

There are two key features of this carry trade: First, it contributes to yen depreciation and dollar appreciation as carry traders switch out of yen. Second, it increases global asset demand, generating asset price inflation.

The yen's depreciation versus the dollar has contributed to continuing large U.S. trade deficits with Japan. It has also pressured other East Asian countries to under-value their exchange rates in order to remain competitive with Japan. Given China's under-valued currency, East Asia's two largest economies have thus anchored down exchange rates throughout the region, thereby increasing the region's trade surplus at the expense of jobs and growth in the rest of the global economy.

Funds switched out of Japan have shifted to other financial markets, with the chase for yield driving up asset prices and lowering interest rates. In the United States, this has complicated the Federal Reserve's task. The Fed has been trying to slow demand growth and cool the housing price bubble to avoid inflation, but carry trade speculators have been easing credit.

Most importantly, the carry trade generates global financial fragility by creating fundamental ˜ and dangerous ˜ mismatches. First, carry traders borrow in yen but invest in dollars and other currencies. Second, carry traders borrow short-term money in Japan but may invest in longer-term assets outside Japan. Unexpected yen appreciation could cause large carry trade exchange-rate losses, as could unexpected closing of the interest rate gap with Japan.

Such losses, or just the thought of them, have the potential to trigger global contagion as carry traders close positions in U.S. markets to repay loans in Japan.

In addition to the global dangers of the carry trade, the policy of ultralow interest rates may also be bad for Japan. This is because ultralow interest rates may hurt Japanese households and lower consumption, and this effect may be larger than the benefit that a weak yen confers on Japan's exporters.

Higher interest rates can spur consumption if their impact on income outweighs the increased incentive to save. This may well be the case for Japan, which has a rapidly aging population. Current ultralow interest rates may be scaring people about the adequacy of future income. Raising rates could alleviate those fears, increasing consumer confidence and spending.

Additionally, raising interest rates would be a form of expansionary fiscal policy. This is because Japan has a large public debt, and increasing interest payments on that debt would put extra money in the hands of households.

The policy of ultralow interest rates was justified in the aftermath of the bursting of Japan's asset price bubble, but Japan stabilized its economy long ago. At this stage, the policy has become a contributor to global financial fragility, and it may be retarding Japan's own prosperity by contributing to consumer anxieties.

Japan should decisively abandon ultralow interest rates, albeit gradually so as to allow an orderly unwinding of speculative positions.

Thomas Palley was chief economist with the U.S.-China Economic and Security Review Commission and is the author of "Post-Keynesian Economics."

This article appeared in the Japan Times on May 23, 2007.

Japan, China, the United States and the Financial World Order

R. Taggart Murphy

Thomas Palley is absolutely right to imply that myopic obsession with China's trade surpluses does not really help bring "today's global financial imbalances" – his wording – into focus; that Japan's monetary policies merit at least equal attention. He is also right to warn of the dangers of the so-called yen carry trade: the practice of borrowing yen at today's super-low interest rates and investing the proceeds in a currency such as U.S. dollars or Thai baht that offers much higher returns. The likes of hedge fund managers who play this high-stakes game seek to cash in on the difference. And as long as the yen stays where it is against the U.S. dollar, the Thai baht or whatever, the carry trade looks like a license to print money. But if the yen were to soar on global foreign exchange markets, the economics of the carry trade would suddenly shift into reverse. If you borrowed yen when a dollar would buy you 120 yen and you have to scramble to pay it back when a dollar gets you only 90, that 25% surge in the value of the yen is going to wipe out many times over the profits you earn from a 6% difference in yen and dollar interest rates – and maybe wipe you out in the process.

Those who scoff at the possibility of that happening display a dangerously weak grasp of recent financial history. For it was precisely a surge of that magnitude in the value of the yen that lowered the curtain on the previous round of yen carry trades and in the process

brought the U.S. banking system to the edge of catastrophe. It all started when the U.S. and Japanese governments succeeded in August, 1995 in joint market interventions that pushed the yen down from its postwar high of 79 yen to the dollar. Convinced that the two governments had both the will and the ability to keep the yen from rising beyond a certain point, hedge fund managers borrowed huge amounts of yen for the carry trade. The proceeds found their way into the coffers of the likes of Thai property developers and Korean banks, in the process fueling an explosive run-up in asset prices through much of Asia and Eastern Europe. The inevitable retraction began with the meltdown of a Bangkok real estate market in the summer of 1997 that in the succeeding months took many of the region's property and equity markets went down with it. The crisis soon spanned the globe, culminating when the Russian government announced that it would suspend its debt service payments. Hedge fund managers rushed to cover their exposed positions, forcing them to unwind their carry trades and sending the yen spiraling upwards as they desperately sought to buy yen to repay their borrowings. On August 17, 1998, the day of the Russian announcement, a dollar would buy 146 yen. A month later, it would buy only 132. Yet another month later a dollar would fetch a mere 115 yen and the largest, most highly respected hedge fund in the world teetered on the edge of bankruptcy. This was Long-Term Capital Management supported by lines of credit from a host of core U.S. banks. Only a coordinated rescue operation by the U.S. Treasury and the Federal Reserve halted what could have been the worst U.S. financial crisis since the 1930s.

So Palley is right to warn of the dangers of yen carry trades that in aggregate today may be even larger than the trades that fueled the asset bubbles of the late nineties. He is also correct that the ultimate motor of the carry trade is the Japanese government's policy of keeping yen interest rates near zero. And few would quibble with his list of side-effects: the contribution to bilateral U.S.-Japan trade deficits, the pressure on other East Asian nations to suppress the value of their own currencies, the complicating of the Federal Reserve's attempts to avoid inflation in the United States.

