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Issue Brief

Japan’s Currency Crisis and Its Implications

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Summary

At the end of the Second World War, Japan's economy was in shambles, hollowed out not only of capital and resources, but also precious manpower. Yet a decade after Japan's surrender, the country had put in place a revolutionary new system of 'guided capitalism' that delivered growth rates averaging 8–10 per cent until the 1970s and 7-plus per cent until the 1990s. Japan's economic reverses in the 1990s persisted in fits and starts across three decades. Now, even as Japan's economy finally shows signs of having recovered from its 'lost decades', currency fluctuations bar its way towards normality.

The Japanese Economy's Lost Decades

In order to understand Japan's rise, it is important to understand the role played by the United States of America's accommodative policies. The US not only opened its domestic markets to Japan's manufactures but also pegged the yen to a fixed value against the dollar. However, the system that guided Japan to success also contained the roots of its failure. Japan's relatively loose antitrust regulations encouraged the creation of giant conglomerates called the *keiretsu,* which were allowed to grow into vast enterprises with interests in multiple sectors, funded by capital generated by other arms within the *keiretsu* itself (a system called cross-holding).[1]

By the middle of the 1980s, the *keiretsu*—and the banks they owned or controlled—began to lend each other (that is, cross-lend) capital to invest in real estate in and around major urban areas in Japan, with the metropolises (Tokyo, Osaka and Nagoya) emerging as prime spots for investment. This created a real estate bubble that artificially inflated the price of real estate.[2] When it burst in 1991, the bubble triggered a deflationary crisis within the economy which led to a run on the banks, investments being wiped out overnight and the value of the yen rising to prohibitive heights. In 1995, when the crisis reached a head with the collapse of the three largest banks in the country, Japan entered a period of steep deflation that has come to be called the 'lost decades'.[3]

In a deflationary economy, prices of goods and services fall, the value of a currency increases and consumers have more purchasing power to increase their consumption. However, when accompanied by a contraction caused by rises in the prices of key assets, the economy runs out of credit and collapses into a deflationary spiral. The central bank of an economy plays a role here, as it is often the source of the speculative credit that firms and other players use to fund their purchase of assets. This kind of 'easy money' policy creates an incentive to be spendthrift with one's investments, leading to the formation of a bubble, which, when it bursts, leaves behind a staggering debt burden on the national account.[4]

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[1] Robert L. Cutts, "**Capitalism in Japan: Cartels and Keiretsu**", *Harvard Business Review,* July–August 1992.

[2] Tomohiro Ishikawa, "**Japan's Bubble, Deflation, and Long-term Stagnation —Review of An Oral History Study—**", ESRI Research Note, Economic and Social Research Institute, Cabinet Office, September 2011.

[3] "**【失われた 30 年】いつから？原因や解決策をわかりやすく解説**" (The Lost Decades: When did it start? Explaining the Causes and Policy Solutions in Easy-to-Understand Way), 政経百科 (Finance and Economics Encyclopedia), 12 May 2024.

[4] "**Why is Deflation Bad for the Economy?**", Investopedia, 17 January 2024.

This was the state of affairs in Japan as well. The Bank of Japan had maintained easy money policies throughout the Japanese economy's growth phase, making it easier for the *keiretsu* to continue investing in the real estate business, first through credit and later through debt held by their banking arms.[5] With the collapse of the main banks, their parent corporations were left holding the debt on their books. Accompanied by the crash in prices of goods and services, deflation caused wages to stagnate, which in turn meant people preferred to save their (stronger) yen instead of recycling it into the economy through consumption. A race to the bottom on prices meant that Japan became a haven for cheap goods and cheap travel as locals sought price efficiency above everything else.

The Rise of Abenomics

To restart the deflationary economy, several successive prime ministers proposed—and occasionally implemented—a series of plans to recover the yen's lost value. The latest in this series, and arguably the most successful, was the so-called Abenomics scheme.

Once he rose to the office of prime minister in 2012, Shinzo Abe officially declared that he would implement his long-touted campaign promise by releasing 'three arrows' in stages to achieve an inflationary economy, where prices of goods and services would follow inflation up and the yen would weaken accordingly.[6] His chosen tools were monetary policy, fiscal policy and structural reform. Of these, only the first will be discussed here, as it is the most germane to the later crisis in the yen.

