The Yen and the Dollar: Irrational Exuberance?

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Introduction

As a global investment advisor, my job is to try to see through the volatility in international financial markets by using information of the past and our knowledge of theory and market psychology to make predictions about the future and then invest accordingly.

The title of my talk shamelessly exploits the term popularized by Federal Reserve Chairman Greenspan some weeks ago when reflecting on the boisterous advance of the U.S. stock market. I expropriate it to draw attention to the very important, frequently controversial, and sometimes even emotional question of the appropriate level of the yen-dollar exchange rate.

Naturally, in any market -- stocks, bonds, real estate, or currencies -- whether the exuberance of market participants is rational or not cannot be known until after the fact. Markets do go to extremes, but not always. When prices in any market are strongly trending, plenty of commentators can make an impressive case why the trend will continue. They simply presume that the factors already at work will persist. If the trend reverses, it soon becomes obvious what they are missing. But some trends do not reverse -- or at least not right away. This is why it is especially interesting and timely to focus on the yen and the dollar today, when we have actually had the first significant rebound rally for the Japanese yen against the dollar in some weeks and when there is a healthy difference of opinion among both participants in the marketplace and specialists in the field of U.S.-Japanese economic and financial relations.

1. Swings in the yen-dollar rate as a recurrent feature of recent financial history

If we begin by recalling the numbers, we find, first, that astonishing swings in the value of the dollar against the yen have been a recurrent feature of recent financial history. [Chart 1, Japanese yen, 1988-present] There was an extended period of time when the yen was weakening during the Persian Gulf War and the rise in oil prices surrounding that. The latest loop of the roller coaster has seen the dollar fall in half against the yen from roughly the 160 level in 1990 to about 80 in 1995 and subsequently rebound to just below 125 currently. These are extraordinary swings; it is very hard to match them in any other currency market. In fact, only commodity markets have moved this much. Incidentally, the 125 yen-dollar level is not too different from that of ten years ago, *and* at the time of the 1988 U.S. presidential election, *and* at the time of the 1992 presidential election.

However, when considering the entire quarter century of floating exchange rates, the recent revival of the dollar is a modest event. The longer-term trend toward a weakening dollar against the yen has not necessarily been broken, as today's little rally reminds us. [Chart 2, Japanese yen, 1970-present]

2. Issues raised by these swings

This dizzying experience raises a number of issues:

- Why is it happening?
- What difference does it make to our representative economies and financial markets?
- Who gains and who loses from all this volatility?
- Why do the financial authorities of the respective countries allow it?
- Do they secretly favor such wrenching fluctuations or are they powerless to do anything about exchange rate instability?
- How much of the exchange rate volatility has to do with economics and how much to

specifically financial market considerations?

- And finally, what can be said about the outlook?

3. Causes of swings in the yen-dollar rate

In assessing the causes of these wide swings in the yen-dollar rate, the conventional place to begin is with the fundamentals of international trade and current account balances, the best single picture of a country's net external position vis-a-vis the rest of the world. And lately this has been a very simple story. [Chart 3, Current Account Balances as a % of GDP] The central fact is one of a large but declining Japanese surplus, combined with a sizable but steady U.S. deficit. To some people this means there should be a long-term trend to a lower dollar. Indeed approximately 80 percent of the variance in the yen-dollar rate over the long term can be explained by this single factor. The central problem is that current account positions not only help shape currency trends but are themselves heavily influenced by exchange rates, and they are both happening at the same time.

While some people ascribe importance to the bilateral trade relationship between the United States and Japan: (28 percent of the U.S. trade deficit is with Japan, but that is down from 37 percent in 1995), I find this argument unpersuasive and counterfactual, in that the yen has trended higher against all currencies, including those of countries against which it runs a persistent trade deficit. Similarly, the United States usually runs a trade deficit with Canada, yet the U.S. dollar has appreciated against the Canadian dollar for years.

