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From a Supporter to a Challenger? Japan's Currency Leadership in Dollar-Dominated East Asia at the Brink of Financial Collapse

Saori N. Katada and R. Taggart Murphy

We present two perspectives on the conundrum of Japan's yen-dollar currency strategy at a time when the yen continues to strengthen against the dollar.

With the crisis on Wall Street dominating the news, both speak insightfully to the sub-prime loan crisis that has shaken Wall Street since September 2008 and the challenges that the US, Japanese and world economy faces.

The Katada article is [here](#).

Why Japan Clings to the Declining Dollar

R. Taggart Murphy

Saori Katada poses a most compelling question: why does Japan continue to denominate so much of its accumulated export earnings in dollars? Katada frames the question slightly differently, asking why Japan has not moved from being a "supporter" of the dollar-denominated currency regime in East Asia to being a "challenger." But it's essentially the same question. Supporting the dollar is largely a matter of using the dollar as the primary settlements and reserve currency for your foreign trade and investments, which the Japanese have done since 1945 -- first because they had no choice and then, from the early 1970s on, as deliberate policy. The question is particularly salient in light of the longterm decline in the value of the dollar. Katada notes that there has been a good deal of talk emanating from Tokyo about the "internationalization" of the yen, but until Japanese companies begin to denominate their export earnings in yen -- which means billing foreign customers in yen and redeploying export profits in yen -- that's all it is: talk.

Japan is the world's 2nd largest economy; it has been more than forty years now since the country needed to have any concern about its ability to afford essential imports. Further, no one could seriously argue that the yen is anything other than the world's third most important currency. Why should such a country doggedly persist in a foreign exchange policy that looks as if it were drawn up for a weak, third world economy: hoarding "precious" foreign exchange as if any day now it couldn't pay for essential imports? Particularly when the dollar has lost more than two thirds of its value against the yen since the fixed link between the two currencies was cut back in 1973? And when Japan is facing a looming financial-cum-demographic crisis with a rapidly aging population and unfunded pension liabilities so large that the government has literally lost track of them? Those liabilities would be a lot less forbidding if Japan had systematically been salting away for the past few decades the earnings from its trade surpluses in yen and/or Deutschmarks and then Euros rather than in dollars.

Perhaps it's because those trade surpluses would not have been so large if Japan had switched from dollars 35 years ago. Katada argues -- and I would concur -- that that explains much. She notes not only the importance of the U.S. market to Japanese exporters -- billing American customers in any currency other than the dollar usually means losing those customers, something few Japanese exporters have been willing to risk-- but that most of Japan's other large trading partners in East and Southeast Asia also use the dollar as their primary external settlements and reserve currency. When a country is accustomed to dealing with other countries in a given currency, demanding that it pay for your goods in another currency carries the risk that it will take its business to a competitor who makes no such demands. Determined to protect and expand their export market shares and thus their country's overall trade surpluses, Japanese companies were never willing to run this risk.

But this raises a deeper question: why Japan feels it must, at all costs, run trade surpluses. As Katada points out, Japan has "long been unwilling to run a current account deficit" (the current account being the broadest measure of a country's economic position vis-à-vis the outside world since it captures not only trade in goods and services but also interest and dividend payments and transfers.) A current account deficit may be a dangerous thing for a poor country living month-to-month on paltry export earnings supplemented by some remittances from its maids and construction workers abroad. Such countries have to finance deficits with aid or borrowings in currencies they don't control. But rich developed countries like Japan need have no such fears; they can finance periodic deficits in their own currencies.

True, the United States seems poised to test the notion that rich countries can forever run and finance current account deficits. But Japan's external economic situation is nothing like that of the U.S. Any college student who expects to earn a passing grade in an introductory macroeconomics course can explain how and why the current account simply plugs the gap between savings and investment in a country. If a country saves more than it invests at home, by definition those extra savings are going overseas and vice versa. That Japan has a perennial current account surplus is simply another of way of saying that Japan has long saved more that it can invest at home. And more savings is the flip side of less consumption.

