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JAPAN ECONOMIC CURRENTS

A COMMENTARY ON ECONOMIC AND BUSINESS TRENDS

Fluctuations in the Foreign Exchange Market and the Japan-U.S. Economic Relationship

by Teruhiko Mano, Tokyo Research International, Ltd.

Background to Instability in the Dollar Market

Currency traders have been watching recent fluctuations in the US dollar/Japanese yen exchange rate (a range of ¥115 ~ ¥135) with some concern.

Shifts in relations between two interdependent economies are always reflected in exchange markets. But the recent fluctuations between the dollar and yen appear to stem largely from factors in the United States – as evidenced by the fact the yen/euro exchange has stabilized around ¥115~117, while there have been much larger fluctuations in the yen/dollar and dollar/euro markets.

There are three causes for the instability of the U.S. dollar:

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First, the US national debt continues to expand. In addition to the cumulative annual deficits of the past, the US will likely have a current account deficit amounting to 4 percent of this year's GDP. In addition to higher import levels and falling domestic production (due in large part to worsened corporate profitability), progress in bringing down the debt overhang has been completely reversed – the Bush tax cuts and increased military expenditures since September 11 are likely to push the US budget deficit to $150 billion this year. By contrast, the US government budget surplus stood at $236 billion just two years ago.

Japan's financial authorities intervened by purchasing dollars which they called "curbing the strengthening of the yen." But as has been proven in the past, intervention against prevailing trends is not effective, even if done under a cooperative arrangement. Moreover, even if currency manipulation brings about a temporary psychological effect, unilateral intervention is nothing more than spitting into the wind. Because the yen/dollar fluctuation stems from factors in the United States, responsibility for restoring stability lies squarely with that country.

The second cause is the correction of the excessively high U.S. stock market. Despite an unexpectedly high GDP growth rate of 5.8 percent during the first quarter of 2002, US stock prices have fallen. The high-tech laden NASDAQ, in particular, has dipped beneath its lowest point that followed the terrorist shock last year – at one point plunging to less than 1,300. The level of 5,000, which prevailed at the beginning of 2000, now seems like a fantasy. The rate of decline in the U.S stock market is comparable to the collapse of Japan's bubble. Skepticism about American style market economy and management methods plays a significant role in weakening investor confidence – one greater than the actual worsening of the economy itself.

Under American-style management, the key objective is to keep the price of company stock rising. That is because the stock price basically determines the amount of bonuses for top management. This generous system of compensation made sense and

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was possible when the post-Cold War "peace dividend" was being enjoyed. But once the IT effect had been digested, companies were unable to maintain profitability at the same pace as they had in the past. As a result, distortion and strain were manifested.

When profits drop, stock prices naturally follow. In order to prevent such a fall, many American companies buy back big blocks of their own stock. Doing so has helped companies exert control over supply (and demand) of their shares and to sustain stock prices.

But as evidenced by recent corporate scandals, in some cases, the funds that should have been used to improve fundamental productivity were instead misused to prop up stock prices which eventually depressed future profitability. Furthermore, when the purchase of company's stock is accomplished with borrowed funds, the financial health of the company might be endangered.

Another factor affecting stock prices is mergers and acquisitions. Amortization of the premium to be paid at that time depresses profits, so it tends to be postponed. As the Enron and WorldCom scandals show, when balance sheets do not reflect reality, distrust of corporate accounting will lead to lower stock prices.

On July 30, President Bush signed the corporate accounting reform bill passed by both the Senate and the House. The so-called Sarbanes-Oxley bill was approved in the unusually short time of less than two weeks after a joint committee of both houses began deliberations. Intending to send a message to financial markets, the bill's signing ceremony was attended by Federal Reserve Board Chairman Alan Greenspan, Securities and Exchange Commission Chairman Harvey Pitt, and many Members of both houses from both parties. There is no question that the objective of the public White House signing ceremony was to restore trust in the U.S. market by domestic and foreign investors, in preparation for the mid-term elections in the fall.

