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An Economy's Crippling Dependence on Its Currency Power: Case Study of Japan

Ahmed Wafee Syed Khan[1]

Introduction

From the beginning of civilization, humanity has assigned value to goods and services. This started with the barter system, where people traded one goat for one cow, an hour of their time for some bread, and other such trades. Over the years, the barter system showcased its flaws, such as the overlap of wants and the differing values of certain items and services in different peoples' eyes, to name but a few. To address these limitations, commodities such as salt, silver, gold, etc., began to be used as mediums of exchange. They had the features of modern money: they had intrinsic value, were transportable, and easily divisible.[2]

At some point, currency, mainly coins, came into being. This replaced the previous materials as a medium of exchange, as coins had a characteristic they did not: they could store value, i.e., they did not lose their value over time. Eventually, paper currency also came into existence and has long been the medium through which the world operates.

A currency is not just a medium of exchange; it is also a representation of a country. A country's economy and the strength of its currency are intrinsically tied. A currency can measure how an economy is performing and a factor that can influence its performance. Japan's depreciating currency is an excellent example of this.

[1] Ahmed Wafee Syed Khan is a research intern at the Bangladesh Institute of Peace and Security Studies (BIPSS). He is pursuing his BSc in Economics and Industrial Organization at the University of Warwick.
[2] The Investopedia Team, "Understanding Money: Its Properties, Types, and Uses," Investopedia, February 4, 2021, https://www.investopedia.com/terms/m/money.asp.

Source: Japan City Tour

Background

Japan is unable to sustain its population due to a lack of agricultural land, capabilities, and raw material reserves. As a result, Japan has to import raw materials and food from overseas and pay for them by exporting manufactured goods such as cars and machinery. As such, Japan has developed itself into a trading economy.[3] Due to this, Japan's economy is heavily dependent on the yen, making it very volatile.

While Japan's economic problems have existed for decades, its current issue with the Yen can be traced to 2012. With the inauguration of Shinzo Abe and the implementation of Abenomics in 2012. Abenomics was implemented to combat the prolonged deflation Japan had been facing for two decades, a problem that had brought down confidence in the economy. Abenomics consists of significant fiscal stimuli and expansionary monetary policy, particularly quantitative easing and structural reforms. The purpose of Abenomics and its extreme measures, such as negative interest rates, was to invigorate the Japanese economy and increase spending. However, the flip side of the policy was the large budget deficit accrued over the years. This

[3] Asia for Educators, "Asia for Educators | Columbia University," Columbia.edu, 2024, https://afe.easia.columbia.edu/special/japan_1950_economy_basics.htm#:~:text=Trade%20with%20other%20countries%20(international.

caused the Japanese Yen to massively depreciate from 1USD=80JPY on average to 1USD=107JPY on average in 2020 when Shinzo Abe resigned.

Source: The Wall Street Journal

Initially, the depreciation of the Yen boosted exports, increasing export revenue and allowing Japan to maintain a current account surplus even through the global pandemic. However, as the world starts to recover from the worldwide pandemic, Japan has lagged due to its overreliance on exports and aging population. Furthermore, the US has begun to raise interest rates and strengthen the dollar to stabilize its economy after the pandemic. This, coupled with Japan's monetary policy, resulted in a wide discrepancy between Japan and US interest rates. This started a rapid downward spiral for the Japanese Yen. Currently, the exchange rate is roughly 1 USD=150 JPY, making the Yen the weakest currency of the decade.[4]

Benefits

Japan's depreciating currency has awarded the economy some benefits. The low exchange rate has allowed Japan to maintain a current account surplus for the last few years. In 2023, Japan had a current account surplus of 152.1 billion USD in 2023[5]. This surplus can be reinvested into the economy for structural reforms, fiscal injections, etc. The low exchange rate has also

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[4] Frank Kaberna, "Japanese Yen: Weakest Currency of the Decade," Tastyfx.com, 2024, https://www.tastyfx.com/news/japanese-yen--weakest-currency-of-the-decade-240220/.
[5] FocusEconomics, "Japan Current Account," FocusEconomics (FocusEconomics, August 23, 2024), https://www.focus-economics.com/country-indicator/japan/current-account/#:~:text=The%20current%20account%20balance%20in.

helped several Japanese firms, such as Canon and Murata Manufacturing, get more than 70% of their revenue abroad.[6]

The tourism sector has greatly benefited from the depreciating currency. Thirty-five million tourists are expected to come to Japan this year, and tourism spending is forecasted at a record 51 billion USD. In June of 2024 alone, Japan had 3.14 million tourists, a record-breaking number.[7] With the tourist boom, Japan's tourism sector is set to become a pillar of the Japanese economy, as it is expected to account for 7.5% of the country's GDP. The icing on the cake is that government data indicates that the industry might exceed predictions.[8] This would be a massive boon for the Japanese economy as the tourism industry has been consistently growing.