The first of Abe's 'arrows' targeted monetary policy by 'reflating' the economy through a steady supply of credit. It did so by:

1) Setting an inflation target of 2 per cent, so that the prices of goods would rise and stimulate more production;

2) Correction of yen volatility, so that the yen remained stable at a pre-determined level;

3) Setting negative interest rates, which meant that producers—and banks—would have to pay the entity holding their capital, whether other banks or

[5] Adam S. Posen, "**Did Monetary Laxity in Japan Cause the Bubble?**", *CESifo Forum*, April 2003.

[6] Keiichi Kaya, "**Abenomics: The Reasons It Fell Short As Economic Policy**", *Nippon.com*, 19 January 2022; William Pesek, "**25-year Weak Yen Obsession is Blowing Up on Tokyo**", *Asia Times*, 25 June 2024.

the BoJ, a standard interest rate on their principal, instead of the other way round;

4) Expansion of public investment, by which the government would aim to inject capital investment directly into the economy; and

5) Quantitative Easing (QE), by which the BoJ would buy government and non-government bonds in the open bond market, in effect using its credit liquidity to buy back its own debt.

To implement these reforms, Abe tapped Haruhiko Kuroda as the new Governor of the BoJ. Over the next 10 years, Kuroda faithfully followed the policy guidelines laid out by Abe and injected massive amounts of credit into the economy.[7] When aggressive bond buybacks failed to curb deflationary pressures on the yen, the BoJ initiated the world’s only experiment in yield curve control in 2016, a technique which involved the central bank essentially setting caps on the returns (yields) from bonds. The BoJ set the yield at a low of 0 per cent over the long term and -0.1 per cent in the short term.[8]

Scholars agree that Abenomics was successful to some extent in creating inflationary expectations. However, there is far less evidence that the monetary and fiscal measures put in place were entirely successful.[9] While GDP per capita did increase, real GDP growth declined, personal consumption rates stagnated near zero and the government deficit ballooned. Further, as structural reforms were never implemented in earnest, labour force participation rates remained low, crimping economic productivity.

Abenomics’ implications for the yen were also a net negative. While it initially stabilised the yen, exchange rates promptly rose back up again. After that, rates continued to mark a see-saw pattern despite the BoJ’s aggressive interventions in injecting liquidity. By the time Abe left office in August 2020, the yen was again hovering around 105 to the dollar, leading many to credit him with a modest improvement in the export profile of his country.[10]

[7] Pawel Kowalewski and Sayuri Shirai, “**History of Bank of Japan’s More Than Two Decades of Unconventional Monetary Easing with Special Emphasis on the Frameworks Pursued in the Last 10 Years**”, Working Paper, Asian Development Bank Institute, May 2023, pp. 16–17.

[8] Leika Kihara, “**Explainer: How Does Japan’s Yield Curve Control Work?**”, *Reuters*, 10 April 2023.

[9] Keiichi Kaya, “**Abenomics: The Reasons It Fell Short As Economic Policy**”, no. 6.

[10] Ibid.

The End of Abenomics

The real cost of the BoJ's aggressive QE policies were felt by his successors Yoshihide Suga and Fumio Kishida. In tandem with the Japanese economy officially entering an inflationary state in early 2024, the initial stimulus packages and fiscal holidays announced by the Abe administration gradually began to expire, leading to firms—and ultimately consumers—having to face greater expenditure for essential goods.

Japanese consumers, already trained to save their hard-earned yen, largely forewent consumption.[11] Barring subsidies and other incentives, firms lost their motivation to produce and raise wages. The strong yen did allow major Japanese exporters to return home with lavish profit margins, leading these major firms to declare the largest wage increases in 33 years, after which 'the average base wage rate has risen by 3.7%, accelerated from 2.3% last spring'.[12]

However, wage rates did not increase in the much larger small- and medium-scale enterprise sphere, which absorbs 69.7 per cent of the 47.5 million people working in the private sector in Japan.[13] In fact, most owners of MSMEs have refused to even consider wage hikes in the near term. Even the new wage increases are not matching rises in the cost of living caused by the weakening yen, leading Kishida to explicitly declare as a policy plank the promise to cajole private enterprises to keep raising wages tied to inflation.[14]

On 18 March 2024, the BoJ's new governor Kazuo Ueda announced an end to the yield curve control policy as well as a tapering-off of QE, ending the 12-year-long Abenomics experiment.[15] The effect on the already-weakened yen was almost instantaneous. Its value began to skyrocket, reaching a 'psychological limit' of 150 yen to the dollar on 19 March 2024.[16] This led the Finance Ministry to issue repeated verbal warnings against currency speculators, who it blamed for the crisis.[17] Finance Minister Shunichi Suzuki also joined his South Korean counterpart to push for a G-

[11] William Pesek, "**25-year Weak Yen Obsession is Blowing Up on Tokyo**", no. 6.

