Japan’s Currency Intervention: Policy Issues

Summary

Japan’s intervention to slow the upward appreciation of the yen has raised concerns in the United States and brought charges that Tokyo is manipulating its exchange rate in order to gain unfair advantage in world trade. This coincides with similar charges being made with respect to the currencies of the People’s Republic of China and South Korea. In the 110th Congress, S. 1021 (Stabenow, Japan Currency Manipulation Act) would require negotiation, reports, and other action with respect to Japan’s exchange rate-related actions.

Japan intervened (bought dollars and sold yen) extensively to counter the yen’s appreciation in 1976-1978, 1985-1988, 1992-1996, and 1998-2004. Since March 2004, the Japanese government has not intervened significantly, although some claim that Tokyo continues to “talk down the value of the yen.” This heavy buying of dollars has resulted in an accumulation of official foreign exchange reserves that exceeded a record $888 billion (March 2007) by Japan. The intervention, however, seems to have had little lasting effect. It may only have slowed the rise in value of the yen, since the yen rose from 296 yen per dollar in 1976 to 103 yen per dollar at the end of 2004. In spring 2006, the exchange value of the yen had depreciated to about 119 yen per dollar. Japan’s intervention, therefore, amounted to what is called “leaning against the wind” or intervening to smooth strong short-term trends rather than to reverse the direction of change. Estimates on the cumulative effect of the interventions range from an undervaluation of the yen of about 3 or 4 yen to as much as 20 yen per dollar. Private company estimates of the misalignment of the yen in 2005 range from an overvaluation of 1.8% to an underevaluation of 14%.

In 2006, the U.S. Secretary of the Treasury indicated that it had not found currency manipulation by any country, including by Japan. An April 2005 report by the Government Accountability Office reported that Treasury had not found currency manipulation because it viewed “Japan’s exchange rate interventions as part of a macroeconomic policy aimed at combating deflation...” In its May 2006 report on consultations with Japan, the International Monetary Fund (IMF), likewise, did not find currency manipulation by Japan. The criteria for finding currency manipulation, however, allows for considerable leeway by Treasury and the IMF.

One problem with the focus on currency intervention to correct balance of trade deficits is that only about half of the increase in the value of a foreign currency is reflected in prices of imports into the United States. Periods of heaviest intervention also coincided with slower (not faster) economic growth rates for Japan.

Major policy options for Congress include (1) let the market adjust (do nothing); (2) clarify the definition of currency manipulation; (3) require negotiations and reports; (4) require the President to certify which countries are manipulating their currencies and take remedial action if the manipulation is not halted; and (5) take the case to the World Trade Organization (WTO) under the dispute settlement mechanism or appeal to the IMF. This report will be updated as circumstances require.
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Japan’s Currency Intervention: Policy Issues

Japan’s intervention to slow the upward revaluation of the yen has raised concerns in the United States and brought charges that Tokyo is manipulating its exchange rate in order to gain unfair advantage in world trade. This coincides with similar charges being made with respect to the currency of China. This report provides an overview and analysis of Japan’s official intervention into currency markets, reviews various studies on the probable effect of that intervention, examines the charge that Japan has manipulated its exchange rate as defined by the International Monetary Fund (IMF), and reviews legislation and policy options.

Foreign governments intervene into currency markets by buying foreign exchange — usually dollars, Euros, or British pounds — in order to increase demand for dollars and support its value relative to the intervening government’s own currency. Likewise, they can sell foreign exchange in order to decrease demand for dollars and increase the value of the country’s own currency. In Japan’s case, it has usually bought dollars from its domestic exporters in exchange for yen and used those dollars to buy U.S. Treasury securities or other liquid dollar assets.

In the 110th Congress, S. 1021 (Stabenow, Japan Currency Manipulation Act) would require negotiation, reports, and other action with respect to Japan’s currency actions. This bill states in its findings that Japan’s exchange rate provides a subsidy to Japanese exporters and an unfair competitive advantage for Japanese automobile manufacturers.

In the 109th Congress, the Fair Currency Enforcement Act of 2005 (S. 377, Lieberman) would have required negotiation and appropriate action with respect to certain countries that engage in currency manipulation. H.R. 3283 (English, passed the House July 27, 2005) would have required the Secretary of the Treasury to provide to Congress a periodic assessment of countries that intervene (including Japan) to influence the value of their respective currency. H.R. 4407 (Kildee) cited Japan’s currency manipulation in its findings to justify a two-year termination of U.S. authority to negotiate and enter into trade agreements.

Concern over such intervention stems from the basic U.S. interest in American national prosperity. Manipulation of exchange rates to undervalue foreign currencies potentially can increase the U.S. trade deficit, increase U.S. dependency on foreign

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1 The overall size of a nation’s current account balance (trade in goods and services plus unilateral transfers) is determined mainly by rates of savings and investment, interest rates, and other factors, but the foreign exchange rate plays a key role in adjusting for imbalances.
investors to finance U.S. budget deficits, affect the level of U.S. interest rates, and negatively affect U.S. businesses competing with imports or exporting.