Drawbacks

Exports and imports are two sides of the same coin. A weaker yen has lowered export prices, increasing export expenditures and the cost of imports. Inflation has never been a primary concern for Japan, as the country has mainly dealt with its "Lost Decades," when it experienced deflation and a loss of confidence. If the Yen keeps depreciating, then eventually, there will come a point when import prices skyrocket to the point where inflation starts to become an issue.

This is even more concerning as Japan imports most of its food, energy, and raw materials.[9] As such, there is a high risk of cost-push inflation spiraling out of control. Cost-push inflation can quickly go out of control as it can cause workers to ask for a wage increase, leading to higher costs and causing a wage-price spiral.[10]

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[6] Tsuyoshi Inajima et al., "Japan Firms Reach Pain Threshold as Yen Keeps Testing Lows against the Dollar," The Japan Times (The Japan Times, May 2, 2024), https://www.japantimes.co.jp/business/2024/05/02/companies/japan-firms-struggle-with-weak-yen/.

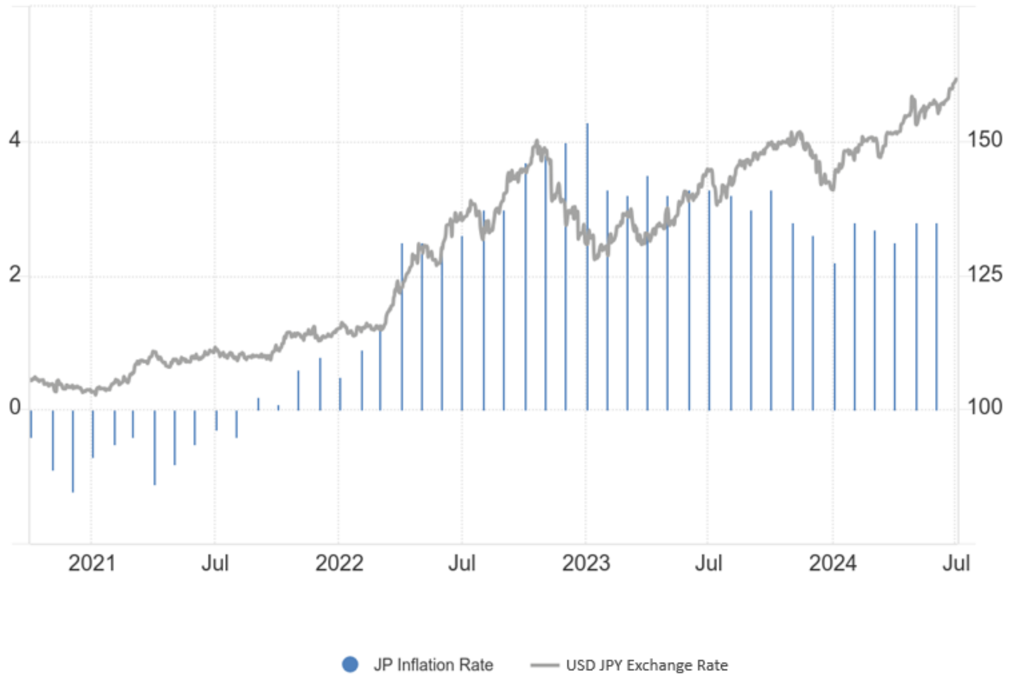
[7] Peden Doma Bhutia, "Japan's 35 Million Tourist Bonanza in 2024: Great for Business, Not so Much for Overtourism," Skift (Skift, July 22, 2024), https://skift.com/2024/07/22/japans-35-million-tourist-bonanza-in-2024-great-for-business-not-so-much-for-overtourism/.

[8] Kathryn Wortley, "Japan's Tourism to Break Records in 2024 | TTG Asia," Ttgasia.com, July 5, 2024, https://www.ttgasia.com/2024/07/05/japans-tourism-to-break-records-in-2024/#:~:text=Government%20data%20indicates%20it%20may.

[9] Leo Lewis, "The Yen Is Everything to Japan's Economy," *Financial Times*, August 1, 2024, https://www.ft.com/content/07276a3f-7ba8-45b2-8017-a886faf1fb71.

[10] Caroline Banton, "Explaining the Wage-Price Spiral and How It Relates to Inflation," Investopedia, March 31, 2022, https://www.investopedia.com/terms/w/wage-price-spiral.asp#:~:text=The%20wage%2Dprice%20spiral%20is.

Case in point: Japan had a 3.27% inflation rate in 2023, the highest since the 80s.[11] The graph below shows that inflation and a country's exchange rate are proportionally related, putting Japan's economy on a slippery slope.



