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Criticism of the Weak Yen and Intervention in the Exchange Market

By OBA Tomomitsu

Both the yen and the dollar are depreciating against the euro, but the yen-dollar exchange rate has remained comparatively steady, perhaps because they are both weak. Japan's foreign reserves have increased by only 50 billion yen in the past two years, just the amount of income from interest gained by the management of foreign reserves. Monetary authorities have not intervened in the exchange market, so Germany and other European nations' criticism of the weak yen is unfounded.

However, Japan's foreign reserves increased by 628.6 billion dollars in the six years from 1999 to 2004, a testimony to how much the authorities intervened by buying a large amount of dollars (some euros) in that period. The monetary authorities' intervention in the exchange market should be made to achieve the goal of stabilizing the exchange rate; that is the original purpose of intervention. But in the six years from 1999, dollar-buying was used as a means to achieve the policy goals of the previous administration, "to get Japan out of depression."

The government tried to do this by implementing a fiscal policy, monetary policy and everything else, but when those measures did not produce sufficient economic recovery, the government resorted to intervention, which should only be used to even out the "violent fluctuations in yen-dollar exchange rate." Perhaps they hoped that a weaker yen and a stronger dollar would stimulate export and contribute to economic recovery. Whatever the idea was, they set a bad precedent.

Intervention is a policy measure to achieve the goal of stabilizing the exchange rate, but it also serves to inform the market players of the intention of the monetary authorities. The importance of intervening in coordination with other countries and the consistency with other economic policies are also factors, but they are simply conditions for making intervention more effective.

What does it mean to intervene to level off the violent fluctuation in the yen-dollar rate? Buying the dollar for 100 yen and selling it at 130 yen produces a profit of 30 yen. Making a profit means the intervention was useful in leveling the exchange rate. If the monetary authorities make a profit by the intervention, it is considered a "good intervention"; if they lose, it is considered a "bad intervention." This argument has not changed since the days of Milton Friedman.

In the last two years without intervention by the monetary authorities, it can be said that private intervention by hedge funds, individual and institutional investors was responsible for the leveling of the exchange rate and the stability of the exchange market. In a globalized market, such private intervention makes it less necessary for the monetary authorities to intervene.

But the goal of private intervention is simply to make a profit and investors do not have the perception that they are stabilizing the exchange market. We must remember that any stabilization of the

exchange market is simply a consequence.

(This is the text of an article by Mr. OBA Tomomitsu, Director of the Japan Center for International Finance, which was originally posted in the JITOW ("Japan In Their Own Words") column of the English-Speaking Union of Japan on July 11, 2007.)