Yen exchange rate movements' impact on Japanese economy

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Executive Summary

Back when Japanese companies sold their products overseas by predominantly exporting from Japan, yen depreciation was beneficial to Japan's real economy. With so many Japanese companies now operating overseas through local subsidiaries, yen depreciation's positive economic ripple effects are almost exclusively confined to the inbound tourism channel. For the real economy as a whole, yen depreciation's benefits are outweighed by the drawback of import price inflation.

Is yen appreciation still a negative for Japanese economy?

One key focal point for the Japanese economy in 2024 is how much, if at all, the BOJ will normalize its monetary policy. In much of the rest of the world, however, central bank policy rates appear to have peaked as inflation has recently slowed, leading to mounting expectations of rate cuts, particularly in the US and Europe. If the BOJ were to start normalizing policy against such a backdrop, international interest rate differentials would tighten in response to divergent monetary policy moves between Japan and other major countries. Narrowing of interest rate differentials between Japan and overseas would pose a risk of a sharp reversal in the yen's depreciation trend of recent years.

Whenever such a scenario appears to be a possibility, economic commentators in Japan invariably trot out the conventional wisdom that the Japanese economy benefits from a weaker, not stronger, yen. In fact, when the BOJ launched its QQE program, Abenomics' so-called third arrow, in April 2013, it did so in response to strong criticism that it had failed to take action to counter the pernicious effects on the Japanese economy of the excessive yen appreciation and resultant domestic deflation that ensued from the GFC. Does the notion that yen appreciation is bad for the Japanese economy still hold true today?

There is no denying that the Japanese equity market performs better amid yen depreciation than yen appreciation. Its preference for a weaker yen reflects Corporate Japan's current geographic footprint and sectoral composition. According to Japan Exchange Group data, manufacturing sectors collectively account for 53.9% (¥452.9tn) of the TSE Prime Market's 1,658 listees' aggregate market capitalization of ¥840.5tn as of November 30, 2023[1].

NOTE

1) In contrast, manufacturers' share of Japanese nominal GDP was only 19.4% in 2022 and has remained in the vicinity of 20% since 2005.

Japanese manufacturers have been progressively expanding their operations into overseas markets year after year. The Japanese Ministry of Economy Trade and Industry's Basic Survey on Overseas Business Activities reported that the overseas subsidiaries/affiliates' share of Japanese manufacturers' aggregate production rose from 17.0% in FY2008 to 25.8% in FY2021. When the survey sample is narrowed down to companies with overseas operations, Japanese manufacturers' overseas subsidiaries/affiliates' production share increased from 30.4% to 40.7% over the same timeframe.

Nowadays, many Japanese manufacturers with overseas operations employ various means to minimize exchange rate movements' impact on their exports and imports. However, when overseas subsidiaries/affiliates' financial statements are consolidated with their parents', they are redenominated in yen. Exchange rate movements during the accounting period unavoidably impact these currency translations. When the yen weakens throughout the fiscal year as it did over the previous two years, overseas subsidiaries/affiliates' balance sheets and profits swell commensurately when redenominated into yen on their parent's consolidated financial statements[2]. As long as manufacturers' overseas operations are generating profits, yen depreciation can drive gains in their share prices. The same may be true for stocks of Japanese non-manufacturers pursuing overseas expansion in response to waning growth prospects in the highly mature domestic economy.

