22. What should the US and China learn from the past US-Japan conflict?

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One recently suggested impediment to China revaluing the renminbi is that the authorities believe that a prime cause of Japan's 20-year stagnation was its caving in to US demand for an appreciation of the yen. This paper argues that it was not caving in to US pressure but resisting it that made monetary policy too lax and contributed to the asset bubble.

Although the rhetoric has recently softened, Chinese leaders have repeatedly said that they would not allow a renminbi (RMB) appreciation while foreign countries, notably the US, are demanding action. They have called the measure 'protectionist' and have made clear that it is the measure, as much as the economics of appreciation, to which they object. However another impediment is that Chinese authorities believe that a prime cause of Japan's 20-year stagnation was caving in to the US demand on yen appreciation. .

We argue here that it is important to learn the correct lessons from Japanese experience for coping with US demands, managing the exchange rate, and avoiding 20-year stagnation. The key fallacies in the argument that US pressure for exchange rate appreciation was a disaster for Japan are the timing and the other elements contributing to the lost decades. While there are several important lessons to be learned from Japan's experience, they are about the importance of the appropriate domestic monetary policy settings, about the need for a clear perspective on inflation trends and about the dangers of unchecked asset bubbles. These are all lessons relevant to China's choice of currency regime.

So what did happen?

It is true that the US demanded many things of Japan when the bilateral trade imbalances became large in the mid-1980s and one of the demands was an appreciation of the yen. It is true that the yen appreciated sharply from 260 yen to the dollar in February 1985 to 155 yen to the dollar in August 1986, which was one of the fastest appreciation episodes in history. It is true that Japan underperformed its potential for most of the 1990s and 2000s. The average growth rate from 1993 to 2003 was just above 1%, and the decade was marked by one crisis after another in the banking sector. But it is too simplistic to say that the US pressured Japan into accepting sharp yen appreciation and that, in turn, caused two lost decades.

The US pressure is most vividly remembered in the context of the Plaza Agreement of September 22, 1985. The yen appreciated from 240 yen to the dollar just before the agreement to reach 200 yen to the dollar by the end of the year. The yen continued to appreciate to 155 yen/dollar by the summer of 1986 - that is, a 45% appreciation in one year following the Plaza agreement. (See Ito, 1987 for details of the Plaza Agreement and the aftermath.)

Was the Plaza Accord, the source of the 20-year stagnation?

Given the timing, if the pressure resulted in making the bubble larger than otherwise, causality could plausibly be suspected. However, the truth is just the opposite.

- First, the Plaza Accord was to correct an overvalued dollar compared with several other major currencies including the German mark, the French franc, and the British pound. So it was not really pressure on the yen but a demand for a coordinated action to change misalignments with the dollar.
- Second, the movement from 240 yen to the dollar to 200 yen to the dollar was well within the range of correcting the overvalued dollar and Japan agreed with the idea. Subsequently the US agreed to stabilise the exchange rates in the Louvre Accord in February 1987 and that, in essence, was the end of US pressure.

How much damage did the yen appreciation cause the Japanese economy?

Exports declined due to the yen appreciation only after 18 months (according to the J-curve) after the Plaza Agreement, and that acted to reduce the surpluses from a very high to a normal level. But the appreciation in 1986 coincided with oil price declines, so the cost of production in Japan was very much reduced, providing a cushion for the squeeze on profits. There is very little evidence that the sharp yen appreciation had major impacts on the Japanese economy in the second half of the 1980s. Those were the famous bubble years - high economic growth with soaring asset prices.

In relating yen appreciation (which may have been partly the result of US pressure) and the bubble, the following observation is crucially important. Monetary policy was relaxed from 1986 to 1987, and the record-low discount rate (at that point) of 2.5% was maintained from February 1987 to May 1989, in the hope that the low interest rate would stop or moderate the speed of yen appreciation. Hence, it was not caving in to yen appreciation demand but resisting US pressure (or the US "wish" to be more precise) that made monetary policy too lax and contributed to bubble enlargement. The logic is just the opposite of what Chinese officials and those who draw strong parallels between the Japan and China, appear to believe to be the case

The on-and-off, 20-year stagnation has been mainly due to the effects of the bubble burst and a series of policy errors, not a slump in the exporting sector resulting from the yen appreciation. In fact, the export sectors continue to be an engine of growth, despite the yen appreciation. Exports are now a much higher proportion of Japanese output than they were in the 1980s. That is part of what made Japan's industrial production so fragile in the face of the global financial crisis. Furthermore, during the period of the bursting bubble US pressure was mostly helpful in urging quick actions to repair banking fragility.

There was only one other episode of yen appreciation that could be seen as resulting from US pressure. Trade conflicts in 1994 to 1995 led to US frustration and a heavy-handed approach but the yen appreciation pressure from 1994 to 1995 was more informal than the first episode. This took the form that the yen/dollar market reacted with yen appreciation whenever Japan resisted US pressure for numerical targets of "voluntary import expansion (VIE)." From a macroeconomic perspective there were no factors requiring or supporting the sudden appreciation from 100 yen to the dollar to 80 yen to the dollar that occurred over five months during this period. The rapid V-shape adjustment - sharp appreciation and sharp depreciation - is also evidence that the appreciation had no fundamental basis. Since appreciation was only sustained for such a short a period, it is doubtful that exporting sectors suffered permanent damage. The US demands for voluntary import expansions - in apparent violation of GATT/WTO rules - frustrated Japan but if they caused any further misery to the already weakened Japanese economy it was not through the exchange rate channel.

