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Japan and the International Monetary System

by Nobumitsu Kagami, London*

The 1970s saw the recurrence of major turmoil in the international monetary scene in which Japan played no small part. Japan's response to past monetary upheavals has always been passive and there were occasions when its passivity and delayed response so undermined the working of the monetary system that an eventual explosion became inevitable. This article tries to trace the underlying causes of Japan's behavioural pattern in an international monetary sphere and identify positive roles it can and should play against the background of a likely revolution in the international monetary system in the future.

In order to understand Japan's perception of, and reaction to, international monetary developments it would be of some use to briefly review the post-war history of its balance of payments. The majority of the people who now hold positions as major decision makers spent their prime periods under the constant fear that their ambitious plans and programmes might be jeopardized through the Government being forced to take severe restrictive measures in response to a deterioration in Japan's balance of payments. Throughout much of the post-war period, until the late 1960s, Japan was a country whose growth had to be held in check time and time again by the balance of payments constraint.

The table shows a summary of the development of Japan's balance of payments in the post-war period. It is clear from this, that fundamental changes took place in the structure of Japan's balance of payments in the second half of the 1960s. However, at the time, very few people saw it that way. The fact that Japan incurred a small deficit in current account in 1967 was only regarded as another recurrence of the old pattern in which an economic upswing was followed by a surge of imports, a sharp deterioration of the balance of payments and an abrupt application of tight monetary policy.

Break with the Traditional Pattern

In retrospect, 1969 marks a break with this traditional sequence of events. The economy was then in its fourth year of recovery from the trough of 1965 – the year of the first major recession in the post-war period –, the balance of payments displayed a healthy

surplus, but prices were beginning to rise at a rate above 5 % per annum. For the first time, the authorities were forced to take decisions based on criteria other than balance of payments. In the end, the control of inflation took precedence over balance of payments and monetary policy was tightened with a rise in the official discount rate from 5.84 % to 6.25 % in September 1969.

With the aid of hindsight the correct policy would have been to revalue the yen. However, at the time, this was totally unthinkable. There was a gross underestimation of underlying forces and of the considerable improvement in Japan's export competitiveness which had been achieved by the massive industrial investment during the preceding decade. Consequently, Japan's surplus exploded culminating in the Nixon measures of August 1971.

Developments since the beginning of the 1970s are well-known. There were genuine efforts on the part of the Japanese to make positive adjustments to Japan's drastically changed external position in the early 1970s. Unfortunately the move was interrupted by the out-break of the oil crisis in 1973/74 which clearly exposed yet again the inherent vulnerability of Japan's balance of payments position. The deficits in the three years from 1973 to 1975 distracted attention from the need for fundamental adjustment, but the underlying forces kept exerting their influence resulting in the re-emergence of a large surplus after 1976, this time more ferociously than before. More recently, the pendulum has swung again with the renewed upheaval of oil prices and the prospect of large deficits for Japan's current account position. In view of the inherent vulnerability of Japan's balance of payments

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MONETARY POLICY

Changes in Balance of Payments Structure

(average yearly figures, in US-\$ mn)

	Reconstruction period	Period towards economic independence	Period towards high growth & open economy	Period towards high growth & external surplus	Transition to a mature economy		
	1946-1952	1953-1957	1958-1964	1965-1969	1970-1972	1973-1975	1976-1978
Trade Balance	-233	-360	151	2313	6907	3384	17265
(Exports)	(661)	(2041)	(4480)	(11327)	(23522)	(48493)	(80331)
(Imports)	(894)	(2401)	(4329)	(9014)	(16615)	(45109)	(63066)
Invisible Balance	100	211	-304	-1129	-1802	-4902	-6419
Current Transfer	316	12	-64	151	-308	-319	-468
Current Balance	183	-137	-217	1033	4797	-1837	10377
Long-term Capital	-8	23	116	-486	-2387	-4634	-5519
Short-term Capital E & O	17	33	85	154	2187	-58	681
Overall Balance	192	-81	-16	701	4597	-6529	5539
Foreign Exchange Reserves at the end of the period	930	524	1999	3496	18365	12815	33019

S o u r c e : K. Takahashi: Fundamental Factors Contributing to the Economic Growth of Post-war Japan, supplemented by the author for the recent period.

to external developments and the continuing vagaries of the international environment, the Japanese may be justified in feeling that they need extra room for manoeuvre in their actions in this sphere.