A second cause is the politicization of trade and currency relationships. This is not a new ingredient in the yen-dollar nexus. It started with the "Nixon-shock" in 1971 and keeps reappearing. Various U.S. administrations have had a dollar depreciation bias since 1985, often to pressure Japan to free up imports faster. Treasury Secretary Rubin's shift toward a more even-handed approach has been noteworthy and has had a big impact on market psychology in favor of a strong dollar. Whatever the political reasons, the views of political leaders matter because they influence people's probability assessments of the likelihood of direct policy changes, monetary and fiscal policy, and exchange market intervention that will result.

Shifting *perceptions* about U.S. economic performance relative to Japanese economic performance are also important for determination of exchange rates. Following a decade of ridicule or worse, U.S. corporations now get credit for doing many things right. Restructuring has gone far and lifted profitability. [Chart 4, U.S. Corporate Profits as a percent of National Income]. But Japanese companies have not been idle. They are leaders in outsourcing and reengineering in a number of manufacturing industries, though not so much in services. Profitability held up surprisingly well, despite the collapse of the bubble, the ensuing recession and the soaring yen through 1995, and has improved further lately. It is not too far below 10 percent now, at a very early stage of the business recovery. Therefore, it is a great over-exaggeration to ascribe the profound weaknesses of the Japanese financial sector to the corporate sector, which has been adjusting and is now doing well. [Chart 5, Japanese Private Corporations Income as a percent of National Income]

It is with regard to government fiscal discipline that the pecking order has changed most dramatically. [Chart 6 , Budget Balances as a percent of GDP, Japan and U.S.] In a period of four years the United States has brought a very large deficit down to close to 1 percent, the forecast for this year. How did this come about? The United States raised taxes and cut defense tremendously, by 3½ percent of the GDP. That meant the redeployment of four million people in ten years. [Chart 7, U.S. Real Federal Government Spending as a % of GDP] Meanwhile, Japan applied textbook Keynesian fiscal stimuli to revive the Japanese economy after the collapse of the bubble, admittedly with not terribly powerful results. This definitely will continue to hurt the yen until the Japanese economy starts to grow faster.

The paradox of Japanese economic and financial infirmity is that for a long time, the yen moved inexorably higher, despite Japan's economic problems, because the current account and trade position dominated market developments. But other factors were bound to weigh in.
The most important has been the change in relative interest rates. Huge interest rate differentials emerged, all across the yield curve, favoring U.S. investments. [Chart 8, Yield Spreads: U.S. less Japan, 10-Year Government Bonds] Now people can borrow yen day to day, at ½ percent per annum, convert that money into dollars and buy U.S. 30-year bonds yielding almost 7 percent. This has been one of the big time financial market plays that has made the dollar stronger.

The other side of the equation is the relative performance of the equity markets. An ailing Japanese stock market reflected concerns over hollowing out, deregulation, and absorption of information technology. [Chart 9, Japanese Equity Market Relative to the Rest of the World] It should come as no surprise that many Japanese business people between the ages of 35 and 50 are sour and cynical. Indeed, many in this "spark plug" generation bought their apartments at the peak of the real estate boom in the late 1980s and then invested their excess savings in the stock market, where they have since lost half their money. Such stark generational differences are more extreme in Japan than in any other country and they feed back on exchange markets through the interaction of savings flows and investment decisions both domestically and abroad.

Since investment returns are what matter at the end of the day, it is worthwhile reviewing the outcome to investors in the financial markets of the two countries. [Chart 10, Investment Returns in Japanese and U.S. Financial Markets]. For the decade of the 90s, the average annual total rate of return for equities in the Japanese equity market is -7.5 percent per year, whereas in the bond market the rate of return has averaged +7.9 percent per year. For the United States the bond market outcome is similar to that of Japan because our interest rates on balance have come down during the decade of the 90s. The equity market contrast is dramatic, particularly in the last two years. In fact, there is no other time period in American history where the stock market has gone up this much two years in a row and then gone up again in the third year.