[12] Spencer Feingold, "**Japan Ends Era of Negative Interest Rates. A Chief Economist Explains**", World Economic Forum, 26 March 2024.

[13] "**Number of People Working in Private Business Enterprises Operating in Japan from 2009 to 2021, by Company Size**", Statista, 30 May 2024.

[14] "物価高を上回る所得増へ" (Raising Wages above Rising Costs of Living), 首相官邸 (Prime Minister's Office of Japan), Government of Japan.

[15] "**BOJ Ends Negative Rate Policy in Shift from Bold Monetary Easing**", *Kyodo News*, 19 March 2024.

[16] "**Dollar Tops 150 yen as BOJ Ends Negative Rates**", *Kyodo News*, 19 March 2024.

[17] "**Japan Mulling All Options, to Take Appropriate Steps as Yen Falls**", *Kyodo News*, 23 April 2024; "**Japan Committed to Act Appropriately on Weak Yen: Finance Minister**", *Kyodo News*, 25 April 2024.

7 mechanism to handle 'excessive currency speculation' in April, while also requesting the US to aid them in curbing bets against the yen and the won.[18] The latter move was especially significant, as the US economy's strengthening has had a direct impact on the yen's value. As the Biden administration has focused on righting the balance books, the reduction of its national debt and the increase in employment rates has led the US Federal Reserve to maintain high interest rates on its bonds. This makes the dollar more attractive as a currency to buy, leading many markets to dump yen holdings, which weakens the yen further. Thus, though the US did promise to 'consult closely' with Japan and South Korea, comments made by Secretary of the Treasury Janet Yellen immediately set limits to many expectations, as she warned Japan against 'excessive intervention' in the currency market.[19]

As it is, despite a massive undeclared injection of liquidity throughout April and May,[20] the yen temporarily declined only to rise again in the ensuing weeks. At the time of writing, it hovers around 160 yen to the dollar, a level unattained since 1986, and there is speculation it may decline further.[21] Top finance officials are threatening to intervene again, while the BoJ has remained firm on continuing bond purchases for now.[22]

However, there is little confidence that intervention by the authorities will be of a large enough scale to alter the trajectory of the yen. 'Excessive intervention' already has the potential to be the red-line beyond which the US may decide to react. On 21 June, it returned Japan to its list of currency manipulators after only one year off it, where it joins China, Vietnam and others in conducting 'persistent, one-sided intervention in foreign exchange markets' while maintaining a current account surplus with the US.[23] Despite the quiet defiance shown by the Japanese authorities so far, it is unclear whether they would be bold enough to take the risk that their continued interventions cause the US to designate Japan a currency manipulator, which could invite heavy sanctions. The weak yen, thus, has implications that could well set Japan on a course to a deep crisis.

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[18] **"US Nods to 'Serious' Japan, S. Korea Concerns over Slumping Currencies"**, *The Japan News by the Yomiuri Shimbun*, 18 April 2024.

[19] **"Yellen Says Currency Intervention Acceptable Only in Rare Situations"**, *Mint*, 26 April 2024.

[20] **"Japan Spent Record 9.8 trillion Yen in April-May to Slow Currency Fall"**, *Kyodo News*, 31 May 2024.

[21] Naomi Tajitsu and Masaki Kondo, **"Yen's Tumble to Weakest Since 1986 Boosts Risk of Intervention"**, *The Japan Times*, 26 June 2024; Ruth Carson and Yui Hasebe, **"Forget ¥160 — Traders See Currency Falling as far as ¥170 Against Dollar"**, *The Japan Times*, 25 June 2024.

[22] **"Japan, South Korea Air 'Serious Concerns' About Weak Yen, Won"**, *Kyodo News*, 25 June 2024.

[23] **"U.S. Puts Japan Back on Currency Manipulator Watch List After 1 Year"**, *Kyodo News*, 21 June 2024.