To a large extent, Japan's policies and attitudes towards international monetary affairs stem from this background. However, a word of caution is perhaps in order at this stage because Japan's stance has been changing rapidly in recent years and some of these changes are quite significant, warranting further discussion below.

In the first place, it would be fair to say that Japan's attitude in this field as in other international matters has on the whole been characterised by its passiveness. At least until the late 1960s, international monetary problems did not exist in the eyes of most Japanese, although events such as the 5 % revaluation of the DM in 1961, the sterling devaluation of 1967, the gold crisis of 1968 and the DM - FF realignment of 1969 were all headlined in the Japanese press. When the yen came under upward pressure in the 1970s, question was seldom raised as to the working of the international monetary system itself: or if it was, it was generally felt that its malfunctioning was beyond Japan's control. Japan's response was mainly "to adjust" to external pressures.

Secondly, many would agree that in general, Japan has until recently maintained a policy of low exchange rates for the yen. There has always been a deep-rooted and widespread sense of fear and apprehension whenever the yen was subjected to heavy upward pressure. I would argue that this was sensible and justifiable policy for a country whose economy was experiencing a rapid and dynamic growth with an abundant supply of labour. In addition, Japan, with its almost total dependence on foreign

sources for the supply of energy and other essential raw materials and also with the sense of insecurity that many Japanese feel in an unsettled world, has always felt that it needs extra safety margins to maintain its export competitiveness.

Thirdly, Japan has always placed great importance on exchange rate stability. Without any secure foundation such as the Common Market for European countries, which are linked together by long standing common social and cultural tradition, the Japanese cannot help but feel insecure and secluded in their relations with the rest of the world. Therefore, it is natural that Japan wants an international system which can give in itself at least the semblance of a guaranteed stability.

Slow-down in Japan's Economic Growth

Fourthly, the maintenance of a stable exchange rate relationship with the US dollar has been of utmost priority to Japan. Compared with this the yen's exchange rates with other currencies are of subsidiary importance. This simply reflects the fact that the key note of Japan's external relations, be they economic or political, has lain, and will continue to lie, in the maintenance of a close alliance with the US. This point is further reinforced by the fact that the majority of Japan's foreign trade is still denominated in US dollar. Therefore, Japan's inclination towards a unitary global monetary system based on a strong and stable dollar is a natural corollary of the close affinity, both real and psychological, that the Japanese have developed towards the US.

The question to be asked here is whether the policies and attitudes of Japan so far discussed are compatible with the changing conditions of the world economy. In this regard, problems facing Japan are

compounded and complicated by developments on both internal and external fronts.

On the domestic front, the most important is the fact that since the beginning of the 1970s, there has been a significant slow-down of Japan's secular growth rate. What has been overlooked is the external consequences of such a slow-down of an economy which is after all the second largest in the free world. In retrospect it was almost inevitable that when the growth of the Japanese economy slowed from over 10 % p. a. to about 6 % p. a. one of the results would be a large external surplus during the transitional period. Consequently some disturbance in the working of the international monetary system should have been foreseen.

Unfortunately, Japan's transition from a fast growing economy to a moderate one started at a time when the international monetary system itself was showing signs of breaking down. Had the world monetary system been more stable, or had Japan been a less important force in the world economy, Japan's transition would have been more easily accommodated. In the event, however, increasing instability in international monetary development which was seen to be making the future of Japan less secure tended to deter Japan's resolve to take positive action with regard to its external position while Japan's continuous surplus accelerated the erosion of confidence in the existing monetary system during the period from 1977 to 1978.

The logical link between the slow-down of Japan's growth trend and the resulting large external surplus is simple enough. With the lowering of expectations for future growth, investment demand had to fall sharply in relation to total demand. During the 1960s, when the economy was growing at more than 10 % p. a. Japan used to set aside 20-25 % of its GNP for private capital investment. With a 5-6 % growth rate considered as a realistic possibility, this ratio had to fall to about 15 % and the latest upheaval of oil prices seems to have had an effect of further reducing Japan's growth expectations. A huge gap between investment and savings was created ex-ante. If a post-ante identity of investment and savings had had to be arrived at domestically alone, without a corresponding reduction in savings ratio there would have had to be a serious contraction of Japan's total national income. In the event, Japan was not a closed economy and the ex-ante oversaving had found its way into an external surplus until 1978 which had kept growing thanks to what appeared to be almost an inexhaustible appetite for Japanese exports in the rest of the world.

