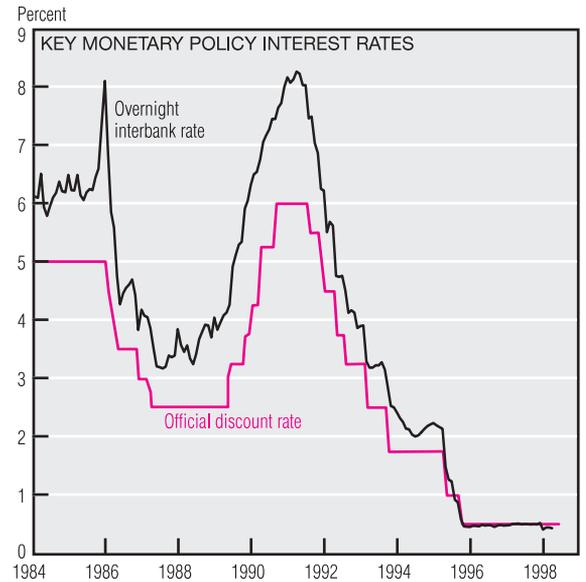
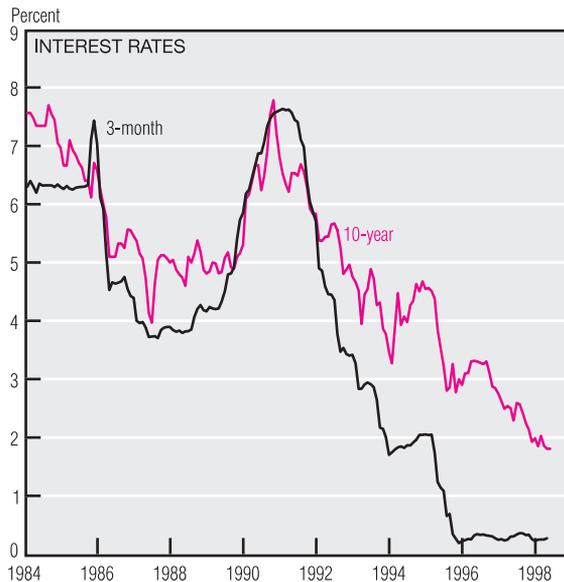
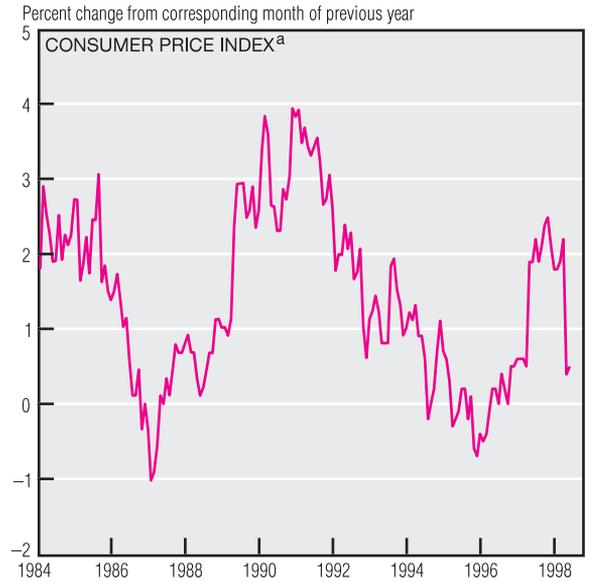
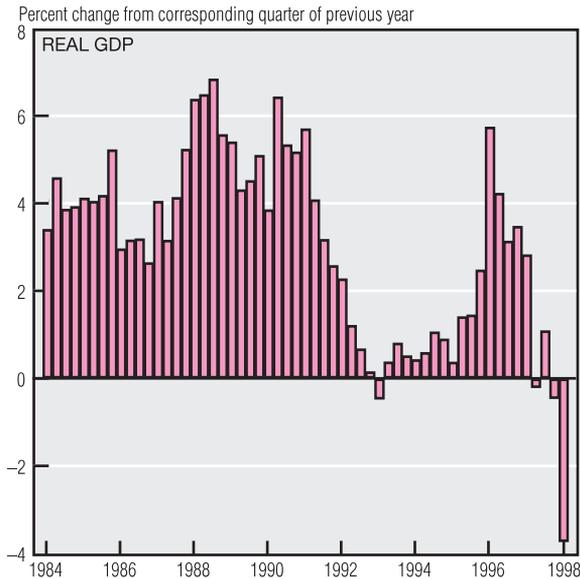