Although investment has been falling more slowly than it did the

Chart 1 Yen - Dollar Rate

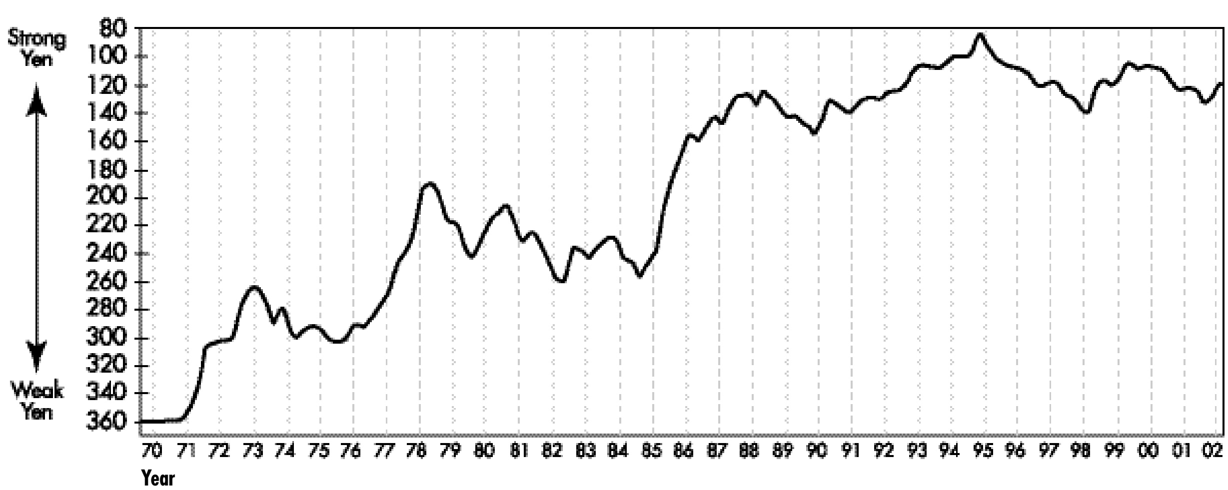
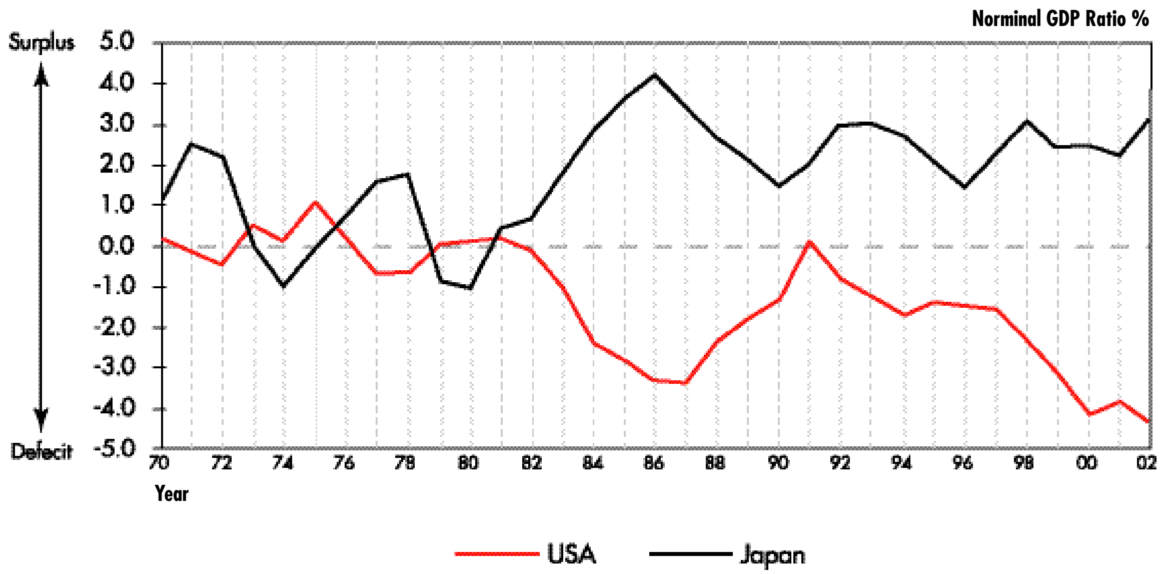


Chart 2 Current Balance of Payments



previous year, it has not yet rebounded to its once-feverish pace, reflecting worsening corporate profitability.