This does not mean to say, however, that the Japanese Government just sat idly watching its oversaving absorbed by foreigners. A large part of the oversaving in fact was absorbed by the sharp expansion of government deficit. The total public sector borrowing requirement including both the central and local governments increased from 6.7 % of the nominal GNP in 1975 to 12 % in 1978. However, even this size of government deficit was not enough to absorb all the domestic oversaving and there was clearly a limit to how far the government deficit should be allowed to increase.

Inadequacy of Present Monetary System

One of the fundamental questions to be raised in this respect is whether the present monetary regime is really capable of dealing with such dynamic changes as Japan has been recently experiencing. For that matter, one can also ask if it can deal effectively with changes such as those caused by the emergence of OPEC countries as major surplus countries, the increasing competitiveness of the newly industrializing countries or, taking developments in the opposite direction, the continuous financial difficulties of the non-oil developing countries.

To a certain extent, it may be argued that the international monetary system which has developed over the post-war period is basically based on static principles. This may have been suitable for regulating monetary relationships among countries at more or less equal stages of economic development and with equal social and political backgrounds, but it is beginning to prove rather inadequate when confronted with new dynamic forces such as those discussed above. Without going into detail it seems clear that exchange rate alteration or manipulation of domestic demand under the present monetary system is unlikely to solve problems caused by these dynamic forces.

Dynamic economic change is caused by investment which requires a flow of long-term capital. What we are seeing is the emergence of a significant difference between the global distribution of savings and the distribution of long-term capital flows. The fundamental role of a monetary system, be it domestic or international, is to transfer the surplus savings generated in some sectors of the system to those sectors where they can be invested productively and hence to match the pattern of savings with the pattern of long-term capital requirements. In a nutshell, my personal view is that the basic cause of the present

monetary instability largely lies in the failure of the existing monetary system and institutions to make sufficient adjustment to the underlying changes in the pattern of savings and investment throughout the world.

On the other hand, in the present discussions on world monetary reforms, it seems that too much attention has been given to the question of exchange rate regime. As we have recently witnessed, exchange rate adjustment has become less effective in correcting a balance of payments disequilibrium. The stubborn resistance of trade unions and workers to any reduction in real income in depreciating countries combined with the failure of companies to pass benefits of currency appreciations onto the final consumers in appreciating countries is certainly a factor reducing the effectiveness of exchange rate adjustment. As a result, both virtuous and vicious circles between exchange rates and domestic rates of inflation have become more pronounced than was anticipated.

In addition the recent doubling of oil prices poses another fundamental question on the disruptive effect of exchange rate adjustment. The large transfer of income to oil producing countries necessitated by the oil price increases has not only eliminated Japan's oversaving but also led to a substantial deficit in its current account position. The sharp rise in the relative price of oil means that the comparative advantage for Japan, which has no indigenous source of energy, will shift towards the production of less energy-intensive, high-technology, sophisticated manufactured goods, relative not only to oil producing countries but also to other industrial countries more fortunately placed than Japan in energy resource endowment. If left to the market, the foreign exchange rate of the yen will move in such a way as to promote the development of this new pattern of international specialisation, by becoming undervalued against other industrial currencies. Whilst in the long-run, this is probably inevitable, if these changes are forced upon us too suddenly, the immediate disruption to the world trade-flow could become politically intolerable.

At the same time, adjustment of external balance through control of domestic demand has become more burdensome. As a result of the considerable increase in the proportion of foreign trade in the national economies over the last 20 years, the level of adjustment to domestic demand that is required to eliminate a given external imbalance has also increased as a proportion of GNP. Given the generally

high levels of unemployment and the increased rigidity of the labour market in nearly all advanced countries, the management of domestic demand has become a very politically sensitive issue about which there is only a narrow scope for manoeuvre.

Japan's Role in the Future World Monetary Order

Where will we go from here and what role can Japan play in bringing about some kind of order and stability in international monetary affairs? In the short run, in the immediate aftermath of the recent oil crisis, Japan will probably be primarily concerned with its direct effects on domestic inflation and the balance of payments. With the prospect that inflation may reach double digit levels and the current account continuing to show a large deficit there is a danger that all the positive actions and initiatives that Japan has rather belatedly begun to take may yet again be shelved, at least temporarily.

