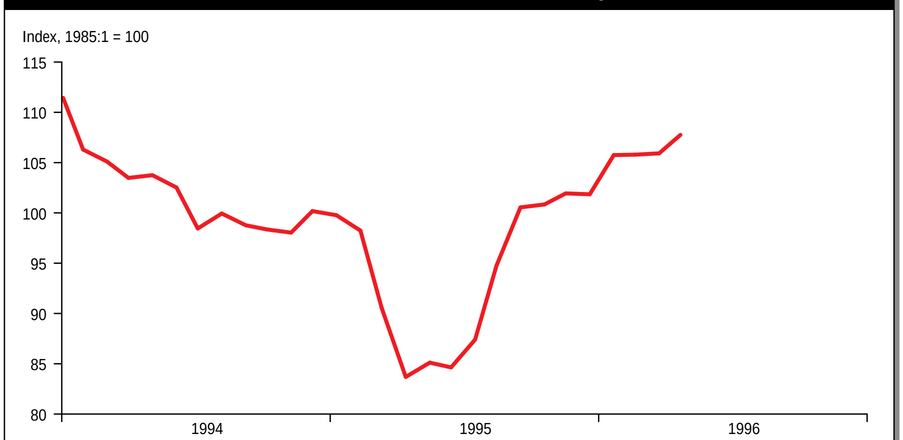
Beyond the Border

What's Behind Those Yen–Dollar Swings?

Recent movements in the yen–dollar exchange rate largely reflect relative business cycle movements and expectations of near-term growth in the United States and Japan. The yen–dollar exchange rate has been subject to wide swings as Japan has struggled with financial-sector difficulties and policy uncertainty.

The real value of the dollar relative to the yen has been extremely volatile over the past year. In fact, on a monthly basis, the real value of the dollar has been even more volatile against the yen than against the Mexican peso. From February to April 1995, the real value of the dollar fell by 15 percent against the yen; since then, the dollar's value against the yen has appreciated a dramatic 29 percent (*Chart 1*).

Chart 1
Real Value of the Dollar Relative to the Japanese Yen



Since 1992, the U.S. economy has been growing steadily, while Japan's economy has been extremely sluggish, with average growth of less than 1 percent a year. Japan's unemployment rate has reached new highs.

Some of Japan's sluggishness is the result of banking difficulties. Japan's banking problems have not been unlike those of the U.S. savings and loan crisis during the late 1980s. Both had their seeds in overvalued asset prices. The value of many assets on financial institutions' books have plunged since late 1989 when the Japanese stock market declined nearly 40 percent. Overall, Japan has had to contend with declining prices. Japan experienced 0.1 percent deflation in 1995. Deflation continued in January and February 1996 as well. As asset prices have fallen, lending has declined.

Japan's government has attempted to bail out several financial institutions that have large amounts of unrecoverable debt. A recent proposal to bail out mortgage lenders drew strong opposition and resulted in a federal budget impasse. On March 26, 1996, the legislature passed a short-term budget that kept the government operational and gave both sides 50 more days to resolve the impasse. By mid-April, a budget compromise was reached, but it excluded the proposal to bail out mortgage lenders.

Although Japan's economy has been sluggish over the past few years, signs of a recovery have emerged recently. While U.S. real gross domestic product (GDP) grew by an annualized 0.5 percent in the fourth quarter of 1995, Japan's real GDP grew by 3.6 percent. Capacity utilization and new machinery orders increased in 1995, with orders currently at their highest level in the past three years. Housing starts have increased dramatically since August, growing 7 percent in January 1996 compared with year-earlier numbers. Dun and Bradstreet's latest survey of business expectations reveals that business confidence has improved sharply in the past few months. Finally, real household spending grew 3.4 percent in January, compared with January 1995.

Japan's financial markets also are sending some positive signals. The yen has appreciated about 4 percent against the dollar since the end of 1995. The Japanese stock market index, the Nikkei, has hit the 22,000 mark, the highest level so far in 1996. Since April 1995, the Nikkei has grown about 27 percent.

If these conditions continue, a sustained recovery is possible. A poll conducted by *The Economist* magazine indicates expectations of GDP growth of 2.3 percent in 1996 and 1997. A 2-percent growth rate would have seemed sluggish by 1970s standards, but in 1996 it would signal a welcomed economic recovery.

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