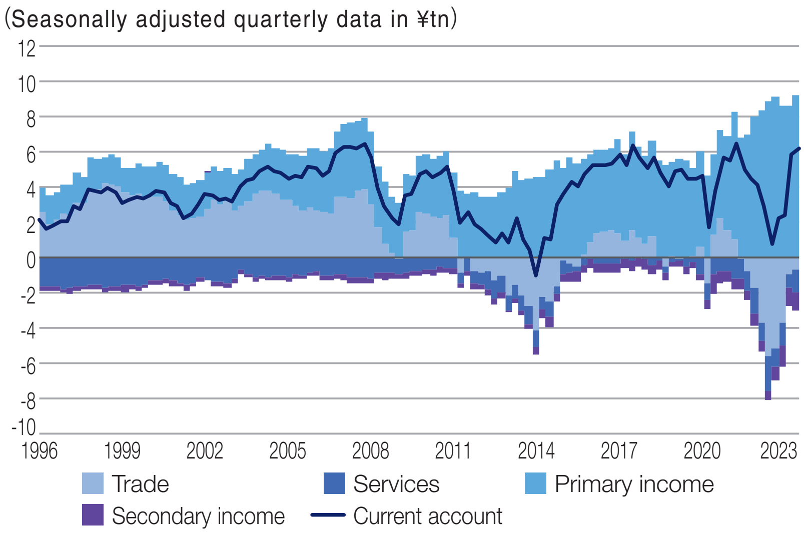
2) With certain exceptions (e.g., transactions between parent and subsidiary), overseas consolidated subsidiaries' income statement accounts must be translated into yen using the average exchange rate during the accounting period while balance sheet accounts must be translated into yen using the exchange rate as of the balance sheet date.

Yen depreciation's positive ripple effects are now muted by large stock of outward FDI

Meanwhile, Japan's balance of trade has been intermittently flipping into deficit, largely as a function of commodity prices, more often in recent years. Japan has been running a chronic services account deficit also, as strong growth in income from inbound tourism (except during the pandemic) has been outweighed in recent years by rapid growth in outbound payments for digital services, such as copyright royalties on streamed music and cloud service usage charges.

Japan's primary income account surplus, by contrast, has continued to grow, driven largely by returns from foreign direct investment and foreign portfolio investment. Its FY2022 surplus was ¥34.6tn. Overseas investments have been supplanting exports of domestically produced goods as Japan's chief source of income from abroad, as corroborated by overseas production's growing share of

Japan's current account balance



Source: MOF's international balance of payments statistics

Japanese manufacturing production as discussed above. In sum, the traditional Japanese model of generating and repatriating revenues and profits from overseas trade has drastically changed.

Back when Japan was predominantly an exporter of goods, revenues from exports flowed back into Japan to pay suppliers and employees. Consequently, whenever Japan gained export competitiveness in relative terms by virtue of yen depreciation, the Japanese economy benefited from ripple effects big enough to potentially outweigh the drawback of higher import prices.

However, when a Japanese company generates overseas sales through local subsidiaries/affiliates, it may receive dividends and/or royalties from the subsidiaries/affiliates but those inflows are no longer linked to transactions with domestic counterparties like suppliers or employees. As such, the inflows do not have much impetus to find their way into the domestic real economy.

As a result, even if yen depreciation boosts the (consolidated) profits and, in turn, equity prices of companies that have expanded overseas, it does not provide much if any benefit, aside from increased inbound tourism, to the Japanese public or to SMEs that mostly do business domestically. Whatever benefit the public and domestically focused SMEs might get from yen depreciation is vastly outweighed by input cost inflation.

Over the past few years, yen-denominated prices of energy and food, Japan's supplies of both of which are heavily dependent on imports, have soared in the wake of the yen's depreciation coupled with commodity price inflation. Such import price inflation has in fact eroded Japanese households' purchasing power. Total cash earnings per worker[3] as of October 2023 were 3.7% above their 2000 average in nominal terms but when converted to real terms using the headline CPI, they were 4.1% below their 2000 average (both the nominal and real data were seasonally adjusted).

3) Based on data from survey of establishments with five or more workers.

In a survey of SMEs conducted by the Japan Chamber of Commerce and Industry in mid-November 2023[4], 47.8% of respondents reported that yen depreciation to date has had a major adverse impact on their earnings due to input price inflation while only 3.3% reported benefiting materially from yen depreciation.

4) November 2023 JCCI Local Business Outlook.

In light of such, even if yen appreciation is still negative for share prices, it may now be net-beneficial to Japan's real economy if it is fairly gradual and alleviates the burden of cost inflation fueled by the yen's depreciation over the past few years.

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