In Japan’s case, the Bank of Japan (in consultation with the Ministry of Finance) has bought U.S. Treasury securities and other liquid dollar assets at times when the value of the dollar relative to the yen was declining. The intended result was to keep the value of the yen from appreciating too quickly in order to keep the price of Japanese exports from rising in markets such as the United States and to maintain the profitability of those exports. Some experts argue that the yen is undervalued by 10% to 20% or more. If so, this would give many Japanese manufacturers a 10% to 20% price advantage over U.S. competitors.

Most economic studies, however, indicate that currency intervention for large countries with floating exchange rates, such as Japan, merely slows the rate of currency appreciation or depreciation over the short run (less than 30 days) and has little effect over the long term. Whether Japan has manipulated its exchange rate under criteria set by the International Monetary Fund (IMF) is open to debate. The IMF and the Secretary of the Treasury have not found such manipulation in recent years, but others charge that such manipulation has taken place. Japan claims that it has not intervened in foreign exchange markets since March 2004, although some claim that Japan still “talks down the value of the yen.”

Even without official intervention, Japan’s holdings of foreign exchange continue to increase because of interest Japan earns by investing that foreign exchange in U.S. Treasury bills and other securities. In 2006, Japan earned $40.3 billion more on its investments (including business direct investments) in the United States than Americans earned on their investments in Japan.

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**The Interventions**

In 1971, when the link between the U.S. dollar and gold was severed and the dollar was allowed to float within certain bands, the yen began to appreciate in value. The yen/dollar exchange rate, established during the U.S. occupation of Japan in 1949, had been held at 360 yen per dollar for 22 years. Since then, it appreciated to around 105 yen per dollar in early 2005, but in late 2005 it had depreciated to around 120 yen per dollar before rising slightly to about 119 yen per dollar in March 2007.

Japan’s government has intervened in currency markets to buy dollars or other foreign exchange at times when the yen was appreciating at a pace considered to be too rapid. Japan also has intervened by selling dollars at times when the yen was

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depreciating too rapidly. The net result of this intervention is that Japan’s holdings of foreign exchange reserves have risen to about $888 billion in March 2007.4

As can be seen in Figure 1, the most significant of Japan’s interventions to counter the yen’s appreciation took place in 1976-1978, 1985-1988, 1992-1996, and 1998-2004. Since March 2004, the Japanese government has not intervened significantly in currency markets to support the value of the dollar.5 Figure 1 also shows that despite heavy buying (or selling) of dollars during certain periods of time, the intervention seems to have had little lasting effect. It might have slowed the change in value of the yen, but the appreciation (or depreciation) occurred anyway. This is called “leaning against the wind” in economic parlance or intervening to oppose strong short-term trends rather than to reverse the direction of change. In most cases, Japan’s intervention resulted in the “smoothing” of fluctuations in exchange rates rather changing the direction of movement. As one author put it, Japan seems to have won many daily battles with the foreign exchange market, yet it lost the war.6

Even though Japan has invested hundreds of billions of dollars in buying dollar assets that are then held as foreign exchange reserves, many observers point out that such transactions are small when compared with the average daily turnover of $1.9 trillion in traditional foreign exchange markets and $2.4 trillion in over-the-counter currency and interest rate derivatives markets.7 Currency transactions in support of imports and exports, investments, remittances, and other purposes dwarf interventions by central banks. Still, it is the effect of central government intervention on net — rather than gross — flows that make the difference (since imports and exports tend to balance on a global basis). Government purchases and sales constitute a net addition to or subtraction from global demand and supply. Also government interventions can have a powerful signaling effect on market participants who may prudently reduce their speculative buying should it be in a contrary direction to what the government is doing. Central banks also often coordinate intervention (intervening in the same direction the same day). This multiplies the effect of the intervention.

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Figure 1. Japan’s Exchange Rate and Foreign Exchange Reserves 1972-2006

Source: Data from World Bank, World Development Indicators

Academic studies of intervention generally conclude that interventions did increase exchange rate volatility (moved the market), were a good indicator that the magnitude of the change in exchange value on subsequent days would decrease, and that much of it amounted to “leaning against the wind.” A recent study of the 1991-2002 period of Japanese intervention concluded that “prior to June 1995, Japanese interventions only had value as a forecast that the previous day’s yen appreciation or depreciation would moderate during the current day. After June 1995, Japanese purchases of dollars had value as a forecast that the yen would depreciate” in the very short run. This analysis also confirmed that large, infrequent interventions, which characterized the latter period, had a higher likelihood of success than small, frequent interventions. For 2003 and 2004, despite the record size and frequency of the intervention by Japan, the authors found it difficult to statistically distinguish the pattern of exchange rate movements on intervention days from that of all the days in that particular subperiod. This showed little effectiveness in the interventions for that subperiod and only modest effectiveness overall.