The third cause is the wearing away of the wealth effect that until very recently had sustained domestic consumption. Setting aside stock prices, Americans have seemingly hit their limit in extending their cash flows by using home equity lines of credit and refinancing their primary residences. Even though consumption during the first quarter of 2002 remained high (3.5 percent), stock prices dropped because the market somehow sensed that consumption was running out of steam. As a matter of fact, the consumer confidence index has worsened, which is prominently reflected in the GDP figures for the second quarter.

Issues in the Japan-U.S. Relationship

The current environment in which the highly-touted American style of management is being questioned is very similar to the changes that took place in Japan right after the so-called "Japan as Number One" era. Another parallel is the intensification of competition with low-cost nations such as those in Asia. The future Japan-U.S economic relationship should be considered against a backdrop of market competition.

Until recently, the Japan-U.S. economic relationship mutually sustained the gap in the external balance of payments (See Chart No.1). In other words, Japan expanded its economy by using exports as a lever. The United States absorbed Japanese exports and offset its resulting deficit in the balance of payments through the capital account. What made this possible was that the United States provided great investment opportunities and its dollar was the stable international currency. Thus, Japan's U.S. dollar-denominated surplus was automatically recycled back into the United States.

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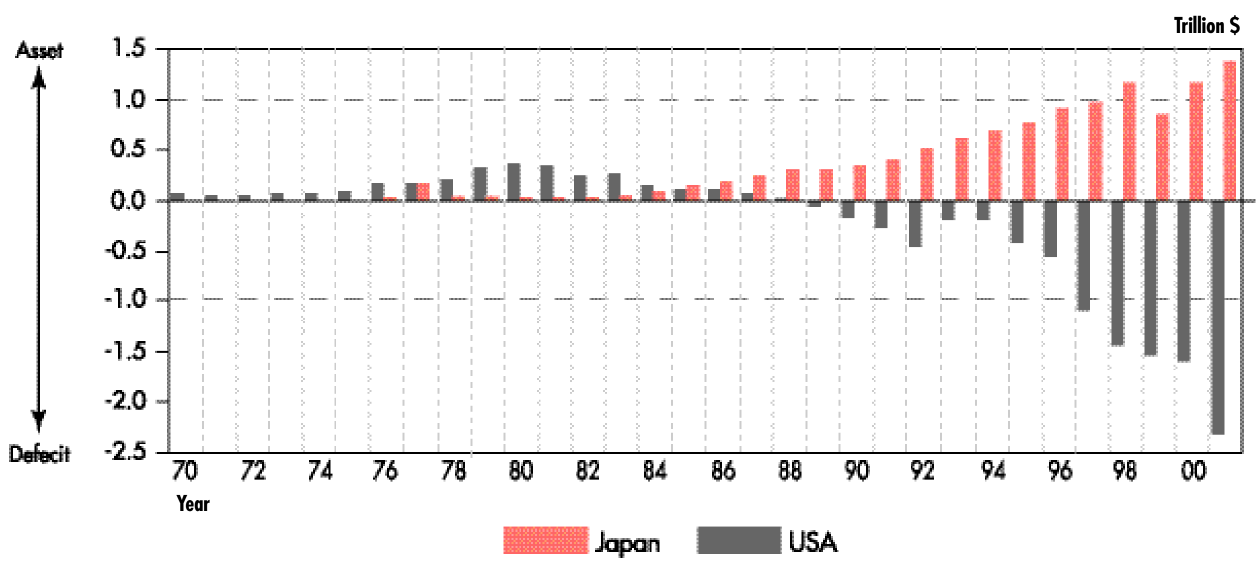
The foreign exchange market, however, will not overlook the expansion in U.S. cumulative debt. While the yen/dollar market corrects occasional excesses, it consistently moves in the direction of a weaker dollar (See Chart No.2). In 1971, then President Nixon replaced the post-WWII fixed market rate of ¥360/$1 with a float – as a result, the "Nixon Shock" saw a devalued dollar hit ¥308. The 1985 currency coordination known as the Plaza Accord resulted in the dollar valued at ¥240. The next joint intervention to sell dollars resulted in the value of the dollar being reduced by one-third to ¥180. Currently, the dollar is worth around ¥120. Thus the market, so cherished by the United States, can be seen to be functioning soundly.

