The Japanese yen has strengthened significantly against the U.S. dollar since mid-May, reflecting improved growth prospects for the Japanese economy. However, the potential impact of a stronger yen on Japanese exports has caused concern. Official efforts to weaken the Japanese currency through foreign-exchange intervention (selling yen) have been mostly unsuccessful.

The U.S. has posted a current-account deficit, heavily financed by foreign investment, since 1992. In 1999:IIQ, this deficit reached a record level of $80.67 billion. Robust U.S. economic growth has been the main cause of foreigners' willingness to invest here. U.S. imports of goods increased 5% in 1999:IIQ, consistent with the view that the current-account deficit reflects the strength of domestic demand. This view is bolstered by our record July trade deficit of $25.2 billion, which represents an increase of 70% in the last year.

In contrast to the U.S., Japan has long been running a current-account surplus. Data for 1999:IIQ show this surplus at $28.4 billion, which is less than 1999:IQ. Japan's trade surplus was $6.9 billion in July, 5.8% less than in June. Private demand in Japan continues to be weak, fueling concern that the yen run-up, by harming Japanese exports, could sidetrack the country's economic recovery.

One possible reason why Japan has failed to reduce the international value of its currency is that its intervention is sterilized, so that there is no increase in the Japanese money supply. Much research has shown that such intervention is likely to have only a fleeting influence on exchange rates. By selling yen, the Japanese authorities try to convince the markets that a lower level for the yen is appropriate, but traders are more likely to evaluate the yen's
level in terms of the fundamental strength of the Japanese and U.S. economies. This reasoning implies that intervention will not succeed unless it conveys information about new Japanese policies.

One new policy, advocated by some, is an increase in the Japanese money supply. By some measures, U.S. and Japanese money growth have both been weak in 1999. Japanese authorities have expressed a hope that the U.S. or other countries will join the intervention effort, but U.S. sales of yen could only succeed in driving down the yen if the policy were supported by higher U.S. interest rates. Although increased U.S. economic strength might lead to higher interest rates and thus help bring down the yen, Japan’s monetary loosening cannot lower its interest rates much further. Rather, such a policy might seem to indicate official willingness to do more for the economy even at the expense of higher inflation.

One link between interest rates and the exchange rate is uncovered interest-rate parity. This condition implies that when the U.S. short-term interest rate exceeds its Japanese counterpart, the dollar is expected to depreciate against the yen. The yen’s appreciation is supported by capital flows into Japan, buoying the Nikkei stock index. Capital movements from the U.S. into Japan might raise the cost of financing the U.S. current-account deficit and weaken U.S. equity markets.

The difference between 10-year and 3-month interest rates can be viewed as an indicator of market expectations of future interest rates. Thus, the widening of this spread in both the U.S. and Japan since the beginning of the year indicates that interest rates are expected to rise in both countries.

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The money supply consists of M2 for the U.S. and M2 plus certificates of deposit for Japan.

SOURCES: Board of Governors of the Federal Reserve System; and DRI/McGraw-Hill.