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Another study examining data from 1991 to 2000 found strong evidence that “sterilized” intervention (buying of dollars offset by domestic selling of yen-denominated bonds to keep Japan’s money supply unchanged) systemically affected the exchange rate in the short-run (less than one month). Large-scale intervention (amounts over $1 billion) — coordinated between the Bank of Japan and the U.S. Federal Reserve — gave the highest success rates. Of the 12 “large scale coordinated” interventions studied, 11 achieved the desired effect: they moved the yen either up or down in accordance with the policy goal of the moment, although the effects were short-lived.10

The estimate that the yen is 10% to 20% undervalued comes mainly from U.S. automaker interests. In 2003, General Motors claimed that the yen should be trading at about 100, rather than at 110 yen per dollar.11 In late 2005, as the dollar strengthened, General Motors claimed that the relatively weak yen (111 per dollar at the time) was providing a significant cost advantage (about $3,000 per vehicle) to Japanese automakers. GM also raised the issue of “jawboning” and verbal currency intervention (talking the yen down) by high-ranking Japanese officials.12 In a meeting between President Bush and the Big Three U.S. automakers, General Motors Chairman Rick Wagoner indicated there is still a chasm between the auto industry and President Bush on foreign exchange issues. Wagoner said the yen, in particular, was “systematically undervalued” with the car companies estimating that Japanese competitors gain a $3,000 to $9,000 cost advantage per vehicle over U.S. automakers thanks to what is seen as an unfair currency advantage.13 In April 2007, the Automotive Trade Policy Council (with membership by Daimler Chrysler, Ford, and GM) claimed that Japan’s weak yen policy had forced U.S. automakers to contend with a $4,000 subsidy on vehicles that their Japanese competitors export from Japan to the United States.14

A leading proponent of the position that Japan has manipulated its exchange rate is Ernest Preeg.15 In one study, he concluded that Japan had manipulated its

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9 (...continued)


12 Mohatarem, Mustafa. Statement before the House Committee on Ways and Means, Hearing on United States-Japan Economic and Trade Relations, September 28, 2005.


15 Ernest H. Preeg is a Senior Fellow in Trade and Productivity at the Manufacturers Alliance/MAPI.
exchange rate and that the yen in 2002 was about 20% undervalued and should have been around 100 yen per dollar.  His analysis is based on the observation that Japan’s intervention has been large, protracted, and one-sided, but the 20% figure is a rough estimate based primarily on the extent of the intervention, not on a rigorous economic model.

The International Monetary Fund also conducts surveillance over the exchange rates of its member countries. In the IMF’s August 2005 report on consultations with Japan, the Fund noted that compared to the United States and the Euro Area, Japan stands out for its active use of foreign exchange market intervention as a policy instrument. The IMF reported that since 1991, the Bank of Japan had intervened on 340 days, the European Central Bank on four days (since its inception in 1998), and the U.S. Federal Reserve on 22 days. The IMF further stated that “there is some evidence that intervention has had some impact on yen movements.” It then quoted Takatoshi Ito, a Japanese economist, who found that intervention of about ¥2.5 trillion (about $250 billion) on average moved the exchange rate by ¥1 per dollar or about 1%. The IMF’s May 2006 report on consultations with Japan did not discuss exchange rate intervention.

A fundamental problem with exchange rates is that no commonly accepted method exists to estimate the effectiveness of official intervention into foreign exchange markets. Many interrelated factors affect the exchange rate at any given time, and no quantitative model exists that is able to provide the magnitude of any causal relationship between intervention and an exchange rate when so many interdependent variables are acting simultaneously.

A 2007 Occasional Paper No. 7 by economists at the U.S. Treasury surveyed exchange rate models and misalignments in currencies. The authors concluded that currencies cannot be said to be misaligned without estimating what the exchange rate should be. Economists use various models to estimate such hypothetical exchange rates and then compare the modeled rates to the actual ones. The study notes that the models produce widely divergent results and depend heavily on their assumptions, methodologies, and mathematical structure in trying to capture all the relevant features of an economy, particularly the behavior of financial markets. For Japan, the

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18 See, for example, International Monetary Fund. *IMF Country Report No. 05/273, Japan: 2005 Article IV Consultation — Staff Report; Staff Supplement; and Public Information Notice on the Executive Board Discussion*. August 2005. p. 7.
authors note that according to the purchasing power parity approach, Japan’s currency in 2003 was overvalued by 21%. According to a Big Mac index of the cost of this hamburger across countries, in May 2006, the yen at 112 yen per dollar was 28% undervalued. Using relative labor costs to calculate real effective exchange rates, in 2004, Japan’s yen was undervalued by 6.3%, but was overvalued by 2.2% using relative consumer prices in the calculation. Private sector estimates likewise vary widely. Using various methods, the Hong Kong and Shanghai Banking Corporation (HSBC) estimated the yen to have been 1.8% overvalued at the end of 2005, while Goldman Sachs estimated that it was 6.9% undervalued, while J.P. Morgan came up with the figure of 14% undervalued.20

Setting aside the problems with statistical estimates, what can be said is that the Japanese economy has generated a surplus in its trade accounts for much of recent history. Without an offsetting deficit in its capital account, market forces would have forced an appreciation of the yen that would have worked to eliminate the trade surplus. From 1977 to 2004, Japan’s cumulative surplus on current account (net trade in goods and services plus remittances) totaled $2,077 billion. Offsetting Japan’s surplus on current account was its net capital outflow and net official purchases of foreign exchange reserves (intervention). From 1977 to 2004, Japan recorded a deficit in its capital flows (investments in foreign securities, buying foreign companies, deposits in foreign bank accounts, etc.) of $1,314 billion. In other words, Japan’s private investors sent $1,314 billion more abroad than foreigners invested in Japan. The remaining $763 billion outflow ($2,077 billion minus $1,314 billion) of dollars was primarily from official currency intervention that added to Japan’s foreign exchange reserves. This net buying of $763 billion21 in dollars — over the 1977-2004 period provided more than a third (37%) of the total capital outflow from Japan to offset the country’s surplus in trade. If Japan had not intervened to this extent, the yen likely would have appreciated more than it did.