Isn't it a truism that the Japanese economy suffers from anemic domestic demand; i.e., not enough consumption? Wouldn't it therefore make sense for Japan to run periodic current account deficits from time to time? So why doesn't it? The answer is bound up in the question Katada raises -- why Japan continues to "support" a dollar-denominated East Asia.

Katada writes that "Japan's Ministry of Finance ... has clearly realized the benefits that could come from an active promotion of the yen as an international currency" and then goes on to enumerate those benefits: easier foreign exchange risk management for Japanese companies, enhancing Tokyo's role as an international financial center and greater macroeconomic stability in East Asia. While those benefits are indisputable and I don't doubt that a wish to capture those benefits explains some of the periodic calls emanating from the Ministry of Finance (MOF) and other Tokyo power centers for greater yen internationalization, I'm not convinced how "clearly" the inevitable price of those benefits is understood or articulated. Because internationalization of a currency spells periodic current account deficits -- and this is something that Japan's power holders seem unwilling or unable to understand

A currency cannot be "internationalized" -- that is to say, widely used overseas -- unless it is available in sufficient quantities. Availability stems from outflows: either through the issuing country's current account of its international balance of payments, or through the capital account thereof. Outflows via the current account are, by definition, current account deficits. Outflows via the capital account mean that the country is deploying its surpluses overseas in its own currency in the form of loans to foreign borrowers, purchases of foreign bonds issued in the purchaser's currency, equity stakes in foreign companies, plant and equipment investments in foreign countries and so forth. But for these loans and investments to make economic sense, the interest and dividend payments they generate -- not to mention principal repayments and profit repatriation -- have to be denominated in the currency in which the original investment or loan was made, otherwise they expose the investors to unacceptable foreign exchange risk. Thus the foreign entities that borrow the money or receive the investment have to have a way of earning the currency in which the loan or investment was originally made. As the foreigners use the capital deployed to make things or perform services that are sold back into the country that initially made the loan or the investment -- thereby earning the money needed to service the debt or repatriate the profits -- the issuer of an international currency opens itself to the probability of periodic current deficits.

Those deficits carry risks -- primarily that the outflows of the international currency will over time weaken its value as market participants see the inevitability of

structural current account deficits. Great Britain attempted to shore up the waning international status of the pound after 1932 by a system of Imperial Preferences – essentially, a requirement that its colonies buy first from Britain and each other, using sterling. And for fifty years now, analysts have forecasted the end of the dollar's role as the world's premiere currency because of the contradiction between the outflows required of an international currency and the inevitability of current account deficits in their wake. (The dollar problem was first spelled out in 1956 by the Belgian economist Robert Triffin from whom it acquired its name: the Triffin dilemma.)

But as Katada notes, Japan has never been prepared to accept this logic: that periodic current account deficits are an inevitable price of the internationalization of a currency. Instead of making loans and investments overseas in yen, Japanese companies and financial institutions have invested largely in dollars. It is not that Japanese companies and financial institutions do not want to make loans and investments overseas in yen. When I worked as an investment banker in the 1980s, the likes of Japanese insurance companies were desperate for yen returns from credit-worthy overseas borrowers and we used all the legal and technical skills at our disposal to give them what they wanted. Sometimes we succeeded. But it wasn't enough to slake their appetites. They ran up against the implacable reality that foreigners were exceedingly reluctant to expose themselves to unhedged yen risk or, to use financial jargon, to find themselves short yen i.e., in a position where they owed yen but had no way of acquiring it save for spot purchases on the foreign exchange market. A foreign company that had predictable sales into the Japanese market in yen might be happy to borrow in yen, but such companies are few and far between (the deals done by so many airlines in the mid 1980s in yen are the exception that prove the rule – after all, they had yen revenues in the form of ticket sales in Japan). Japan's notoriously low propensity to import high value-added goods coupled with the insistence of the major trading companies that long term commodity import contracts be denominated in U.S. dollars means that earning the yen to repay loans or repatriate profits was very hard.

