

Research Focus

Lessons for the US and China from past US-Japan conflict

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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 United States, are demanding action. They have called this demand 'protectionist' and have made clear that it is the demand, 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 US demands 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. 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.

The United States demanded many things of Japan when the bilateral trade imbalances became large in the mid-1980s, one of which was an appreciation of the yen. But it is too simplistic to say that US pressure for a sharp yen appreciation caused two 'lost decades' in Japan. US pressure is most vividly remembered in the context of the Plaza Accord of 22 September 1985 which was followed by a 45 per cent appreciation in one year. However, the Plaza Accord was not really pressure on the yen, but a demand for a coordinated action to change misalignments with the dollar. Subsequently, the United States agreed to stabilise the exchange rates in the Louvre Accord in February 1987, in essence ending US pressure.

Japanese exports initially increased, and then declined, but

only 18 months after the Plaza Accord, which reduced surpluses from a very high to a normal level. However the 1986 appreciation coincided with oil price declines, so costs of production in Japan were greatly reduced, providing a cushion for the squeeze on profits. The sharp yen appreciation had major impacts on the Japanese economy in the second half of the 1980s, the famous bubble years of high economic growth with soaring asset prices.

There were other complicating factors. Crucially important was monetary policy which was relaxed from 1986 to 1987, and the then record-low discount rate of 2.5 per cent was maintained from February 1987 to May 1989, in order to moderate the speed of yen appreciation. Hence, it was not caving in to yen appreciation demands but resisting US pressure 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.

Japan's on-and-off, 20-year stagnation resulted mainly from the bubble burst and a series of policy errors, not a slump in the exporting sector resulting from the yen appreciation. Exports continued to be an engine of growth, despite the yen appreciation, and are now a higher proportion of Japanese output than in the 1980s. That is what made Japan's industrial production so fragile in 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.

One other episode of US currency pressure occurred during trade conflicts in 1994 to 1995, but US pressure for the yen appreciation was informal and

the yen/dollar market reacted with yen appreciation whenever Japan resisted US pressure for numerical targets of 'voluntary import expansion' (VIE). No macroeconomic fundamental factors required 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 period, exporting sectors did not suffer permanent damage. 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.

The key cause of the bubble expanding and becoming 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 per cent to 6 per cent. The causes of the subsequent prolonged stagnation in Japan were a complex mix of factors, including the fragility of the banking system, which suffered near collapse over a 5-year period, resulting in a short credit crunch in the late 1990s. Worse yet, problems in the banking sector were initially not addressed properly by the supervisory authority.

At the same time, an ageing population, falling labour force participation and slow productivity growth hampered the supply side of the economy while political

Events

4 May *Community Impacts of Religious Schools: Evidence from Pesantren in Indonesia* Risti Permani, University of Adelaide
2:00 pm – 3:30 pm Seminar Room B, Coombs Building 9

6 May *Resources Management for Asia and the Pacific Argument Seminar - Climate change and gender* Gillian Brown, AusAID
12:30 pm–1:30 pm Seminar Room B, Coombs Building 9

11 May *Social Safety Nets and Nutrient Deprivation: An Analysis of the National Rural Employment Guarantee Program and the Public Distribution System in India* Raghendra Jha, Australia South Asia Research Centre
2:00 pm – 3:30 pm Seminar Room B, Coombs Building 9

Crawford Seminar series

4 May *New approaches to saving water: Practical application of behavioural socio-economic modelling* Dr Don Perugini, CEO Intelligent Software Development Acton Theatre, Level 1, Crawford School of Economics and Government
12.30-1.30pm

Publications

Bulletin of Indonesian Economic Studies Vol 46, No 1.

Pacific Economic Bulletin, Volume 25 Number 1 (2010) Special issue on economic surveys. Available at: http://peb.anu.edu.au/peb/current_issue.php

Policy and Governance Discussion Papers PDP 10-01

'How Effective is Cost-Benefit Analysis in Assisting Decision Making by Public Sector Managers?' Case Studies of two Australian Department' by I Putu Suidiana

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inertia was unable to deliver significant deregulation, impeding structural change. Major policy failures, such as an aggressive fiscal tightening in April 1997, undermined confidence at moments when recovery might have taken off. 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 were high.

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. Continuing US reluctance to allow depreciation of the yen during the lost decades created these deflationary expectations. Expectations of a continuously appreciating currency require that wages growth be moderated to maintain competitiveness. Wages and prices fall and a deflationary spiral results. But 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. With growth falling and unemployment rising to historic highs, the downward pressure on wages was inevitable. The link between exchange rate policy and what might happen in labour markets seems an uncertain basis for 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, where expectations of appreciating exchange rates drive interest rates and price expectations down. Thus low 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. But deflationary expectations could also come from the continuing failure of monetary policy to combat price declines, for reasons more to do with political economy than with the exchange rate. Some economists argue that the best way out of deflation and liquidity trap for Japan involves a depreciating currency, but following, rather than leading, the change in monetary policy.

Even if both these routes contributed to creating deflationary expectations in Japan, they were but 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 prevent Japan using beggar-my-neighbour policies to recover from recession, perhaps a misplaced concern, but 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.

Refusal to accept yen appreciation in the 1980s 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. China may already be underestimating the extent of its property bubble. The fact that yuan appreciation may help global imbalances is an added bonus, but need not influence China's decision. China should look carefully and critically at the right lessons from Japan and from successful appreciations which achieved precisely the alleviation of inflationary pressures and structural changes that China needs. One example is Australia in the 1980s. And China should remember that the factors that caused 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.

This article is based on 'What should the US and China learn from the past US-Japan conflict?', chapter 22 in Simon Avenett (ed.) *The US-Sino Currency Dispute: New Insights from Economics, Politics and Law* published online via VoxEU website (at: http://www.voxeu.org/reports/currency_dispute.pdf).