Implications for the Japanese Economy

The first and most significant implication of the weakened yen is the decline in both economic productivity and consumption. As the yen's purchasing power declines, Japanese citizens are progressively finding it hard to make ends meet. This is exacerbated by Japan's heavy reliance on food and energy imports as well as raw material.

Successive price rises of essential foodstuffs, as well as the spiralling costs of industrial raw material, have had cascading impact on things as diverse as the Expo 2025, scheduled to be held in Osaka, and Japan's ranking among the world's largest economies. While the former is now seeing a wave of cancellations brought about by spiralling costs of construction,[24] the latter has seen Japan concede the title of third largest economy to Germany due to the weak yen, with projections seeing India slated to take over Japan a full year before schedule.[25]

A silver lining of the yen crisis has been the exponential increase in the number of tourists coming to Japan. Though East Asian countries were late to open in the wake of the COVID-19 pandemic, the depreciation in the value of the yen has driven tourist flows up to levels seen pre-pandemic, only to exceed them this year.[26] However, the silver lining has proven to be a double-edged sword for Japanese municipalities. The flood of tourists has not only exposed the deficiencies of public infrastructure, but also dialled up the cost of living in areas such as Kyoto and Nara, where citizens now have to share the same resources and public services as tourists. This has caused many within Japan to question whether Japan's aggressive tourism promotion policies have overshot their mark, and invited 'the wrong sort of tourist' to the country.[27] Many municipalities have also decided to capitalise on their touristic potential, and levied differential charges for foreign tourists in an attempt to cash in on their higher purchasing power.

The yen crisis also has knock-on effects on Japan's defence modernisation. Prime Minister Kishida's commitment in the 2022 Defence Buildup Scheme to raise defence spending to 2 per cent of GDP by an absolute increase in spending of 43

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[24] **"Iran, Pakistan Give Up on Building Own Pavilions for 2025 World Expo"**, *Kyodo News*, 25 June 2024.

[25] Jiji Press, **"India Seen Overtaking Japan in Nominal GDP in 2025"**, *The Japan News by the Yomiuri Shimbun*, 29 April 2024.

[26] **"Foreign Visitors to Japan Top 3 mil. for 3rd Straight Month in May"**, *Kyodo News*, 20 June 2024.

[27] Walter Sim, **"Welcome to Japan... or not? Overtourism Forces Japan to Consider Relationship with Tourists"**, *The Straits Times*, 23 March 2024; Jay Allen, **"Are Foreign Tourists to Japan The Only Ones Behaving Badly?"**, *Unseen Japan*, 27 May 2024.

trillion yen by 2027 depends to a large extent on a strong yen and tax revenue. Given the economic pain already plaguing citizens, any discussion of taxation is likely to fall on deaf ears, while the weak yen all but ensures that the Japanese military, which depends largely on imported platforms,[28] will have to compromise on big-ticket line items in the foreseeable future. Added to this is the fact that a significant portion of the government budget is also being diverted towards measures to tackle demographic decline and debt servicing.

The biggest loser in this crisis, of course, may well be Kishida himself, along with the Liberal Democratic Party. The yen crisis threatens nearly every policy plank he has set for his administration, from expansive childcare assistance to overseeing wage rises pegged to inflation. Given that his popularity has slumped to historic lows in recent years, the rejection signalled in polls conducted on business leaders and ordinary people[29] has emboldened calls within his party for a leadership change. Recently, young members of his party have openly called on him to decline a second term as the party's secretary-general—and by extension, as prime minister—in elections slated for September.[30] Though he remains defiant, only time—and the currency markets—will tell whether he lives to see the new year.

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28 Jiji Press, "**Japan's Arms Imports Up 155% Over Last Five Years, Report Finds**", *The Japan Times*, 11 March 2024.

29 "**Most Japan Firms See No Need to Follow the U.S. with Tariffs on China**", *The Asahi Shimbun*, 20 June 2024; "**Only 10% Want PM Kishida to Stay as Support Rate Sags: Kyodo Poll**", *The Mainichi*, 23 June 2024.

30 "【自民党総裁選】若手議員が岸田首相再選に公然と反対" ([LDP General Secretary Elections] Freshman Parliamentarian Publicly Opposes PM Kishida's Re-election), *日テレ* (Nippon Television), 22 June 2024.

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