A clear example is what happened to Malaysia in the mid 1980s. The Malaysian government looked at the profile of its foreign trade and determined that its borrowings ought to reflect that profile – that if Japan accounted for some 30% of Malaysia's total foreign trade, then yen borrowings should likewise account for some 30% of Malaysia's international borrowings. While yen interest rates at the time were far higher than they are today, they were also far lower than dollar interest rates, so Malaysian government entities, public corporations and the like went shopping for yen deals.

Japan's banks and insurance companies began swarming around Malaysia like a pack of hungry teenagers at a table freshly laid with pizzas. I helped arrange four major deals, including a thirty billion yen package (some \$150 million back then) for the Malaysian Highway Authority that partly financed the construction of the Johor-Kuala Lumpur expressway. At the time the deal was the longest fixed-rate yen financing ever done by any borrower in any market including the Japanese government itself. We foreign investment bankers got into the act because we were more experienced than our Japanese competitors back then at figuring out how to structure deals to meet the appetites of particular types of Japanese institutions. In the case of the financing for the Highway Authority, the money ultimately came from Japan's life insurance companies. Life insurance companies anywhere love long-term assets that generate fixed returns in their own currency that they can match up with their actuarial tables to allocate predictable streams to pay off sick and dying policy holders.

It was a spectacular arrangement for the Japanese life insurance companies, but not, it turned out, for the Malaysians. The reasoning that suggested the make-up of their foreign borrowings ought to reflect the make-up of their foreign trade turned out to have a fatal flaw: while Japan was (and is) an important customer for Malaysia, most of the long-term contracts between Malaysian exporters and their Japanese buyers were, as Katada demonstrates for Southeast Asia in general, denominated in dollars. Thus when the yen soared against the dollar in the late 1980s the Malaysians were left with yen debt they had taken down when a dollar would buy some 210 yen. But when they went to service the debt, each dollar they had earned from their exports would buy fewer than 140 yen.

Malaysia's then-Prime Minister Mahathir Mohamad complained publicly about the extra burdens the soaring of the yen had imposed on his country, but there was not much he could do about it. The rest of the region took notice of what had happened: yen transactions essentially dried up. (If I can be forgiven a bankersese aside: the swap market was no refuge – the yen/dollar swap market was plagued by a paucity of yen payers; IOW, no one wanted to be short yen which meant yen borrowers could not unload their foreign exchange risk in the swap market for anything approaching a price that would make an underlying yen borrowing economic.)

Malaysia is the sort of place that should stand at the head of the line in a list of candidates for participation in a yen bloc. Mahathir was a great admirer of Japan's economic methods and had publicly called on his country to model itself on Japan with his "Look East" rubric. The Japanese economic presence in Malaysia is huge and the two countries are important trading partners. Yet Malaysia ran into what Katada describes: when it came down to it, the Japanese were unwilling to do what it takes to internationalize the yen, specifically, make it possible for countries such as Malaysia to earn yen by selling goods and services freely into the Japanese market for yen. Instead, the yen climbed in value with Japan's endless current account surpluses.

Much has changed in the past twenty years. Among other things, there are now plenty of players prepared to find themselves short yen; that is to say, plenty of non-Japanese are now prepared to borrow yen. But that has nothing to do with long-term borrowings to build highways. It is opportunistic short-term borrowing by the likes of hedge fund managers who borrow yen at the next-to-zero interest rates that have prevailed since the mid 1990s and then flip the proceeds into a higher-interest currency such as dollars or baht. The practice is known as the "yen carry trade." The practitioners expect to profit from the interest rate differentials and bet that the yen will not appreciate significantly during the life of the borrowings. It's a license to print money provided, indeed, that the yen doesn't appreciate. But at several points since the carry trade first appeared, the yen has shot up on the foreign exchange markets– most spectacularly, at the time of the Asian Financial Crisis of the late 1990s, when the unwinding of its short positions helped to bring on the near-collapse of the hedge fund Long Term Capital Management. This is not, presumably, the sort of internationalization sober policy makers want to see.

