Mitchell's Musings 3-21-11: What the U.S. Shouldn't Do to Help Japan is What We are Doing

In these musings, I have been harping for some time on U.S. trade and exchange rate policy as it relates to helping the U.S. climb out of the aftermath of the Great Recession. Improving our trade balance could play an important role in job creation, particularly in manufacturing. Now we have something new in international affairs: the Japan earthquake/tsunami/nuclear disaster. In that context, I read an article in the New York Times of 3/18/11 which I will break into three excerpted segments with some commentary on each. You can read the full article at http://www.nytimes.com/2011/03/18/business/global/18group.html

Segment #1

"Investors might have been expected to sell yen as Japan struggles to deal with the impact of an earthquake, a tsunami and a nuclear crisis. Instead they had flocked to the currency, briefly driving its value relative to the dollar to the highest level on record Thursday, before it receded to close at about 79 yen to the dollar."

The argument in this first segment seems to be that it is somehow unnatural for the yen to rise, given the disaster in Japan. Bad things happening in Japan – the segment suggests – should cheapen the yen. So let's consider that argument. Over many years, Japan has followed economic policies designed to ensure a trade surplus with the rest of the world (including especially the U.S.) and a positive current account balance. If a country chronically spends less abroad than it earns from abroad, its hoard of reserves will grow and grow. The result of those policies was thus the steady accumulation of foreign exchange reserves by Japan. Those reserves currently stand at roughly $1 trillion according to the IMF.

Now, thanks to the ongoing disaster, Japan will need to spend some of those foreign exchange reserves. There will need to be a massive rebuilding program which will divert Japanese capacity from exports to domestic use. And there will need to be imports. It's not just structures that will have to be replaced. All of those ruined cars you see in the news photos and everything that was in those structures will also have to be replaced. Again, all of that replacement activity will mean diversion of Japanese resources to domestic use and more imports from abroad. The diversion will come at a time when Japan's domestic production capacity is limited due to reduced electricity supplies and due to the displacement of many people who would otherwise be working.

One might expect, therefore, that spending those foreign exchange reserves by Japan would drive down the value of the currencies being held (especially the U.S. dollar) relative to the yen. The appreciation of the yen is not the product of some irrational investor behavior. It could be, in fact, investor anticipation of a likely course of events. Appreciation of the yen is, after all, part of the mechanism that will bring world resources into Japan to deal with the consequences of the disaster.

I didn't make all of this analysis up as you can see from Segment #2 of the New York Times piece:

"Some analysts said the buying was driven by speculation that Japanese insurance companies and other investors would sell foreign assets to cover the cost of rebuilding after the earthquake. Japanese officials sought to dispel that theory, noting that past disasters such as a 1995 earthquake did not create such an effect."

The only thing missing from the quotation is that it will not just be insurance companies that will be spending on rebuilding and replacement. The Japanese government will itself have to undertake a massive program. Consumers in Japan will have to spend on replacement as well.

What we really learn from Segment #2 is that as reasonable as the rationale for a rising yen might seem, the authorities in Japan don't want to believe it. (Clearly, the current disaster is far worse than the 1995 earthquake they cite.) In short, the powers-that-be in Japan want to go on with an undervalued yen to promote exports as if nothing had happened. Clinging to old ways is their privilege, I suppose, but surely – you might think - the U.S. and other major countries would not encourage them in that approach. Think again, however. Japan has in fact been actively trying to prevent the yen from appreciating and here is Segment #3 which is the lead-in to the story:

"The United States and other major industrial nations will join Japan in a highly unusual effort to stabilize the value of the yen by intervening in currency markets, the Group of 7 nations announced Thursday night. Markets responded immediately by driving down the value of the yen against the dollar, reversing almost a week of sharp increases."

"Stabilize" above is code for preventing yen appreciation as the second sentence in the segment makes apparent. In short, the U.S. is cooperating with an effort that is not what Japan should be doing and that is bad for job creation – particularly in manufacturing – in our own labor market. What Japan needs at this time is technical aid to deal with its dysfunctional nuclear power plants. What it does not need an export promotion campaign. It is the U.S. that needs an export promotion campaign. If we help maintain an undervalued yen (an overvalued dollar), we are not promoting U.S. exports or jobs.