Daiwa Securities

Daiwa's Economic View

Why is weak yen considered "bad"?

- Dual nature of Japan's economy arising from yen depreciation
- Corporate benefits from yen depreciation decreasing, but still remain
- Real reason for "bad" yen depreciation: Multifaceted effects brought about by rising resource costs, income distribution

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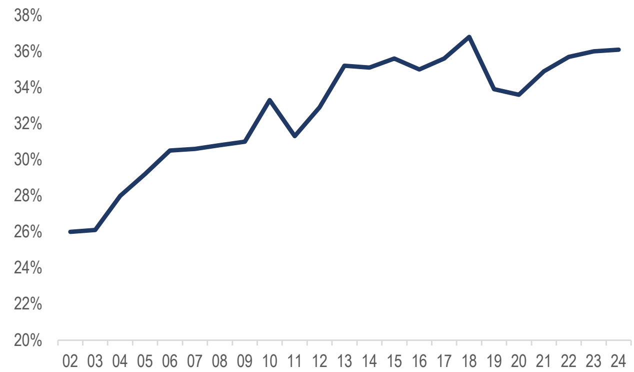
Dual nature of yen depreciation

Generally speaking, a weaker yen benefits Japanese exporters, while also boosting Japanese tourism and service industries by increasing inbound demand (foreigners visiting Japan). Meanwhile, rising prices for imported goods spread to essential items like energy and food, increasing household burdens due to higher corporate costs. As yen depreciation persists, the dual nature of Japan's economy creates a deep divide within Japanese society over how to best assess a weakening yen.

Corporate side: Diminishing weak yen benefits

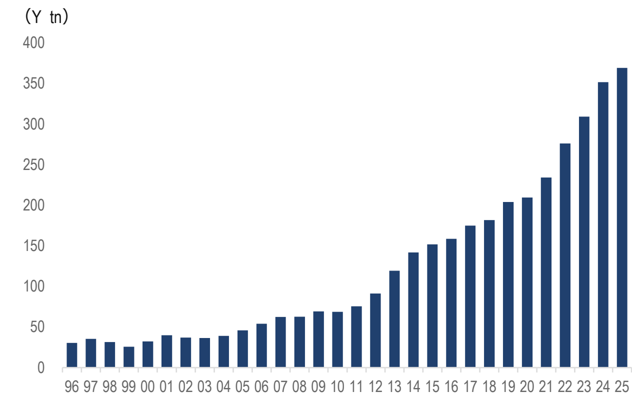
First, from a corporate perspective, the key focus is that the mechanism described as "currency depreciation → enhanced price competitiveness → increased export volume (including J-curve effect) → boost to domestic economy" has only achieved limited effectiveness in recent years, contrary to the traditional expectations. Background factors include transferring production bases overseas and the rise in the proportion of intra-company trade, driven by the long-term appreciation of the yen since the 1990s and the decline in international competitiveness triggered by the rise of emerging markets.

Overseas Production Ratio



Source: JBIC; compiled by Daiwa.

Balance of Outward Direct Investment



Source: BOJ; compiled by Daiwa.

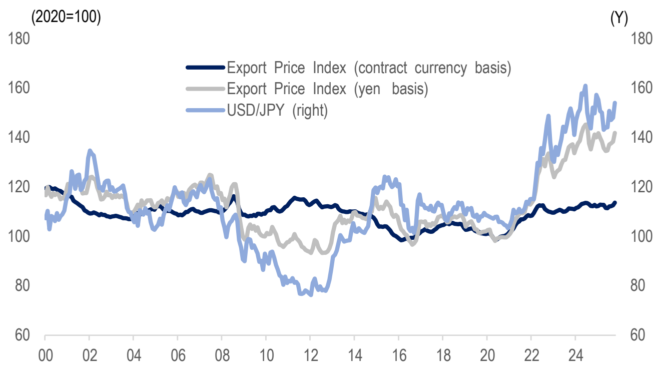
By shifting production bases overseas, supply chains centered on intra-company trade ratios tend to adopt the practice of fixing transaction prices in the counterparty's currency or in US dollars to prioritize internal control and stabilize foreign exchange risks in transactions between parent and subsidiary companies. Once such contractual practices become established, companies' selling prices become fixed on a contract currency basis. Even during periods of yen depreciation, there are many cases in which foreign currency-denominated prices are left unchanged. As a result, while exchange rate fluctuations boost sales and accounting profits on a yen-converted basis, they do not directly translate into improved competitiveness through export volumes.

Moreover, the decline in international competitiveness itself may have contributed to a situation where companies absorb foreign exchange risk domestically, leading to the selection of dollar-denominated export invoice currencies. As a result, the improvement in price competitiveness due to the weak yen is less likely to lead to an increase in export volume, yielding only the revenue-related effect of "fixed foreign currency pricing → increased sales in yen terms."

Furthermore, a significant portion of profits generated by overseas subsidiaries tends to be reinvested locally, resulting in a limited proportion being repatriated to Japan. The outstanding balance of foreign direct investment continues to increase, even now, confirming that corporate production networks and profit structures are becoming increasingly internationalized.