Experience of the 1970s, has however, taught us that events such as oil price upheavals and subsequent stagflation have tended not only to accelerate rather than retard, but also to mask underlying changes already in progress. Therefore, once the masking effect of the initial confusion is removed the world is likely to suddenly be faced with drastic and insurmountable changes. It is for this reason I feel rather strongly that every attempt should be made to sustain Japan's recent initiatives, otherwise we will probably find ourselves more or less in the same situation a few years hence that we found ourselves in during the 1975-78 period.

On the broad issue of world monetary reform, it would be unrealistic to expect a reconstruction in the near future of a global, unitary monetary system on the lines of the post-war Bretton Woods System. Compared with the period preceding the establishment of the Bretton Woods System the present seems to lack a number of prerequisites for any major reform on a world-wide scale.

The major differences between the time of the Bretton Woods System and the present can be summarized as follows:

- In the present world, there is no country which can exercise the strong leadership that the US was able to demonstrate with its overwhelming political dominance and economic supremacy during the period leading to Bretton Woods.
- The sense of urgency of crisis proportions, which

was felt in the course and aftermath of the 1930s depression and the World War II, is not felt now.

□ Although there may be a general agreement as to the cause of the present instability, disagreement persists as to the prognosis. This probably reflects the increased diversity of the present day world compared with the relatively simplistic monolithic world which existed 35 years ago.

□ At the time of Bretton Woods, a strong academic under-current was present based on the general systems approach of Keynesian economics which had a significant influence on the mode of thinking of the people concerned with the creation of a new monetary system. At present there are no such influential proponents. Although monetarism is gaining influence, it is atomistic and static and therefore may not be suitable for the construction of a global and dynamic solution.

Under these circumstances we will continue to see only gradual and partial solutions being applied to the problems inherent in the existing monetary arrangement. In the process some attempts will be made to organise various forms of currency stabilization schemes mostly on a regional basis by countries whose intra-trading relationships are closer than their trading relationships with the outside world. However, it seems likely that no other currency arrangement will attain a higher degree of integration than that envisaged for the European Monetary System which will remain, after all the political capital invested in it, no more than a loose attempt to fix parities among its member countries.

Managed floating will continue to be a main feature of exchange rate arrangements. Even within a currency bloc or zone of monetary stability a fair amount of flexibility will be allowed for changing parities among member countries in order to adjust for inflation differentials. On the other hand, since exchange rate adjustment in real terms is more difficult to attain among countries with high degree of interdependence – the very reason why a currency stabilization scheme is sought – pressure for other means of structural adjustment such as redistribution of income and resources, special investment programmes, etc. among member countries will increase.

Increasing Political Influences

Between currency blocs or between a given currency bloc and the outside world, there will be greater exchange rate fluctuations to achieve an

exchange rate adjustment in real terms, which is probably easier to attain than within a currency bloc. Although market forces will continue to play a significant role, exchange rate relationships among currency blocs and between leading currencies from each currency bloc will also be increasingly influenced by political considerations. What may emerge after all could be some sort of unofficial de facto target zone agreements among main currencies such as the US dollar, DM and the yen whose principal aim would be to increase predictability of their exchange rate relationships while efforts will be made to achieve better coordination of economic policies among the countries of these currencies.

With regard to the question of reserve assets a single currency system appears simply inconsistent with the world of floating exchange rates, be it based on the US dollar or any other currency. Once the possibility of exchange rates alteration is introduced it is simply not wise to put all one's eggs in one basket. Furthermore, chances of some international composite currency taking over the role of the dollar seem to be very remote. Therefore, again without any official proclamation it seems likely that the world will be moving towards a system of multi-currency reserves.

The recent moves by international asset holders to diversify their portfolios away from the dollar into assets denominated in other currencies have a force which goes beyond this process of diversification to proceed without too much disruption of exchange rates. While diversification is proceeding, exchange rates are likely to be more directly affected by the shifts of assets from one currency to another than by the flow of trade and investment. Unless properly handled this process should lead to an unnecessary depreciation and undervaluation of the US dollar with all its destabilizing effect on the workings of the international monetary and trading systems.