Taking the estimate by Takatoshi Ito that $250 billion in intervention moved the exchange rate by about 1% or ¥1, the net effect of the direct intervention that ended in 2004 would have been around ¥3 or ¥4 per dollar. Taking the estimates by Preq and General Motors, the upper bound on the effect of the intervention would be around 20% or about ¥20 per dollar. The range, therefore, for the effect of exchange rate undervaluation because of Japanese intervention would be from ¥3 to ¥20 yen per dollar with the statistical likelihood more toward the lower end of the range.

**The Link Between Exchange Value and Trade**

Setting aside the question of the efficacy of Japan’s intervention into exchange markets to weaken the yen, a second question is whether changes in the yen-dollar exchange rate actually affect imports and exports. In theory, Japan’s intervention by

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21 Japan’s holdings of foreign exchange reserves actually rose by $811 billion over this period. Some of this may have been interest earned on its holdings.
buying dollars and selling yen induces a cheaper yen which then assists Japan’s exporters by allowing them either to lower their export price or to maintain their export price while increasing profits. It also makes imports relatively more expensive in Japan. Lowered export prices and higher import prices will tend to increase Japan’s trade surplus which then contributes to a higher growth rate. The Bank of Japan may or may not sterilize the currency operation by selling Japanese bonds locally to keep the domestic money supply constant. In an economic sense, if the intervention is not sterilized, buying dollars is equivalent to increasing the Japanese money supply, since the Finance Ministry purchases the dollars from Japanese exporters with yen which then enters the Japanese money supply.

In actual practice, the operation of currency markets often deviates from that represented in economic theory and in models. In particular, the long-term link between intervention and the foreign exchange rate is difficult to show empirically. While the intervention has short-term effects, the long-term effects on exchange rates and trade flows are much less apparent — especially considering that most of the time, the intervention leans against the wind rather than reversing the direction of change.

A second problem is that, in practice, Japan’s automakers and other exporters to U.S. markets usually do not make short-run adjustments to prices in response to exchange rate fluctuations. Unlike generic commodities (such as crude oil or wheat that have standardized commodity markets), Japan’s exports tend to be brand-named products for which the sellers have some control over prices. When selling in the United States, dealers and retailers of products from Japan tend to “price to market” or set prices according market conditions.22

For instance, between January 5, 1994, and April 19, 1995, the Japanese yen appreciated by 34% against the dollar (it rose from 113 to 80 yen per dollar). Prices for exported products from Japan to the United States should have risen significantly, but, for example, the U.S. sticker price of a Toyota Celica ST Coup rose by only 2% (it went from $16,968 to $17,285), while the suggested retail price of a large-screen Sony Trinitron television receiver actually fell by 15%. Japanese exporters simply absorbed exchange rate changes into their costs. They tended to gain or lose profits — rather than market share — because of exchange rate changes. In the case of Toyota Motors, it is estimated that the company’s profit increases by ¥25 billion ($227 million) a year for every ¥1 the currency depreciates against the dollar.23 For shipments to the United States, economic studies have found that, on average, an exchange rate change induces a price response equal to one-half the amount, although it varies by industry.24 An implication of this lack of a complete response of

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23 “Toyota Hits Year’s High on Robust Car Sales, Weak Yen.” Nikkei Weekly, August 22, 2005. p. 27.

domestic prices to exchange rate changes is that a currency depreciation will not necessarily eliminate — or even reduce significantly — a nation’s trade deficit.

Empirical studies indicate, however, that for most countries over the long run, a real depreciation (adjusting for domestic inflation) is likely to improve a nation’s current account balance while a real appreciation is likely to worsen it. In the short-run, however, the opposite is likely to occur. This is called the J-curve effect. As the value of the yen rises, for example, some Japanese exporters do increase their prices, and U.S. importers end up paying more for the quantity of goods they need. This worsens the balance of trade before U.S. importers can switch to other suppliers.25

Still, Japan’s balance of trade does respond somewhat in the long run to a large appreciation of the yen. Japanese exporters ultimately have to either raise prices or decrease costs of production, and importers of commodities in Japan face lower international prices. This works to reduce Japan’s surplus in trade (exports fall while imports rise).

One economic study indicated that, in 2002, a 1% appreciation of the yen induced a 2.2% decrease in Japan’s current account surplus (balance of trade with the world in goods and services plus unilateral transfers).26 At that time, Japan’s current account surplus was about $110 billion. Therefore, a 1% yen appreciation was estimated to decrease Japan’s current account balance by about $2.4 billion. Another study for 1985-1991 found that a 10% sustained appreciation of the yen would reduce Japan’s trade surplus by 0.7% of gross national product (GNP).27 At that time, Japan’s GNP was around $3,000 billion. A 1% appreciation of the yen, therefore, would have reduced Japan’s trade surplus by about $2.1 billion.