Tracking private capital flows in and out of the two countries does not give the full story. Official operations are also important. Up until mid-1995, a weakening dollar was provided sizable support to cushion its decline and provoke a turnaround. But Japanese official reserves continued to go up even as the yen's strength subsequently faded. [Chart 11, Japanese Foreign Exchange Reserves] This represents a form of market manipulation that may or may not be warranted, depending on whether you believe the yen had well overshot sensible levels from a longer-term perspective. It is instructive that the Japanese authorities have not chosen to feed some of these reserves back into the market as the yen depreciated, which implies they have not minded a weaker yen.

Let me end this section with a theoretical observation. Exchange rate changes are fundamentally redistributional. They change the nature of who gains and who loses. They shift incentives and income toward different groups in society. Depreciation of the currency tends to favor the strong in a society, and appreciation of the currency tends to favor the weak. It is a very simple proposition. Export industries in any country relative to the overall economy are the stronger industries since they have a comparative advantage. When the currency depreciates the income generating potential or profitability of export industries goes up. At the same time, import prices go up for consumers so relative power shifts away from ordinary people toward the more powerful in society. On the other hand, a strong currency holds down inflation and particularly import prices, which benefits consumers. This fundamental social-political point is important to bear in mind when looking at the large swings in exchange rates over the last 25 years. They have had enormous redistribution effects benefitting ultimately Japanese who have less power than the Japanese exporters and benefitting American exporters (and manufacturers who compete with imports) over consumers.

<u>The yen, the dollar, and the nature of financial markets</u>

Now looking forward with regard to the yen and the dollar, let me propose three precepts about the nature of financial markets.

First, it is wrong to treat financial markets as if they were a single all-knowing individual. Markets do no believe anything, or think anything -- it is only the people who inhabit them who actually do the thinking and believing. By contrast, movements of prices or exchange rates do convey information to both investors and officials, although sometimes false signals are emitted so the information content is not clean.

Second, at every point in time, there is an equally convincing argument for a rise in price or a fall in price for every stock, bond, or currency. If one side of the argument starts to dominate, even briefly, prices adjust and they move until once again equally convincing arguments are in place. Put another way, there always has to be a balance between those who believe the latest trend will persist and those who think it will be reversed. In this dynamic sense, there is never a "contrarian" view in a market.

Third, markets often make lousy forecasts. For example, if we are given the spot, three-month forward, and one-year forward rates for a given currency at a given point in time, what can we say about the actual future rates of that currency? While some people argue that forward rates provide the most neutral forecast that can be made about the future and anything different from that requires knowing something, the fact is most of the time the forward rate is in fact no better than a coin flip -- and this is just on direction of the rate, forget magnitude. In other words, the market is a lousy forecaster. [Chart 12, Forward Exchange Rates as a Predictor of Future Currency Movements] Does this pitiful forecasting record mean that the foreign exchange markets are infected with irrational exuberance? Not necessarily, but it does mean that they may be incompetent! Currency markets do not have any wisdom; they do not "know" what the rates should be or where they are going.

What are the implications of this for investment decision making? Don't be intimidated by the implicit market forecasts of either interest rate or exchange rates. Pay attention to the technical conditions of the market -- how powerful the momentum of the existing trend is. Pay close attention to fundamental determinants. When they are pointing in the same direction, then invest with some confidence. Otherwise, be patient and somewhat defensive.

On dollar-yen right now we are mildly neutral. We are not expecting a strong decline in the Japanese yen. Instead, we foresee basically a trading range with a slight tendency for the yen to weaken in the very near term but to strengthen in the medium term. This is in contrast with our view of the outlook for most European currencies, which we assume will fall against the dollar for some time. The European cost structure is too high to permit healthy profitability, and European businesses will seek to invest outside Europe unless the dollar strengthens substantially. The improving profitability of Japanese firms shows that the Japanese adjustment mechanism is working better, and so Japanese corporations do not require a weaker yen for financial viability.

5. What is the likely course of developments from now on?

The U.S. economy has very strong prospects, grounded in a much better performance of previous struggling sectors and areas (commercial real estate, defense, Southern California, New York metropolitan area), and continued solid performance in much of manufacturing and high-tech services. A strong dollar has held down inflation, so interest rates are still at moderate levels -- which helps interest-rate sensitive sectors like home-building. All this breeds good income generation.