Palley advocates that Japan reverse its low interest rate policy in order to head off these dangers. This would presumably dry up the carry trade and put more money in the hands of Japan's households by increasing the returns on their savings. Palley suggests that higher interest rates would "increase consumer confidence" by giving them more money to spend. Alas, the intractable sluggishness of Japan's household spending stems from something more fundamental than lousy returns on savings: fear of job loss and the slow unraveling over the past fifteen years of the implied contract between the nation's work force on the one hand and its corporations and government on the other. The terms of that contract had seen the government run what amounted to a full-employment economy while corporations underwrote the economic security of their core employees. In return, employees had effectively surrendered the right to strike, labor markets had been suppressed, and the most productive workers and managers had subsidized the less productive. The drawn-out stagnation of the 1990s made it clear that the government and corporations were unable to keep their side of the bargain. Palley writes that "Japan stabilized its economy long ago" but the late 1990s do not seem "long ago" to families whose principal breadwinners fell off the corporate escalator back then or whose children found that on entering the labor force, there were no stable jobs to be had. They are unlikely to start spending again until they are sure those days are not coming back.

For that to happen, Japanese companies will have to begin investing in a major way in people and facilities in Japan. Japanese companies are, to be sure, investing again, but most of that investment is outside Japan. And while it is true that hiring of recent graduates has finally rebounded, commentators here speak of a "lost generation" – people today between their late twenties and late thirties who came of age at a time when Japanese companies were not hiring. Many of these people cannot find decent jobs now (a recent article in Business Week "How a Generation of Workers Got Left Behind" 5/28/07, p. 40 discusses their dilemma). Fretted about in the mass media, their plight the subject of television shows, they depress consumer demand. It is not just their own lack of disposable income and job security; it is the warning they embody both to younger people ("Could it happen to me?") and to their parents ("Who will take care of them after we're gone?"). It may be, as Palley suggests, that putting more money in savers' pockets could spark an economic boom that would help these people land good jobs. But few here believe it; rather they tend to think that high interest rates would kill what they see as a still-fragile recovery. And even if the recovery continues, it shows every sign of leaving out this "lost generation."

For these reasons and more, advocates of a high interest rate policy are not easily found here beyond a few academics and some officials at the Bank of Japan who squirm under the "abnormality" of the current regime. They are certainly not to be found in the ranks of politicians who do not relish explaining to voters why they want to take chances with a recovery still seen as young and fragile. Nor are they to be found in a business community that fears what higher interest rates would do both to their borrowing costs and to their export revenues – higher interest rates would, other things being equal, send the yen soaring – why, presumably, Palley is in favor of it. And advocates of a high interest rate policy are most certainly not to be found from those who staff Japan's Ministry of Finance, the country's most powerful bureaucracy. They fret continually over the fiscal position of a Japan with the worst government debt-to-GNP ratio among the major industrialized powers. Palley's hailing of the "expansionary fiscal" effects of higher interest rates – i.e., more government debt -- would be seen as daft by these bureaucrats. It bears remembering that the Japanese policy elite pulled off something unprecedented in financial history: maneuvering a country through what amounted effectively to a meltdown of its banking system as recently as 1998 while preserving social peace and quarantining the core of the real economy from the worst effects. Japan's officials are not lightly going to tamper with the policy mix that they believe got them through the trauma until they are convinced it will not recur.

Any serious policy prescription has to take political reality into account, which Palley's, alas, does not. Palley started his piece by lamenting the excessive attention paid to China's trade surpluses. But the same lament could be made of any analysis that considers any such phenomenon in isolation, whether that be China's trade surpluses, Japan's super low interest rates, or the American trade and current account deficits. For ultimately these are all different facets of an underlying unity: a global financial architecture that supports the U.S. dollar as the principal reserve and settlements currency for three of the four of the world's top economic powers.

This architecture has been labeled "Bretton Woods II." In contrast to the first Bretton Woods, a series of formal institutions drawn up in 1944 that enthroned the U.S. dollar at the center of the postwar global financial order, Bretton Woods II is a product of ad hoc institutional arrangements that have taken shape since 1973 when Bretton Woods I broke up. The most important of these arrangements are structural U.S. trade and current account deficits, structural Japanese trade and current account surpluses joined in the last decade by Chinese surpluses of comparable scale, accommodative monetary policy in Japan that has as its principal objective a stable yen/dollar rate at a level that gives Japanese exporters an edge in global markets, and, most recently, a rapid accumulation of dollar reserves in China. The arrangements serve the political interests of the three countries that support them. They permit Americans to enjoy standards of living higher than they otherwise could and allow the United States to project military power around the world at low cost since financing can be done in the U.S. currency and repayments postponed indefinitely. These arrangements are crucial to China's dash for great power status since they allow for the rapid accumulation of production and employment capacity. The arrangements have enabled Japan to thrive under the political settlement put in place in the 1950s without substantive overhaul and, more recently, to maintain the essence of its political and economic system while riding out what in absolute terms was the largest financial crisis in world history.

To be sure, these arrangements have had unintended and unwanted side effects that have had to be controlled – the asset bubbles stemming from the yen carry trade being one of them (the loss of much of American manufacturing capacity and concomitant effect on American middle class economic security being another). But until these side effects become intolerable to the political and economic elites of one or more of these countries, the arrangements that produced them will continue. And when one of these institutional arrangements does finally unravel – whether it be Japan's low interest policies, China's dollar buildup, or chronic U.S. deficits –it will not unravel in isolation.

R. Taggart Murphy is Professor and Vice Chair, MBA Program in International Business, Tsukuba University (Tokyo Campus). He is the author of The Weight of the Yen (Norton, 1996) and, with Akio Mikuni, of Japan's Policy Trap (Brookings, 2002). He contributed this article to Japan Focus. Posted on June 9, 2007.

Created by Datamomentum