

# US-Japan conflicts over rising yen

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A year after US president Clinton warned that the world was facing its worst financial crisis in 50 years, finance ministers of the G7 all but declared it to be over at their meeting in Washington last Saturday. While “we still face a number of challenges”, economic prospects for the major industrial nations had improved, the meeting claimed.

But rapid changes in currency values, particularly the relationship between the US dollar and the Japanese yen, together with the ever-present fear that the US stockmarket could undergo a precipitous fall are indications that the global financial storm may be far from over.

The major item of discussion at the G7 meeting was the steep rise in the value of the yen against the US dollar. Since June it has appreciated by 15 percent, and since August 1998 by more than 40 percent. As is customary at such meetings, the official communiqué from the G7 meeting sought to convey the impression that some agreement had been reached. In fact, the finance ministers left the meeting deeply divided over what had to be done.

The Japanese insisted that there should be a joint intervention by the G7 powers in currency markets in order to bring down the value of the yen.

The US position, supported by the rest of the G7, is that the rising yen is a Japanese problem which must be overcome by an increased fiscal stimulus to the economy—more government spending—coupled with a looser monetary policy.

The Japanese maintain that with the budget deficit already at 10 percent of Gross Domestic Product (GDP) and the total issuance of government bonds now the equivalent of 120 percent of GDP there are limits to this program. Furthermore the Bank of Japan, which is insisting that monetary policy is conducted independently of government directives, maintains that with official interest rates close to zero further expansion of the money supply will lead to inflation. In the lead up to the summit, Bank of Japan governor Masaru Hayami declared that monetary policy would not be changed and that “manipulating exchange rates is not an object of monetary policy.”

Attempting to reconcile the opposed positions, the official communiqué stated that the G7 “shared Japan's concern

about the potential impact of the yen's appreciation for the Japanese economy and the world economy.”

At the same time, it continued, Japanese authorities had pledged to “implement stimulus measures until domestic-demand-led growth is solidly in place and, in the context of their zero interest rate policy, to provide ample liquidity until deflationary concerns are dispelled.”

This was widely interpreted to mean that the Bank of Japan had reversed its previous position on the need to further loosen monetary policy. However, in response to these claims, the Bank of Japan governor called a special press conference in Washington to make clear that “nothing had changed.”

An editorial in last Monday's *New York Times*, which often reflects the position of the US administration, gave an indication of the tensions between the US and Japan over the issue:

“Masaru Hayami ... tantalized Western finance officials ... by hinting that the bank would begin printing more yen—a necessary step if Japan is to pull itself out of a decade-long slump. But the governor issued no firm commitments. Indeed, he even denied that his words represented a change in policy.

“This is dismaying. Bank officials resist pumping up the domestic money supply out of a remarkable fear of inflation. But Japan's problem is the opposite—deflation. Japanese prices have been falling for years, and the longer they fall the more Japanese consumers postpone buying until prices fall even further. That downward spiral of prices and spending can become a recipe for disaster.”

The editorial noted that while a rising yen was not a problem in itself, in this case it was the symptom of a “dangerously tight monetary policy.” Noting Hayami's insistence that his pledge to “respond appropriately and timely to developments in the economy as well as in financial markets” represented no significant change in policy, it concluded: “The frightening possibility is that he is serious.”

The main concern in US financial circles is that a rising yen will choke off the nascent recovery in Japan—the economy grew by 2 percent in the first quarter and 0.2

percent in the second—adding to the deflationary tendencies in the world economy.

For the past year the US has been insisting that both Europe and Japan take action to stimulate growth in order to ease its mounting balance of payments difficulties and that the US economy cannot continue to function indefinitely as the “consumer of last resort.”

In July, the US trade deficit reached a new monthly record of \$25.2 billion, following the record trade gap of \$24.6 billion in June. The trade deficit is currently running at an annual rate of \$247 billion, well above the record gap of \$164.3 billion last year.

This has led to fears that if the trade deficit is not corrected it will spark a crisis of confidence in the dollar, leading to a rise in interest rates and a crisis in financial markets, possibly triggered by a rapid fall on Wall Street as capital is sucked into Japan. The potential impact of such a movement is indicated by the fact that Japanese savings account for about 40 percent of the world's total. When the yen falls, this money flows to the rest of the world, providing a base of support for financial markets. But a rapid rise in the yen's value can see a sudden movement in the opposite direction.

There are already signs that this process may have begun. Pointing to what it called an “attack of nerves in financial markets”, in particular last week's 5 percent drop in the Dow Jones index, a comment in September 25 edition of the *Financial Times* said there were “reasons to worry”.

“The Bank of Japan's refusal to loosen monetary policy as the yen appreciates threatens to choke the country's nascent recovery. Meanwhile, the yen's strength against the dollar has frightened US investors, who are rightly concerned that it may trigger a revival in inflation and make the massive US current account deficit more difficult to finance. An outflow of capital would hurt Wall Street directly; it might also force interest rates higher, so slowing growth and undermining valuations. Sadly, there seems little prospect of a co-ordinated response emerging from this weekend's Group of Seven meeting in Washington.”

Fears of a sudden drop in Wall Street—pinpointed by the International Monetary Fund as the chief danger facing the world economy—are based on an analysis of market trends over the past year.

While the Dow Jones index has continued to rise over the past 12 months, some analysts point out that it is based on an increasingly narrow set of stocks which do not accurately reflect broader market trends.

The *Sydney Morning Herald's* Wall Street commentator, Brian Hale, for example, recently noted that even as the Dow Jones rose the underlying “bear market continues to deepen with the market's advance/decline line (the number of rising share prices compared with the number of falling

share prices) extending its negative trend to 17 months. That's the longest negative trend since 1928-29, ahead of the Great Crash.”

The British *Economist* magazine warned in its latest issue that over the past year “evidence of a bubble has mounted with every sign of excess elsewhere in the economy”.

“The private sector's financial deficit has risen to an unprecedented 5 percent of GDP (in the previous 50 years it had never exceeded 1 percent). Money supply growth is rapid. And America's current account deficit is heading for a record 4 percent of GDP this year.”

The September Monthly Economic Review published by the London-based think tank Lombard Street Research notes that all the most commonly used valuation benchmarks show “serious over-valuation.” According to its estimates, in order for the price-earnings ratio to return to historically normal levels share prices would have to be halved. It noted that on all five possible valuation benchmarks US equities were “stratospherically expensive.”

Pointing to the “tension ... between valuations far in excess of long-run norms and unsustainable macroeconomic trends”, in particular the emergence of trade deficits of around \$25 billion per month, it concluded:

“The stability of American asset prices, and to some extent American financial stability more broadly, have become dependent on continued large-scale buying of American assets by foreigners. Yet—if such buying persists—it is simple to show that the USA's external liabilities become unmanageable in the medium and long runs. The final phase of the Greenspan Boom promises to be very interesting. It is difficult to see how the over-extended equity market valuations can be reconciled with the unsustainable macroeconomic trends for much longer.”



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