Policy mistakes

What caused the bubble to expand and become more dangerous was the low interest rate policy of 1987-1989. What brought the onset of the slow growth period was the belated and aggressive tightening of monetary policy from late 1989 to 1990 when interest rates were raised from 2.5% to 6 %. There is still a debate about the full list of causes of the prolonged stagnation in Japan from the early 1990s but it was certainly a complex mix of factors. Among them were the fragility of the banking system, which suffered near collapse over a 5 year period, resulting in a credit crunch at least for small- and medium-enterprises over at least a couple of years in the late 1990s. Worse yet, problems in the banking sector were not addressed properly by the supervisory authority in the early stages. At the same time an ageing population, falling labour force participation and slow productivity growth hampered the supply side of the economy while political inertia was unable to deliver significant deregulation permitting structural change. Major policy failures, such as an aggressive fiscal tightening in April 1997, undermined confidence at moments when recovery might have taken off (see Corbett and Boltho, 2000). Throughout the whole of the 1990s and early 2000s monetary policy was excessively tight, as evidenced by continuing deflation. Though the economy faced a liquidity trap with nominal interest rates at zero, real interest rates in a deflationary environment were high. (See Ito and Mishkin, 2006, for a fuller discussion of monetary policies in the 1990s and early 2000s.)

Deflation and the lost decade

Deflation has also been a chronic problem for Japan for over a decade and, once damaging deflationary expectations set in, credible policy becomes more difficult. It has been argued that continuing reluctance by the US to allow depreciation of the yen during the lost decades created these deflationary expectations. This is a more subtle version of the "US pressure argument". There are two versions of the argument. One focuses on wage setting and the other on international interest parity conditions. In the first version an expectation of a continuously appreciating currency requires that wage growth be moderated to maintain competitiveness, so employers will hold down wages below productivity increases to maintain profits (see McKinnon, 2006). Wages and prices fall and a deflationary spiral results. But in fact the link between currency movements and wage changes is notoriously unpredictable and the decline in Japanese wages during the 1990s is more likely to have been the result, not the cause, of slow growth. It is virtually impossible to distinguish the causality but with growth falling and unemployment rising to historic highs, the downward pressure on wages was inevitable. Further evidence of the unpredictable link between currencies and wage setting comes from Britain, where wage inflation was expected to undo the real depreciation of sterling after the exit from the European monetary system. It never happened and the depreciating currency turned out to be a benefit for British growth. The link between exchange rate policy and what might happen in labour markets seems an uncertain argument on which to base a currency strategy for China that might have other undesirable consequences.

With mobile capital a similar story can be told via interest rates and international arbitrage. Here the expectation of appreciating exchange rates drives interest rates and price expectations down (McKinnon and Ohno, 1997; McKinnon, Ohno and Shirono, 1999; McKinnon 2000). In this story zero interest rates and a liquidity trap come not from independent policy actions by the Bank of Japan, but from the expectation of falling prices driven by rising exchange rates. Equally plausible however, and borne out by survey evidence, is that deflationary expectations came from the continuing failure of monetary policy to commit to fighting price declines for reasons more to do with political economy than with the value of the exchange rate. Svensson (2001, 2003) argued that the best way out of deflation and liquidity trap for Japan does involve a depreciating currency but that can follow, rather than lead, the change in monetary policy: "the optimal way to escape from a liquidity trap, which involves expectations of a higher future price level, would directly lead to a corresponding depreciation of the currency. Indeed, absence of a currency depreciation indicates a failure to induce such expectations." (Svensson, 2003, p 17).

Even if both these routes contributed to creating deflationary expectations in Japan they were a small component compared with the lack of confidence in the policies of the Bank of Japan. Furthermore, the "pressure" in this case was a desire by trading partners to avoid Japan using beggar-my-neighbour policies to recover from recession. The concern may have been misplaced, but it is common and widespread and is different from the concerted pressure for yuan or yen appreciation aimed at reversing trade imbalances. A critical difference is that Japan was already hopelessly mired in a banking crisis, deflation and stagnation when the yen depreciated from 1995 to 1998, while the Chinese economy is booming as the pressure for appreciation is applied.

The advice for China

Refusing to accept yen appreciation (not caving in to yen appreciation) was one of the causes of the bubble economy toward the end of the 1980s in Japan. This was a grave policy error for Japan with long term consequences. So, the lesson is precisely the opposite of the one most people take from Japan's experience. Do not resist the currency appreciation when the economy is booming. Keeping interest rates low and providing large liquidity, through interventions, in order to prevent the currency appreciation will produce a property bubble and eventual burst - a disaster. There is already a risk that China is underestimating the extent of its property bubble (see Ito, 2010). The fact that appreciation may help global imbalances is an added bonus but need not be a factor in China's decision. China should be looking carefully and critically at the *right* lessons from Japan and also at lessons from successful appreciations which achieved precisely the alleviation of inflationary pressures and structural changes that China needs. One such example is Australia in the 1980s. And China should keep in mind that many of the factors that led to Japan's lost decades either do not apply to China (which is not a mature, post-industrial economy with no "catch-up" possibilities left) or were avoidable policy mistakes. Currency appreciation was not the major factor.

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