In actuality, from 2002 to 2004, the yen appreciated from ¥120 to ¥104 per dollar (up by 13%), but Japan’s current account surplus rose (not fell) from $113 billion to $172 billion (up by 52%).28 Part of this rise in Japan’s current account surplus may have been the J-curve effect, but in this case the yen appreciation was overshadowed by other variables. Yen appreciation may have slowed the rise in

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24 (...continued)
pp. 1244, 1270.

25 In order for a real depreciation to improve the current account, exports and imports must be sufficiently elastic respect to the real exchange rate. This condition holds for most industrialized countries for trade in manufactured goods in the long run but not in the short run. Krugman and Obstfeld, *International Economics*, pp. 450, 468.


28 Over the 2002-2004 period, differences in rates of inflation would have changed the real exchange rate and real current account balance somewhat.
Japan’s current account surplus, but it did not stop it. Other factors also came into play. These included growth in the American and other major markets, relative savings and inflation rates, the level of interest rates in various markets, earnings from investments, the competitiveness of Japanese products, the price of petroleum, competition from China, and intra-firm trade between home suppliers and overseas manufacturing subsidiaries.

Another question is whether Japan’s intervention into foreign exchange markets raised its rate of growth. Figure 2 shows Japan’s currency intervention in terms of annual rates of change in its foreign exchange reserves and the yen/dollar exchange rate. It also shows Japan’s economic growth rate (in real gross domestic product). The chart indicates that many of the periods of yen appreciation and intervention into foreign exchange markets to buy dollars also were periods of relatively slower — not faster — economic growth rates. Except in the late 1970s, Japan’s growth performance during periods of intervention was rather lackluster. Growth tended to be higher during periods without intervention, although it can be argued that the intervention may have helped to keep economic conditions from becoming worse than they actually were.

Figure 2. Changes in Japan’s Foreign Exchange Reserves and in the Yen/Dollar Exchange rate with Interventions and GDP Growth Rates, 1972-2006

Source: Underlying data from World Bank. World Development Indicators
Intervention or Manipulation?

A question for U.S. policy is whether Japan’s intervention into currency markets constituted manipulation of its exchange rate. Under U.S. law, 29 the Secretary of the Treasury is required to analyze the exchange rate policies of foreign countries annually (in consultation with the International Monetary Fund) and consider whether countries manipulate their exchange rate for purposes of preventing effective balance of payments adjustment or gaining unfair competitive advantage in international trade. If the Secretary considers that such manipulation is occurring with respect to countries that (1) have material global current account surpluses; and (2) have significant bilateral trade surpluses with the United States, the Secretary of the Treasury shall take action to initiate negotiations with such foreign countries on an expedited basis, in the International Monetary Fund or bilaterally, for the purpose of ensuring that such countries regularly and promptly adjust the rate of exchange between their currencies and the United States dollar to permit effective balance of payment adjustments and to eliminate the unfair advantage. The Secretary of the Treasury also is to provide reports on exchange rate policy that contain the results of exchange rate negotiations conducted pursuant to this law.

At various periods from 1988 through 1994, Treasury found that China, Taiwan, and South Korea were each considered to have manipulated their currencies. 30 In the March and November 2005 and May 2006 reports to Congress as required by the Omnibus Trade and Competitiveness Act of 1988, Treasury indicated that it had reviewed the exchange rates, external balances, foreign exchange reserve accumulation, macroeconomic trends, monetary and financial developments, state of institutional development, and financial and exchange restrictions for U.S. trading partners. In both reports, Treasury did not find currency manipulation by any country, including by Japan. 31 Likewise, in Treasury’s December 2006 report to Congress, the Secretary stated that persistent Japanese deflation since 1998 has led to a substantial depreciation of the yen in real terms. Bank of Japan data indicate that the yen was at its weakest level in real trade-weighted terms in more than 20 years, even though Japanese authorities had not intervened in the foreign exchange market since March 2004. 32


In April 2005, the Government Accountability Office examined Treasury’s assessments of whether countries were manipulating their currencies and concluded that “although China and Japan have engaged in economic activities that have led to concerns about currency manipulation,” Treasury “did not find that Japan met the Trade Act’s definition for currency manipulation in 2003 and 2004.” GAO reported that Treasury viewed “Japan’s exchange rate interventions as part of a macro-economic policy aimed at combating deflation...”33

In September 2005 testimony before the House Ways and Means Committee, Deputy Assistant Secretary of the Treasury David Loevinger stated that Treasury had discussed foreign exchange market issues with Japanese officials. He stated that Japan has supported the G-7 position on exchange rates, expressed in a series of G-7 Communiqués, calling for greater exchange rate flexibility. Japan also has worked with the United States to bring about greater exchange rate flexibility in China and in other large economies in East Asia.34

The International Monetary Fund also conducts surveillance over the exchange rates of its member countries. A 1977 decision by the Fund (as amended), a principle for guidance of member’s exchange rate policies states, “A member shall avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain unfair competitive advantage over other members.” The decision, does allow, however, for governments to intervene in the exchange market if necessary to counter disorderly conditions (disruptive short-term movements in the exchange value of its currency).35 In the IMF’s August 2005 report on consultations with Japan, the Fund did not find currency manipulation, but noted that compared to the United States and the Euro Area, Japan stands out for its active use of foreign exchange market intervention as a policy instrument.36

As a comparison, one can compare the movement of the exchange rate between the German mark and the dollar with that for the yen and the dollar. Figure 3 shows the movement of indexes (1972 = 100) for the value of the two exchange rates. From 1972 to 2005, the yen has appreciated more than the mark, and they generally have moved together. The correlation coefficient between the two indexes is 0.82 (they move together 82% of the time). This indicates that most of the time both currencies are responding to the same outside influences.