The role of the dollar clearly needs to be supplemented and supported by the internationalization of other strong currencies such as the DM and the yen in the long run. If the speed at which this takes place does not coincide with the diversification process, it seems almost inevitable that the international monetary scene will become even more unstable in the future. This is certainly a matter for which countries like Japan and Germany should take more responsibility than hitherto.

By way of conclusion, it seems appropriate to refer to some of the recent initiatives taken by Japan against the background of the above discussion.

Exchange Rate Policy: Japan has in recent years adopted a more flexible approach towards exchange rates than before. The yen was allowed to rise by 30 % during the course of 1978, much more quickly than was dictated by inflation differentials vis-à-vis the rest of the world. Unlike the countries in the closely-knit European community, Japan can attain real changes in exchange rates which, it seems, do have significant effect on Japan's trade and investment. Japan, by itself can be regarded as an optimal currency area and therefore exchange rate adjustment can be an effective tool with which to redress external imbalance. This point now seems to have been sufficiently recognized.

Japan is no longer following a low exchange rate policy for the yen. The sharp depreciation of the yen in the past year is only the reflection of the underlying volatility of the currency. In the course of the recent depreciation of the yen, the fear was expressed perhaps more strongly from the business community than from official circles, that too much undervaluation of the yen would be harmful not only in terms of its effect on domestic inflation but also because it might disrupt international trade. It is also possible to argue that when an economy moves from a developing stage to that of maturity, the benefit of exchange rate appreciation outweighs that of an undervalued currency. The recent changes in Japan's attitude and psychology may simply reflect this point.

Industrial Adjustments: As was indicated earlier, dynamic adjustment of balance of payments can only be possible when adjustment of the industrial structure is achieved. Monetary issues and problems of industrial adjustment are very closely interrelated although unfortunately the two tend to be discussed separately and very often by people from different disciplines and with different inclinations.

Fortunately, in Japan, however, policies of industrial restructuring along the lines of those required from the monetary point of view have been pursued perhaps by accident. Imports of less sophisticated light manufactured goods especially from the developing countries have been increasing rapidly of late. Also, on the export side, there has been a considerable change in the mix of export products against the background of the sharp appreciation of the yen. The proportion of the three main export items – namely, ships, iron and steel and automobiles – in the total export value declined very sharply in 1978 to 32.6 % from 37.5 % in 1977. On the other hand, new export products have begun to emerge especially from the capital goods and technology-intensive industries.

Internationalization of the Yen: In 1979 the Japanese Government announced new legislation which has removed many of the exchange control regulations. This can be regarded as a positive step forward in facilitating the use of the yen for international asset holdings as well as denomination of trade by non-residents. It is estimated that the free-yen deposits held by non-residents reached US \$ 2.0 bn at the end of 1978. Holdings of Japanese bonds by foreigners also seem to amount to US \$ 7-8 bn at present. Additional US \$ 4-5 bn are also held in Japanese equity. Therefore all in all, the total amount of yen asset holdings by non-residents might have already reached over US \$ 15 bn.

Internationalization of the Yen

With the emergence of a large current account deficit, the Government has begun to take a more positive attitude than before towards the internationalization of the yen. In a world of extremely volatile commodity and energy prices, the slow progress in the internationalization of the yen can be regarded as a serious source of instability for Japan's economy and exchange rates. After all, 80 % of Japan's imports consist of energy and raw materials the prices of which fluctuate very widely resulting in balance of payments volatility. Given the composition of Japan's imports, therefore, it seems essential that facilities for compensating financial flows must be developed if destabilizing oscillations of its balance of payments and exchange rates are to be avoided.

It is well recognized that Japan can no longer insulate its domestic monetary conditions from the ebbs and flows of international finance. Attempts in the past to regulate capital flows resulted in the pattern of capital movements which were reinforcing rather than compensating for Japan's current account position. The internationalization of the yen would mean that Japan's domestic money and capital markets will inevitably be opened to, and integrated with the rest of the world. Interest rates will have to be determined by the free inter-play of market forces. It is only when these conditions are met that capital flows in and out of Japan will become responsive to changes in the underlying condition of its external account thereby reducing the volatility of yen exchange rates. It is hoped that the internationalization of the yen will provide a valuable shield for Japan's external positions against the vagaries of international economic surroundings thus encouraging Japan's long-term strategy for structural adjustment at times of both current account surplus and deficits.