Weakening US dollar threatens Japan's recovery

Joe Lopez
5 July 2002

The weakening US dollar, buffeted by the recent financial scandals at Enron, WorldCom and Xerox as well as a growing American trade deficit, threatens to derail the recent export led improvement in the Japanese economy.

The dollar's fall and the consequent strengthening of the yen is of major concern for the Japanese government as it seeks to boost the crisis-ridden economy because it pushes up the cost of Japanese exports, particularly to its largest market, the United States.

Last week it resorted to bringing in the European Central Bank (ECB) and the US Federal Reserve to sell yen in an attempt to weaken the Japanese currency. It was the first time that the Japanese government had called on both the ECB and the Fed to act on its behalf.

The latest attempt was the eighth occasion since May that Japanese authorities have intervened in the currency markets in order to depreciate the yen with $20 billion being spent to push up other currencies, primarily the US dollar. But the measures have been largely unsuccessful as the US dollar continues to weaken.

In recent weeks, Japanese political leaders have been claiming that the economy is on the road to recovery, following an increase in the growth rate for the first three months of this year. But such claims do not cut much ice in international financial circles.

A recent article in the *Financial Times*, for example, pointed out that the Japanese recovery was highly dependent on the US economy and took a swipe at the Koizumi administration's lack of effort on "structural reform".

According to Tokyo correspondent David Ibison: "While Japanese politicians have been trumpeting their alleged successes in promoting structural reform at home and claiming they have created an environment ripe for economic revival, the fact is that Japan's recovery is umbilically linked to the US economy. The combination of a US economic recovery and a weak yen provided a panacea for Japan's economic ills and also promised to alleviate the political pressure on Junichiro Koizumi, the prime minister, whose economic reforms have lost steam."

Although they represent only 10 percent of Japan's Gross Domestic Product (GDP), the recent rise in exports, particularly to the US, accounted for half the economy's growth of 1.4 percent in the first quarter of this year.

Other figures pointed to a continuation of the recession. Capital spending on factories and equipment fell 3.2 percent for the quarter, while consumer spending, which accounts for 55-60 percent of Japanese GDP, decreased by 0.3 percent from the September-December quarter of 2001 when it showed a 1.9 percent increase.

A total of 430,000 jobs were destroyed in April 2002, pushing the unemployment rate to a near record of 5.4 percent.

This has led to cautious assessments by some government officials who describe the latest figures as representing a "bottoming out" of the downturn of the past year rather than signs of a sustained recovery.

If the dollar keeps falling, Japanese business will be hard hit. According to Shuji Shirota, an economist at Dresdner, Kleinwort Wasserstein: "The industrial sector would be able to handle a controlled decline in the dollar against the yen, but exporters of raw materials, like iron and steel would suffer. If the dollar, now worth about 119 yen, were to fall swiftly to below 110 yen that would virtually wipe out the profits of most exporters."

The government's own Cabinet Office puts the break-even rate for most exporters at 115 yen to the dollar.

The continuing economic stagnation is having a major impact on government finances as tax revenues decline. According to the Ministry of Finance, government spending for this fiscal year will total some 81 trillion-yen; however taxes will bring in less than 47 trillion yen. This represents a shortfall of 34 trillion yen or just under $250 billion.

The tax revenue decline is adding to concerns about the ability of the Japanese government to continue to service the public debt, estimated to be around 140 percent of GDP and rising. Government spending aimed at trying to keep down the value of the yen will add to the problem.

The rising public debt is one of the main reasons why international credit rating agencies have downgraded Japan's sovereign debt rating to the equivalent of the African nation of Botswana. And if recent comments by Standard & Poor's head of Asian sovereign debt ratings, Tocharian Ogawa, are anything to go by, the credit rating agencies may be looking at further downgrades.

Commenting on the state of the Japanese economy, Ogawa said: "The banking system still doesn't work, you have the corporate debt problems and capital spending is falling. We don't think this economic recovery is sustainable."

Moody's Investors Service this week cut five of Japan's leading banks' financial strength ratings to the lowest possible grade. SMBC, Mizuho Bank and Mizuho Corporate Bank, UFJ Bank and UFJ Trust Bank were downgraded from E+ to E.

Moody's description of financial institutions given the lowest E rating are banks displaying very modest intrinsic financial strength, with a higher likelihood of periodic outside support or an eventual need for outside assistance. E-rated institutions, Moody's maintains, have financial fundamentals that are materially deficient in one or more respects, or a highly unpredictable or unstable operating environment.