Even more important, as Katada notes, is the emergence of China as a power whose dollar holdings equal or surpass those of Japan. Katada puts forward the provocative suggestion that while both Beijing and Tokyo "share similar concerns regarding the dollar dependence of the region" the Chinese do not wish to see this change for the time being. Katada maintains that China wants no part of dethroning the dollar from its position as the primary reserve and settlements currency in Asia precisely because the only realistic alternative today is the yen – Europe's aggregate trade with the region is insufficient for the Euro to play anything other than at best a supplemental role. China's currency "has no way of competing against the wider use of the yen in the region," she writes. Beijing is in "no hurry" to do what it would take to make the yuan competitive because that would require "liberalization of China's capital account and massive reform of the country's financial system, both of which are politically risky."

But political risk is also surely what stops Japan from any serious move to replace the dollar as the primary currency of its external trade and investment. Katada discusses the lack of political support for any such move from Japan's business community faced, as she explains it would be, with loss of markets, write-down of its dollar investments, and the "one-time high cost" of shifting transactions into yen. This is all true, but I believe there is something more fundamental at work.

Back in 1991, Karel van Wolferen, one of the most astute observers of Japan's political culture, wrote that "We can safely say that Japan's political elite includes very few gamblers. Many businessmen have observed that Japanese organizations are extremely risk-averse, and psychologists/anthropologists have been struck by the degree to which Japanese in charge of anything try to cater for every calculable contingency. My own observations confirm that the unpredictable scares the Japanese to an extraordinary extent." ("No Brakes, No Compass" *The National Interest*, Sept. 1, 1991) He was arguing against the notion popular at the time that Japan's power holders were operating under some secret master plan to seize control of the commanding heights of the global economy.

What was true then is true today – Japan's political culture is risk-averse to an extraordinary and under-appreciated degree. Deliberate change does not occur in the absence of manifest reality that there is no alternative (and even then is often resisted). A systematic series of moves to "de-dollarize" as Katada puts it means dynamiting the key pillars of Japan's postwar political and economic framework: an economy structurally designed to generate current account surpluses, and the all-embracing alliance with the United States. By its willingness to hold its export earnings in dollars without seeking to exchange or repatriate them, Japan has left its export earnings inside the U.S. banking system, thereby automatically helping to finance American external deficits. Thus Japan has been the primary financial facilitator since the 1970s of the American ability to project military power around the world without crushing domestic tax burdens. While it has been joined in the last decade by China and the petroleum exporters, it is safe to say that the end of Japan's support for the dollar would mark the end of the American ability to run endless current account deficits and thus its ability to support its vast military establishment. (If this is not intuitively obvious, ask yourself how the United States could pay for an economically unproductive military establishment when the Japanese, the Chinese and the petroleum exporters would no longer

lend America money, forcing the U.S. to earn yen or Euros to pay for the imports of everything from oil to machine tools to keep that establishment operational.)

While there are surely people in Japan who believe that U.S. military "protection" is making Japan less, not more, secure, there are precious few signs that Japan's political culture is prepared for any serious debate on how the country might provide for its own security in the absence of dependence on US military provision including the nuclear umbrella. Nor is there any real indication of debate on how politically to cope with the dislocations of an economy thrown open to the outside world – the inevitable price of a genuinely international currency. (I believe that Ozawa Ichiro, leader of the opposition Democratic Party probably thinks about these things – that is to say, how to foster an independent political structure and wean Japan from Washington's security teat – but understandably for a politician, he keeps his thoughts mostly to himself.)

Instead, Japan's contemporary power holders follow situational logic, doing what is necessary to sustain the political and economic framework that they have all grown up within. Among other things, that means reflexive support for the dollar. It has been nearly 50 years now since the last serious challenge to that framework – the 1960 riots against the renewal of the U.S.-Japan Security Treaty that brought down the government of Kishi Nobusuke – and alternatives can scarcely be imagined any more.

Of course the current meltdown on Wall Street – not to mention the distinct possibility that a McCain/Palin administration may entrench the flailing, wild-eyed American militarism of the last seven years – could well blow up that framework anyway without any help from Tokyo. But only then do I believe there will be any serious, thought-through effort to replace the dollar with the yen as Asia's pre-eminent currency.

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