36 International Monetary Fund. IMF Country Report No. 05/273, Japan: 2005 Article IV Consultation — Staff Report; Staff Supplement; and Public Information Notice on the Executive Board Discussion. August 2005.
Policy Issues

Even though Japan claims that it has not intervened into currency markets since March 2004, this issue still is a U.S. policy concern because of Tokyo’s past intervention and the possibility that it could resume intervening should the yen strengthen too rapidly or excessively against the dollar. Japan also may use other methods to alter the expectations of currency traders and “talk down” the yen through various statements or other “jawboning.” Japan also could be caught up in the concern over China’s currency policy. Policies aimed at China also could affect Japan. Currently, Tokyo seems content to abstain from active intervention into international currency markets. At some point, however, Japan may want to decrease its $830 billion in foreign exchange holdings. It would likely do this by selling dollar-denominated assets, an action that would weaken the dollar and strengthen the yen. Depending on how this potential divestiture is conducted, it could be viewed as intervention into foreign exchange markets (albeit in the opposite direction of concern).

A question remains, however, of whether the United States should take measures to compensate for past intervention by Japan. Setting aside the issue of how much past intervention actually moved the exchange rate and whether any exchange rate change affected actual market transactions, if U.S. industries were significantly impacted negatively, should remedial action be taken now? If, for example, the U.S. automobile industry lost market share because of past Japanese government attempts to reduce the value of the yen, is there action that should be taken now to remedy the lost market share?

Figure 3. Indexes of the Value of the Japanese Yen and German Mark per U.S. Dollar

Note: 1972 = 100. Underlying exchange rates from PACIFIC Exchange Rate Service.
The major policy options for Congress\textsuperscript{37} include the following:

- let the market adjust (do nothing);
- clarify the definition of currency manipulation;
- require reports and negotiations;
- require the President to certify which countries are manipulating their currencies and take remedial action if the manipulation is not halted; and
- take the case to the World Trade Organization under the dispute settlement mechanism or appeal to the International Monetary Fund.

**Let the Market Adjust (Do Nothing)**

Most economists argue that currency markets are so large that only extensive and coordinated intervention has any lasting effects. Countries that do intervene often find themselves “leaning against the wind” and not materially altering either the direction of or the extent of change. Also, intervention is expensive. It is not clear that Japan could afford to invest another $800 billion in U.S. Treasury securities and other liquid dollar assets. Allowing market forces to determine exchange rates while permitting central banks to intervene only to counter abnormal market shifts is the policy pursued for most major currencies of the world.

In terms of foreign exchange intervention, Japan differs from China in two important respects. First, Japan does not peg its exchange rate to any basket of currency. It generally intervenes to slow down rates of change not to maintain a certain exchange rate. It also does not require citizens to sell foreign exchange to the central bank at an official rate of exchange. Second, Japan allows for free flows of capital into and out of the country. This makes currency manipulation much more difficult in Japan, since speculators and investors can offset official buying and selling of foreign financial assets.

A currency peg without capital controls is expensive and difficult to maintain during a financial crisis. During the 1997-1998 Asian financial crisis, for example, Hong Kong maintained its pegged exchange rate partly by raising domestic interest rates to attract foreign capital and to retard capital flight by local investors (to reduce the incentive to convert Hong Kong dollars to U.S. dollars in anticipation of a drop in the value of the Hong Kong dollar). On October 23, 1997, the overnight rate of interest in Hong Kong jumped from 6.25\% to 100.0\% as the monetary authorities tried to stem the capital outflow. Even though Hong Kong was able to maintain its exchange rate peg, the high interest rates caused a near collapse of real estate markets there. This is one reason China still maintains some capital controls.\textsuperscript{38} Since the Asian financial crisis, Japan and other Asian nations have negotiated currency swap


\textsuperscript{38} For financial data, see Global Financial Data at [http://www.globalfinancialdata.com].
agreements to provide short-term sources of foreign exchange in times of crisis.\textsuperscript{39} This obviates, somewhat, the need to rely on interest rates to attract foreign capital.

Under a policy of allowing market forces to determine exchange rates, some intervention still may be necessary to calm excessive volatility in markets or to counter trends that overshoot because of herd mentality and other effects. In the past, the more successful of such interventions were coordinated among the large, industrialized nations.

### Clarify the Definition of Currency Manipulation

A major provision of various currency bills in Congress has been to clarify the definition of currency manipulation. While this legislation apparently has been aimed primarily at China's currency policy, in cases, the bills also have cited Japan (and South Korea) in the findings.

Currently, the Department of the Treasury, in consultation with the International Monetary Fund, determines each year whether countries are manipulating their exchange rate for purposes of gaining an unfair trade advantage or preventing effective balance of payments adjustments and also have a material global current account surplus and a significant bilateral trade surplus with the United States.\textsuperscript{40}

In the 109\textsuperscript{th} Congress, H.R. 1498 defined exchange-rate manipulation as "protracted large-scale intervention by an authority to undervalue its currency in the exchange market that prevents effective balance-of-payments adjustment or that gains an unfair competitive advantage over any other country."