Plus, the stock market advance of the past few years has produced a huge wealth effect, which encourages risk taking. U.S. household wealth has soared relative to income, which may not generate a lot of consumption spending directly, but does spur risk taking and small business formation. That, in turn, promotes job creation. That is how a rising stock market generates a better economy. [Chart 13, U.S. Household Financial New Worth versus Personal Disposable Income] The allegedly low U.S. savings rate is frequently criticized, but a more interesting point is savings have held up despite gigantic increases in net worth. [Chart 14, U.S. Household Financial Wealth versus Personal Savings] In the United States the national income statisticians' "fresh" savings is low but the real genuine savings in terms of foregone consumption out of wealth is very high, and this bodes well for the budget and inflation in the long term and the sustainability of a strong economy.

The Japanese economy is still facing headwinds, though they are not of gale force anymore. Production and business sentiment are higher [Chart 13, Japanese Industrial Production and Business Sentiment], earnings have turned up, the job market is brightening. [Chart 16, Changes in Total Employees and Job Offers in Japan]. Both job offers and total employment have definitely turned the corner. This will help tremendously consumer confidence and personal spending. I am not too worried about the impact of the consumption tax. The household sector is also in reasonably good financial shape [Chart 17, Japanese Household Financial Net Worth versus Personal Disposable Income]. This is largely because Japanese individuals continue to save a lot. Unlike the United States the change in Japanese financial net worth is not as important a part of the buildup of assets as fresh savings. [Chart 18, Changes in Japanese Household Financial Wealth versus Household Net Savings] Thus, the threat to the Japanese recovery from the consumption tax increase may be overstated.

In short, both the United States and Japan are likely to turn in economic performances this year that are better than generally expected -- with mild, though gently rising, inflation in both countries. On balance this might modestly favor the yen, since sentiment has been so sour. Yet interest rate differentials are so powerfully in favor of the dollar right now that it is hard to see capital not being pulled into our money and bond markets -- and maybe into the stock market, too.

But what about the concerns of trade experts? Won't the higher value of the dollar set off another round of imbalances, setting the stage for yet another cycle of excessive exchange rate swings? Maybe not, for several reasons.

On the U.S. side, the 'import' dollar is stronger than the 'export' dollar. [Chart 19, Import Dollar Stronger than the Export Dollar, Merrill Lynch Dollar Indexes] Export orders in recent NAPM (National Association of Purchasing Managers) reports have registered an impressive surge, one of the highest in the entire business cycle. U.S. companies are leaders in making high-tech capital goods that corporations the world over need to install to remain competitive. Thus, exporters are not being priced out of world markets, but import costs are being held down in the United States because the dollar is not rising against the currencies of our export markets as much as against the currencies of our main sources of imports.   So the U.S. trade deficit will not balloon.

The Japanese trade situation is helped by a weaker yen. There is a very substantial bounce back in export volume after a period of aimless drifting and a huge drop in import volume growth. On the Japanese side, it is true that export trends are reversing, [Chart 20, Export/Import Trends have Reversed] but Japanese exports have for a long time been doing less well than the growth of their markets would suggest. [Chart 21, Growth of Japanese Exports & Export Markets] The rate of growth of Japanese export markets has been consistently higher than the rate of growth of Japanese exports for over 10 years.

Part of this is the *cumulative* effect of a generation of a rising yen exchange rate. But ongoing corporate restructuring and outsourcing are permanently changing incentives and the direction of trade.

6. Conclusions

Given the current state of the U.S. and Japanese economies, which are both far better than anyone expected, there is no reason why the dollar will suddenly fall sharply against the yen in the near term. The yen will experience a serious advance when the United States next slips toward recession, but not before. At that time we will have much greater focus on the trade position and more pressure for the dollar to strengthen. Thus, we will likely have a year or two more of debating whether those who buy the dollar against the Japanese yen are irrationally exuberant.