Source: Trading Economics

Japan's weak currency has also driven investment out of the country. Up to May 2024, Japanese firms had invested 178 billion USD more abroad than foreign firms had invested in Japan. Foreign Direct Investment (FDI) in Japan is worth only 5% of the nation's GDP, roughly 205 billion USD, ranking near the bottom globally and putting it far behind the average of 44%.[12]

Moreover, the revenue Japanese companies make from selling overseas is not reinvested into the country in the form of buying capital but is instead kept in foreign bonds and investments that yield high profit added on to by the high exchange rate between the US Dollar and the Japanese Yen.[13]

[11] Statista, "Japan - Inflation Rate 2024 | Statista," Statista (Statista, April 2023), https://www.statista.com/statistics/270095/inflation-rate-in-japan/.
[12] "Japan's Strength Produces a Weak Yen," The Economist, July 18, 2024, https://www.economist.com/finance-and-economics/2024/07/18/japans-strength-produces-a-weak-yen.
[13] "Japan's Strength Produces a Weak Yen," The Economist, July 18, 2024.

While beneficial for Japan's GDP, the rise of the tourism industry also has some adverse effects. Overtourism has caused pollution and created traffic jams. Tourists are often guilty of inappropriate behavior that disrupts the locals. The tourist problem got out of hand in Fujikawaguchiko, where a barrier was constructed to block the view of Mt. Fuji.[14] Furthermore, Japanese people are demotivated when they see so many tourists and cannot travel because it is too costly for them to purchase foreign currency.

Possibilities to stabilize the Yen

The Bank of Japan has taken measures to strengthen the Yen. In 2022, it spent more than 60 billion USD of its foreign reserves buying the Yen.[15] This was done so that the supply of the Yen would fall, causing the Yen to appreciate.

When the Yen dropped to an all-time low of 1 USD=160.88 JPY on 31 July, the Bank of Japan increased interest rates to 0.25%, which had an effect as the yen began to appreciate afterward. This is the first time the Bank of Japan has increased interest rates above 0.1%.

The leading cause of the rapid depreciation is the significant interest rate difference between the US and Japan due to their vastly differing monetary policies. Thankfully for the Yen, there is a chance of the US loosening its stringent monetary policy.[16] This would ease the downward pressure on the Yen as there would be less demand for the dollar, weakening it as the interest rate decreases.

Japan's Global Presence

Japan is one of the world's largest trading economies. As such, any fluctuations in the Japanese economy will have ripple effects on the globe. For example, the Bank of Japan's move to increase interest rates aggravated the stock market's panic. The week after the interest rate in Japan was increased to 0.25%, the Vix Index, Wall Street's fear index, rose to 65 points, its highest point since the Covid-19 pandemic. [17] Due to the modern world's interconnectedness,

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[14] Peden Doma Bhutia, "Japan's 35 Million Tourist Bonanza in 2024: Great for Business, Not so Much for Overtourism"

[15] John Power, "Why Is Japan's Yen Falling and Why Is It so Weak against the US Dollar?," Al Jazeera, April 30, 2024, https://www.aljazeera.com/economy/2024/4/30/why-is-japans-yen-so-weak-against-the-us-dollar.

[16] Leika Kihara et al., "Bank of Japan Yen Intervention: A Short History," Reuters, August 9, 2024, https://www.reuters.com/graphics/JAPAN-YEN/EXPLAINER/xmvjnxjmbvr/.

[17] Adam Samson, "What Drove the Global Stock Sell-Off?," *Financial Times*, August 5, 2024, https://www.ft.com/content/91050c8c-e2b3-4753-9484-c010037dae9b.

insecurity or sudden shifts in any economy will spread throughout the globe. This is particularly true for Japan, one of the world's largest trading economies.

Conclusion

The Bank of Japan is ordinarily reluctant to strengthen the Yen due to how reliant Japan's economy is on exports, but an extremely weak Yen is also harmful to Japan. So, the Bank of Japan's recent actions to strengthen the Yen is an excellent move on the organization's part.

However, as Japan is still highly dependent on trade, the Bank of Japan should be cautious when intervening in the currency market. A volatile currency is the worst thing for the Japanese economy. A stable Yen is needed to secure Japan's future, as stability breeds confidence. Low confidence levels have plagued Japan for decades, reaching one of the lowest points in 2022.[18] There is speculation that the Bank of Japan will likely increase interest rates again in December.[19] This will destabilize the currency market for some time. Still, it is hoped that this move will incentivize companies to start investing in Japanese stock and that Japanese firms convert their Dollar investments into Yen and invest in the Japanese economy.

Stabilizing the Yen would help the Japanese economy in several ways. It would streamline the country's balance of payments and reignite consumer and investor confidence, which might lead to increased spending and investment. Furthermore, a stronger, more stable Yen would also improve the quality of life for Japanese residents, as imports would be cheaper and international travel would be more accessible.

[18] Ryan Hogg, "Japan Consumer Confidence | Everything You Need to Know," capital.com, November 18, 2022, https://capital.com/japan-consumer-confidence-outlook.
[19] Kana Inagaki and Leo Lewis, "Bank of Japan Raises Interest Rates to 0.25%," *Financial Times*, July 31, 2024, https://www.ft.com/content/599790b6-abf1-4ca5-a1d9-40ccb352c9e2.