In determining whether exchange-rate manipulation is occurring, the administering authority is to consider the exporting country's:

- bilateral balance of trade surplus or deficit with the United States,
- balance of trade surplus or deficit with other trading partners,
- foreign direct investment in its territory,
- currency specific and aggregate amounts of foreign currency reserves, and
- mechanisms employed to maintain its currency at a fixed exchange rate and the nature, duration, and monetary expenditures of those mechanisms.

The bill also specified that trade data are to be those of the United States and other trading partners of the exporting country, unless such trade data are not available or

\begin{itemize}
  \item This is called the Chiang Mai Initiative. See Seok-Dong Wang and Lene Andersen. “Regional Financial Cooperation in East Asia: the Chiang Mai Initiative and Beyond,” *UNESCAP Bulletin on Asia-Pacific Perspectives* 2002/03, Chapter 8.
  \item Omnibus Trade and Competitiveness Act of 1988, 22 U.S.C. § 5304(b), § 3004(b). The global current account surplus is the current account surplus of merchandise, services, and transfers with all other countries, while the bilateral trade surplus is the surplus in goods and services trade with one trading partner country only.
\end{itemize}
are demonstrably inaccurate, in which case the exporting country’s trade data may be relied upon if shown to be sufficiently accurate and trustworthy.

S. 377 (109th Congress) defined currency manipulation in three parts to mean:

- large-scale manipulation of exchange rates by a nation in order to gain an unfair competitive advantage as stated in Article IV of the Articles of Agreement of the International Monetary Fund and related surveillance provisions,
- sustained, large-scale currency intervention in one direction, through mandatory foreign exchange sales at a nation’s central bank at a fixed exchange rate, or
- other mechanisms used to maintain a currency at a fixed exchange rate relative to another currency.

These bills would have provided further specificity to the definition of currency manipulation. The criteria identified are those that usually are examined when Treasury and the IMF determine whether or not a country is manipulating its exchange rate, but the bills focus the criteria on intervention, the type of foreign exchange regime (fixed rate), and the source of data.

Bills (such as S.Amdt.309 to S. 600, 109th Congress) would have focused the criteria for determining currency manipulation on the existence of large-scale intervention for the purpose of gaining an unfair advantage in international trade. Under IMF surveillance guidelines, such intervention is not necessarily considered to be manipulation, but it may trigger discussions between the IMF and the member country involved.

The bills also would have defined intervention in terms of government purchases of foreign exchange in order to support certain types of foreign exchange regimes, particularly fixed or pegged rates of exchange. Under IMF rules, a country is permitted to maintain a fixed (or pegged) exchange rate. Economies, such as Hong Kong and Malaysia, also peg their exchange rates. For the IMF, the currency regime, *per se*, is not the issue. The issue is whether the pegged rate fails to reflect market conditions and whether large-scale intervention is required to maintain it. In Japan’s case, it has intervened massively even though its exchange rate is floating.

As for the source of data when considering a country’s trade balance, S. 377 (109th Congress) would have required U.S. data to be used to determine the exporting country’s bilateral balance of trade with the United States. For the exporting country’s global current account deficit or surplus, however, the bill would have relied on U.S. and other partner country data first and the exporting country’s own data second.

The issue of which data to use applies primarily to China, mainly because of imports and exports that flow through, but do not originate in, Hong Kong and the

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41 International Monetary Fund. *Articles of Agreement, Article IV — Obligations Regarding Exchange Arrangements.*
general lack of confidence in China’s system for compiling statistics and reporting them. The data problem, however, also arises with Japan. In 2004 for Japan, Japanese data (as accessed through the IMF or Global Trade Atlas\textsuperscript{42}) reported a merchandise trade surplus of $110 billion (2.4% of GDP), but a compilation of partner country data (statistics from countries that export to and import from Japan) showed a surplus for that year of $208 billion (4.5% of GDP).\textsuperscript{43}

Each bill placed more emphasis on large-scale intervention by a country into currency markets — particularly when evidenced by large accumulations of foreign exchange. Such accumulations of dollars, do not constitute \textit{prima facie} evidence of currency manipulation, but they would be used along with other criteria to determine whether a country has been engaged in it.

The bills did not address the issue of sterilization in currency intervention.\textsuperscript{44} In 2003 and 2004, Treasury found that Japan did not meet the criteria for currency manipulation in part because its exchange rate interventions were considered to be part of a macroeconomic policy to combat deflation.\textsuperscript{45} (It was considered to be unsterilized intervention to increase the money supply.) A policy question is whether large-scale interventions are justified when part of macroeconomic policy even though they may have adverse affects on exchange markets.