Clearly, the foreign exchange market has a tremendous impact upon the real economy and price levels. The primary cause of the twin oil crises of the 1970s stemmed from the reduction in external purchasing power of the oil-producing countries when the dollar's value fell. Even if oil producers had exported the same amount of crude oil, the decreased value of the dollar made them unable to afford the same level of imports. Thus they were forced to raise prices.

In addition to these uncertain factors in the United States, there are other external factors that could upset the reflux of funds. First is the emergence of Europe's new currency, the euro. However problematical the euro may be, its function as an international currency having an economic base greater than that of the U.S. will probably expand. In fact, recent euro-denominated bonds have exceeded the volume of dollar-denominated bonds, and trading for crude oil in euros has begun to take place. In the currency field, the unipolar U.S. dollar-dominated system is beginning to undergo change.

Chart 3 External Net Asset Balance of Japan and USA



Second are the changes taking place in Japan. Due to the pressure from international competition resulting in the transfer of capital and technology to low-cost nations, structural reform is steadily underway, although its speed may not be as great as expected in the West. There is a strong possibility that Japan's aging society and depressed birthrate may begin to cut its legendary savings rates. Should net savings decline, the current account surplus would also drop.

In the international currency environment, the system of automatic reflux of funds back into the United States is facing a significant transitional period. Like low water reserves in a dam, the U.S cumulative deficit has been, to a certain extent, covered by funds recycled from abroad. But if it appears that the water risks drying up altogether, foreigners will no longer continue to invest in the US. The very level of the dam may be affected.

America's external net debt at the end of last year was approximately $2 trillion, constituting more than 20 percent of its GDP, whereas the drop in stock prices, which according to Newsweek magazine, amounted to approximately $8 trillion in lost wealth. Thus, in the future, a reverse asset flow will be unavoidable. The American dam, which tends even under normal circumstances to be short of savings (low water reserves), is reaching a dangerous level.

Temporary imbalances can be adjusted by external borrowing. But structural imbalances cannot be supplemented through borrowing alone. In spite of living in the era of globalization, it is essential that each national economy exercise discipline.

In conclusion, it's clear that both countries should enact macro economic reform. For Japan, the Koizumi government should dedicate itself to diverting national savings into investment in the Japanese economy. Conversely, the United States is in need of structural reform that will enable it to make up for the shortage in its domestic savings.

Each economy will have to discipline itself to remedy its weaknesses and to avoid too much dependence on other economies. Only in that way can a national economy secure its prosperous future. ■

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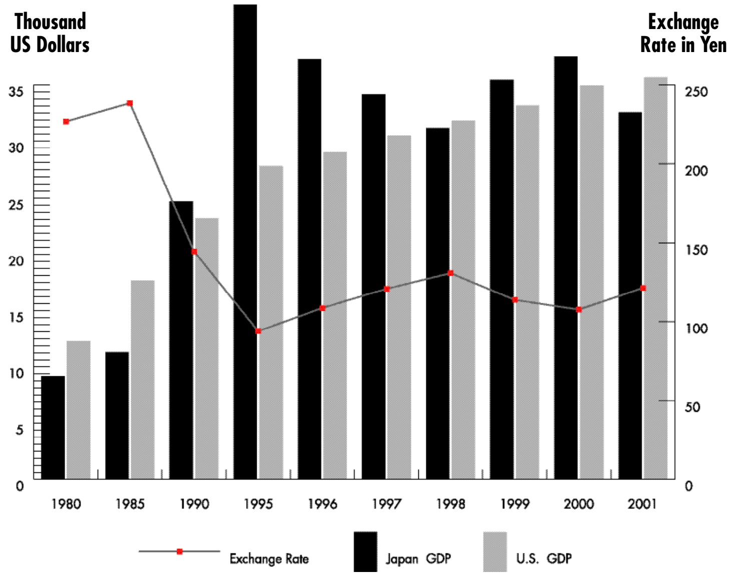
JAPAN-US ECONOMIC SNAPSHOT