International Aspects of Japan's Business Cycle



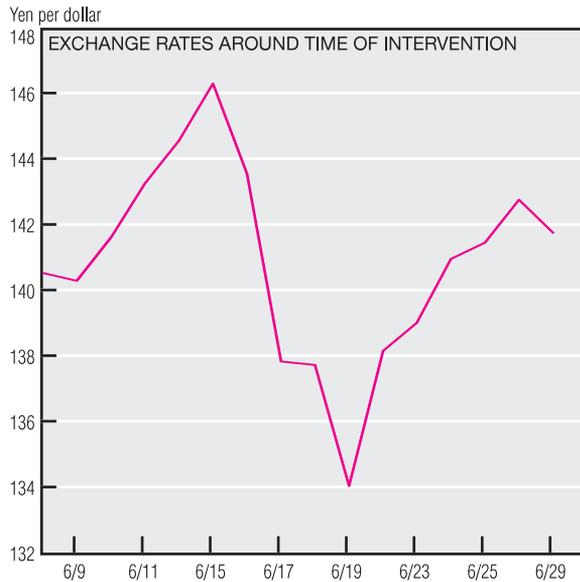
a. Sales taxes account for the year-over-year jump in prices between April 1997 and April 1998.
 SOURCES: Bank of Japan; Statistical Bureau of the Prime Minister (Japan); and DRI/McGraw-Hill.

Rocked by Southeast Asia's economic crisis, Japan sank deeper into recession during 1998:1Q. Some economists believe the country's modest inflation rate and corresponding low interest rates have actually hampered its recovery by eliminating a key channel through which monetary policy affects aggregate demand. Since it cannot force nominal interest rates below zero, an expansionary Japanese monetary policy might not affect consumption, investment, and savings decisions.

In these circumstances, fiscal initiatives coupled with monetary ease may be effective, but such policies raise important questions about prospective debt burdens and about the public's response to implied future taxes. The uncertainty surrounding these questions may explain Japan's reluctance to deploy a stronger fiscal stimulus. Alternatively, monetary policy might still affect aggregate demand through exchange rate channels, but this could raise the ire of Japan's trading partners, notably U.S. trade protectionists.

Independent of monetary policies, however, currencies often depreciate during economic downturns and appreciate during expansions. Since 1995, the yen has depreciated 59% in nominal terms and 66% in real terms against the dollar. When global business cycles are nonsynchronous, as in the 1990s, such countercyclical exchange rate movements can have moderating effects, especially for countries with close trade ties. The yen's real depreciation against the
(continued on next page)

International Aspects of Japan's Business Cycle (cont.)



U.S. Interventions against Japanese Yen, January 1985–March 1997

	Total number	Percent successes ^a	Percent virtual successes ^b	Forecast value ^c
Appreciation/depreciation				
Purchases	180	46	48	No
Sales	82	41	50	No
Change direction				
Purchases	180	28	24	No
Sales	82	29	25	No
Smooth movements				
Purchases	180	49	41	Yes
Sales	82	65	41	Yes

a. Days on which exchange rate movements corresponded to the criteria in column 1 and intervention occurred.
 b. Days on which exchange rate movements corresponded to the criteria in column 1 whether or not intervention occurred.
 c. Based on a statistical comparison of actual and virtual successes.
 SOURCES: Board of Governors of the Federal Reserve System; Federal Reserve Bank of New York; and Federal Reserve Bank of Cleveland.

dollar should expand Japanese exports and aggregate demand. Of course, lower exports will have the opposite effect in the U.S.

Considering the countercyclical benefits of a yen depreciation, the recent intervention may seem odd. On June 17, the U.S. and Japan bought a substantial number of yen in a concerted attempt to support the sagging currency. Most countries routinely neutralize the monetary implications of their interventions, so the yen purchase probably did

not shrink Japan's monetary base. Studies suggest that intervention does not alter the fundamental determinants of exchange rates, but sometimes may influence market perceptions and expectations of those fundamentals. It is possible that the U.S. and Japan intended the June 17 intervention as a signal that the yen's depreciation was too rapid or too large.

If monetary authorities routinely had better information than the market about underlying fundamentals, interventions would have posi-

tive value to traders as forecasts of future exchange rate movements. Between January 1985 and March 1997, U.S. intervention against the yen had positive value only as a forecast that a recent movement of the yen-dollar exchange rate would moderate. This country's purchases and sales of yen could not predict dollar depreciations or appreciations against the yen, nor could its intervention anticipate changes in the direction of the yen-dollar exchange rate.