**Require Negotiations and Reports**

Current trade law requires the President to seek to confer and negotiate with other countries to achieve:

- more appropriate and sustainable levels of trade and current account balances and exchange rates of the dollar and other currencies consistent with such balances; and

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{42} The Japanese government reports trade data in yen values. They convert those data into dollars when reporting them to the IMF. Global Trade Atlas is a propriety database of trade statistics.
\item \textsuperscript{43} Data from International Monetary Fund. \textit{Direction of Trade Statistics}. September 2005. For 2004, China reported a merchandise trade surplus of $32 billion, but the exports and imports of trading partners implied a trade surplus of $314 billion. The IMF notes that data reported by exporting and importing countries can be inconsistent because of differences in country of origin or destination classification concepts, lack of destination detail, time of recording, valuation, coverage, and processing errors.
\item \textsuperscript{44} Sterilized intervention refers, in the government of Japan’s case, to the buying of dollars (or other foreign exchange) from Japanese holders and using those dollars to buy dollar-denominated securities in the United States while simultaneously selling yen-denominated securities in Japan to keep the domestic money supply unchanged.
\end{itemize}
\end{footnotesize}
• improvement in the functioning of the exchange rate system to provide for long-term exchange rate stability consistent with more appropriate and sustainable current account balances.46

The United States and Japan also conduct regular cabinet and sub-cabinet meetings that provide a venue to discuss exchange rates. In addition, the two countries meet in G-7 summits and at the APEC (Asia Pacific economic cooperation) meetings where currency and exchange rate policy is discussed.47 In a 2000 G-7 meeting, for example, the communique stated that the group had discussed developments in exchange and financial markets and said that they welcomed the reaffirmation by the Japanese monetary authorities that exchange rate policies would be conducted appropriately in view of their potential impact and that they would continue to monitor developments in exchange markets and cooperate as appropriate.48

S. 1021 (110th Congress, Stabenow) would require Treasury to submit a semi-annual report to Congress on currency intervention by Japan to include any effort by Japan to create an exchange-rate misalignment (including intervention and statements by Japanese government officials). The bill also would require Treasury to submit to Congress a proposal for a comprehensive joint U.S.-European Union plan to address the exchange-rate misalignment of the Japanese yen. It also would require the U.S. government to initiate consultations with Japan for the purpose of decreasing the foreign currency holdings of the government of Japan.

Certify Currency Manipulation and Take Remedial Action

Several of the currency bills in the 109th Congress would have required the President to certify which countries are engaging in currency manipulation (defined in S. 295 (109th Congress) to be “acquiring foreign exchange reserves to prevent the appreciation of the rate of exchange between its currency and the U.S. dollar”) for purposes of gaining an unfair competitive advantage in international trade.49 This certification would then have triggered certain remedial actions under U.S. trade law.

Under current law, the Secretary of the Treasury (and International Monetary Fund) determines whether a country is manipulating its exchange rate. A presidential certification arguably raises the profile of the process and could require more detailed procedures on how the certification is made.

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49 The certification also can be that a country is not engaged in currency manipulation.
Appeal to the WTO or IMF

Some of the currency bills in the 109th Congress called for taking the currency manipulation case to the World Trade Organization through its dispute settlement mechanism or to the International Monetary Fund.

Currently, an agreement between the IMF and WTO requires the WTO to refer exchange rate disputes to the IMF and accept the IMF’s findings as conclusive. If the IMF finds currency manipulation, it is not clear how a WTO dispute settlement panel would rule. There is no precedent for a case in which currency manipulation is considered to have the effect of an export subsidy and allows for direct retaliation against the exports of the offending country.

Even though the IMF has not found that Japan was manipulating its currency during its Article IV consultations, the United States could inform the IMF that it believes Japan is not complying with the requirements of Article IV. This would trigger consultations with Tokyo and a report by the Managing Director to the IMF’s executive board.50 While the IMF still might not find Japan guilty of currency manipulation, it would put pressure on the Bank of Japan not to intervene in currency markets in the future.

50 For detail, see CRS Report RL33018, China’s Currency: U.S. Options, by Jonathan E. Sanford.
## Appendix

Table 1. Japan’s GDP Growth Rate, Yen/Dollar Exchange Rate, and Foreign Exchange Reserves, 1970-2006

<table>
<thead>
<tr>
<th>Year</th>
<th>GDP Growth Rate (%)</th>
<th>Exchange Rate</th>
<th>Foreign Exchange Reserves (US$)</th>
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<tr>
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<td>10.7</td>
<td>360.0</td>
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<td>4.7</td>
<td>350.7</td>
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<td>1972</td>
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<tr>
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<td>3.1</td>
<td>296.8</td>
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<td>4.0</td>
<td>296.6</td>
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<td>1977</td>
<td>4.4</td>
<td>268.5</td>
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<td>5.3</td>
<td>210.4</td>
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<td>2.8</td>
<td>226.7</td>
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<td>220.5</td>
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<td>2.8</td>
<td>249.1</td>
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<td>237.5</td>
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<tr>
<td>2001</td>
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<tr>
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<td>115.9</td>
<td>663,289,100,000</td>
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<tr>
<td>2004</td>
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<td>103.8</td>
<td>833,891,000,000</td>
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<tr>
<td>2005</td>
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<td>118.5</td>
<td>834,275,000,000</td>
</tr>
<tr>
<td>2006</td>
<td>2.2</td>
<td>116.3</td>
<td>874,596,000,000</td>
</tr>
</tbody>
</table>

**Source:** World Bank. World Development Indicators. Global Insight. Japan Ministry of Finance.

**Note:** The growth rate is the annual change in real gross domestic product. The exchange rate is yen per U.S. dollar, period average. Foreign exchange Reserves are official reserves excluding gold.