"Historical Change of Per Capita GDP"

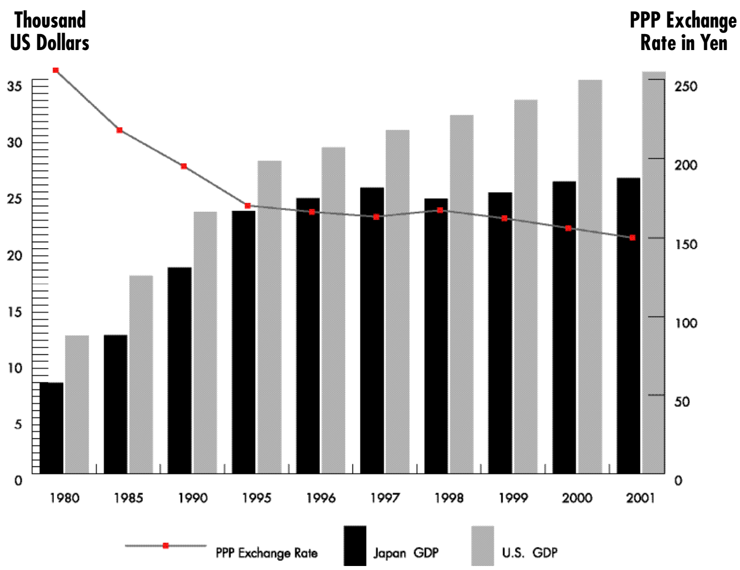
1) Per Capita GDP in Current US Dollars

Japan's per capita GDP in current US dollar terms is showing big swings due to changes in currency rates. It has exceeded the U.S.'s in most of the 1990's and shows little fluctuation when compared in the PPP currency rate, as shown in the chart.



2) Per Capita GDP in PPP Dollars

While Japan's per capita GDP in current U.S. dollar terms exceeded that of the U.S. in the 1990's, Japan's per capita GDP in PPP dollar terms is still below that of the U.S. Japan's per capita GDP was about 65-70 percent of that of the U.S. during the 1980's and about 73-80 percent of the U.S. level during the 1990's and in recent years. Chart shown at right.



SOURCE:

(JAPAN); Statistics Bureau & Statistics Center, GROWTH OF POPULATION, http://www.stat.go.jp/english/data/nenkan/zuhyou/b0201b00.xls .

(U.S.); BEA, National Income and Product Accounts Table, Table 8.7. Selected Per Capita Product and Income Series in Current and Chained Dollar, http://www.bea.doc.gov/bea/dn/nipaweb/SelectTable.asp?Selected=N.

NOTE: Japan figures are calculated by dividing [1-2 Nominal GDP in Current US Dollar] by Exchange Rate and Japan's Population, by [PPP Exchange Rate (See 2-5 PPP Exchange Rate)] and [Japan's Population].

Japan Business Dialogue

KKC's monthly program featuring Japanese experts on the economy.

"Japanese IT Sector: Why It Lost Out and How It Will Recover"

Mr Risaburo Nezu,
Fujitsu Research Institute.

After defining the world's technological edge for decades, Japanese companies disappeared from the world's IT (information technology) field of competition over the course of the 1990s, said Mr. Risaburo Nezu, Senior Executive Officer of the Fujitsu Research Institute.

Speaking at the July 25 Japan Business Dialogue, Nezu explained that of Business Week magazine's "Top 10 Info Tech Companies," only one company – NTT DoCoMo – made the list. In fact, he pointed out, no Japanese IT firm was on any of Business Week's top ten rankings for "fastest growing," or "most profitable," or "providing best returns."

In other indices, too, Japan lags behind. Japanese electronic machinery production – once neck-and-neck with the US and Germany in 1991 – is now far below its chief competitors.

Similarly, in the production of semiconductors, Japan seemingly miscalculated in the mid-1980s. Whereas the US focused on manufacturing MPUs (microprocessing units), Japan bet its future on DRAM technology. But MPUs have proven to be far more profitable than DRAMs, as evidenced by the price gap between $400 Pentium 4 chips and DRAMS, which cost less than $2. Not surprisingly, Nezu said, Japan's share of the global semiconductor market is far below that of the US, though still considerably ahead that of Europe's.

