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A weaker currency will make Japan stronger

By Kumiharu Shigehara

Published: April 1 2003 20:54 | Last Updated: April 1 2003 20:54

In spite of a monetary policy geared to virtually zero nominal short-term market interest rates and huge increases in the monetary base, Japan's economy continues to struggle with deflation. Accelerated bank restructuring or further fiscal expansion alone will not solve the problem. The country must, with the support of its trading partners, resort to another effective stimulative mechanism: currency depreciation.

Between 1993 and last year, Japan's share of world merchandise exports fell from 10 per cent to 6.6 per cent, while both US and German shares remained stable at about 11 per cent and close to 10 per cent respectively. Higher wages and other production costs in Japan than in its partner countries brought about by high yen exchange rates have weakened its exports, impeded foreign direct investment inflows and encouraged Japanese manufacturers to direct investment abroad.

Resorting to a protracted period of nominal wage cuts and price deflation would be costly for Japan. It would aggravate debtors' balance-sheet positions and increase banks' new bad loans. Currency weakening would be a less costly remedy.

The net effects of currency depreciation on the trade balances of Japan's partners would be small over time, with higher export growth jump-starting Japan's domestic economic recovery and later increasing import demand. But in the short run, yen exchange adjustment could adversely affect the partners' external accounts.

With these considerations in mind, I propose the following policies to be jointly adopted now by the Bank of Japan and the Japanese government.

First, the BoJ should set an operating target in terms of total bank reserves and aim at its annual growth in line with desirable growth of nominal gross domestic product, say, 5 per cent. There should be a proviso that any unforeseen increase in demand for bank reserves will be accommodated so that nominal short-term market rates should remain close to zero.

Second, the government should announce the target range of the yen exchange rate, say, 150 to 160 yen per US dollar. Pegging would be another option. In addition, the BoJ should automatically raise the targeted level of bank reserves by amounts equivalent to the yen counterparts of dollar purchases in the exchange market. In the past, forceful exchange market interventions by the Ministry of Finance have been undermined by lack of co-ordination with the BoJ's domestic monetary management.

Third, to avoid tensions with foreign businesses, the government should impose a special exchange rate adjustment tax on big companies' "windfall" profits resulting from the weaker yen.

Fourth, the government should further encourage competition between Japanese and foreign companies in once protected sectors. Non-viable industries and companies should not be protected by subsidies.

Fifth, increased revenues from the special tax should used to support those workers who lose their jobs.

Sixth, the government should announce a credible medium-term plan for reducing structural budget deficits. Automatic stabilisers should be allowed to work.

Seventh, once these government policies are in place, the BoJ should specify the price level to be achieved on a two-year time horizon and announce its intention to move to a regime of inflation targeting once it is achieved. Price forecasts should be published with explicit assumptions about the fiscal policy stance and the yen's

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nominal effective exchange rate.

Eighth, Japan should advise Asian partner countries to adopt currency baskets in which the yen's weight is raised to absorb some of the shocks associated with exchange adjustment.

Ninth, Japan should argue for greater fiscal flexibility in the eurozone. This would help prevent the euro area from getting into a recession arising in part from weaker exports associated with the recent firming of the euro against the dollar and the yen.

Last, Japan should take a leading role in the post-Uruguay round of trade liberalisation. Further market opening should increase the import elasticity of Japanese domestic demand.

Some of these policies may be painful to implement. But they are the only way Japan can secure vital support from its trading partners in its efforts to achieve economic recovery through exchange rate and monetary policies.

The writer is former deputy secretary-general and chief economist of the Organisation for Economic Co-operation and Development

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