With regard to the production mix by individual companies, Nezu made a startling observation: that there is virtually no product differentiation between what Japan's top chipmakers (Toshiba, Hitachi, Fujitsu) make. But the production mix of top US semiconductor companies (Intel, Micron, and IBM) is very stark – each company has a strong product concentration. Korean and European companies also tend to have a discrete focus.

Japanese semiconductor companies are trying to restructure, Nezu acknowledged. But they are hampered by long-held assumptions – that it is best to internally manufacture all components and adhere to an integrated approach from R&D all the way through to the after-sales market. But this vertical approach has proven not to be the best way to control the market. On the contrary, Nezu explained – American and Taiwanese companies are huge importers of components and are more profitable.

The overseas production of original equipment for personal computers and laptops is also much more pronounced for American and European PC makers than for Japanese. Here too, Japanese producers followed an integrated approach doing everything at home, while American and European makers pursued a modular approach, outsourcing manufacturing overseas.

Shifting his attention to the dominance of non-Japanese companies in the Internet server market, Nezu explained that all top five companies are American (IBM, Sun Microsystems, Compaq, Hewlett-Packard, and Dell Computers). Among Japanese firms, Fujitsu Ltd. enjoys the highest penetration of Internet servers in the world market, but even so, has only captured less than three percent.

Japan is well-known for its saturation of mobile telephones. But this fact is misleading – none of the dominant producers in the world market for mobile phones (Nokia, Motorola, Siemens, Samsung, and Ericsson) are Japanese. Indeed, only 15 percent of the "Other" category is Japanese.

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Turning to software, Nezu pointed out that no Japanese company is a major producer – indeed, none even ranks in the top 100 software worldwide producers. Moreover, he explained, Japanese firms are not willing to buy "off the shelf" software – they instead insist that manufacturers tailor-make software for their company alone. "It is not efficient to refuse to adjust," Nezu concluded.

Unlike the US, India, and Israel which dominate the world software market, Japanese firms are held back by a number of factors: it is difficult for Japanese start-ups and entrepreneurs to secure venture capital; computer science is not widely taught in Japan; software companies are vertically integrated in Japan under large computer companies; and the market is segmented. Finally, Nezu said, Japan only has a few strong areas in the IT sector – namely, animation, games, and TRON (a Windows-like product).

Moreover, the forces of creative destruction do not play much of a role in Japan as they do in the US. To illustrate, Nezu identified the top ten American PC software companies in 1983. By 2000, all but one (Microsoft) had gone out of business. By contrast, the same Japanese IT companies are as dominant today as they were 20 years ago.

Regarding Japan's telecom sector, Nezu said that though privatization technically began in 1985, real competition did not occur until 1997, when the local loop was opened to competition. Yahoo Japan's entry in 2000 resulted in an explosion of broadband with the lowest prices. But too-high wages in the Japanese telecom sector, coupled with declining numbers of ISDN subscribers as users shift to cheaper ADSL, suggests bleak prospects for the future: it is already clear that the enormous investment by the Japanese government in broadband produced overcapacity in certain areas while demand remains low.

In conclusion, Nezu said, despite the bursting of Japan's IT bubble, its long-run effect on productivity and competitiveness will continue. This in turn will force a major transformation of Japanese companies' strategies and organizations.

He offered a number of policy recommendations: Japanese firms will need to concentrate resources on their areas of strength and to outsource the rest, as do the US and Taiwan. Production in China and the rest of Asia need to be integrated with their value chain. Nor should Japanese firms continue to try to go it alone, Nezu said. On the contrary – new strategies, such as restructuring and forming alliances at home and abroad should be vigorously pursued. Furthermore, Japan must establish an environment conducive to high tech ventures and university-industry collaboration.

Finally, Nezu said, Japan would do well to reevaluate its fear of the forces of creative destruction – telecom companies may well melt down, the majority of incumbent operators may disappear, and stock prices may hit near-zero. But an infusion of dynamic forces would do Japan well. ■

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