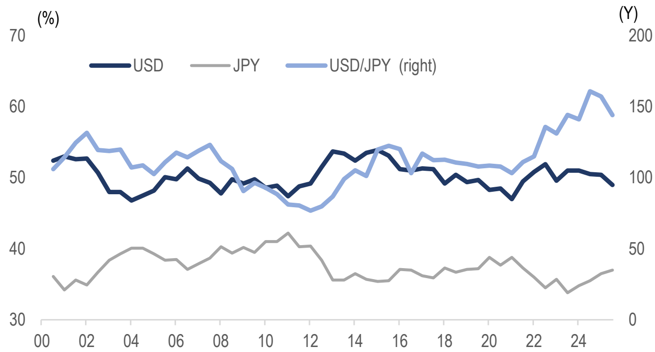
Given these structural changes, it can be said that the effect of a weaker yen boosting the domestic economy through increased export volumes has diminished. Also, the reduction in profits repatriated to Japan, due to relocation overseas, further weakens the extent to which the benefits of a weaker yen reach the domestic market. Under these circumstances, the economic stimulus effect of a weaker yen is not as significant as it was in the past. That said, as a result of corporate actions to maintain prices in foreign currency terms, the weak yen continues to boost corporate profits to a certain extent in the form of forex gains.

Export Prices, USD/JPY Rate



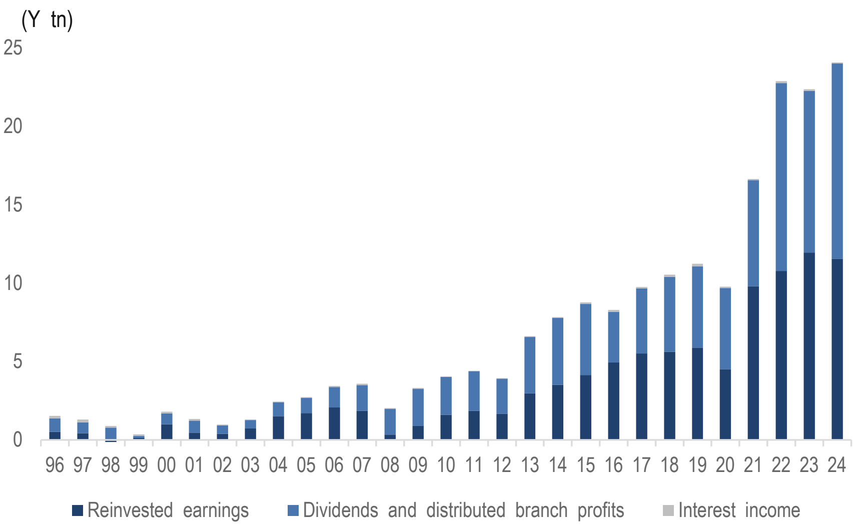
Source: BOJ, Bloomberg; compiled by Daiwa.

Ratio of Invoicing Currencies for Exports, USD/JPY Rate



Source: MOF, Bloomberg; compiled by Daiwa.

Breakdown of Direct Investment Income



Source: BOJ; compiled by Daiwa.

Household-side: Weak yen contributing to purchasing power decline, but primary causes are high resource costs, distribution issues

Within this situation, the background to yen depreciation being labeled as "bad" can be attributed to rising import prices pushing up overall prices, resulting in a decline in real wages, while placing a greater burden on household finances.

That said, from the household perspective, the primary factors behind the recent decline in real wages are multifaceted. Breaking down real wages from 2020 onwards into contributions shows that deteriorating terms of trade increasingly contributed to real wage declines starting in the latter half of 2021. Furthermore, since 2023, the decline in the labor share has been the primary factor driving down real wages.

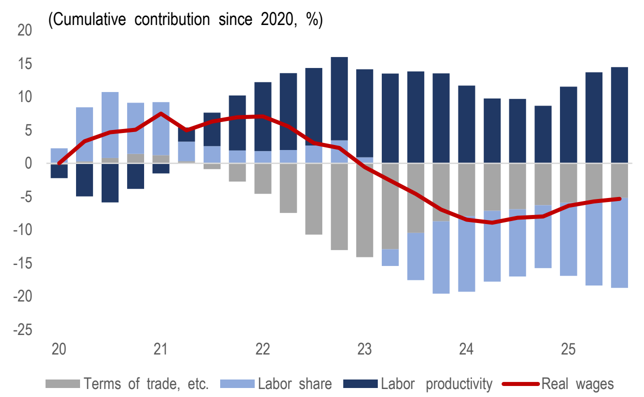
Here, "terms of trade" refers to an indicator showing the ratio of export prices to import prices. A deterioration in the terms of trade implies a relative increase in import prices. If terms of trade deteriorate, the amount of imported goods that can be purchased with the same amount of export revenue decreases. So, in effect, income is transferred overseas, thereby depressing domestic real income.

However, when breaking down the terms of trade by contribution, while exchange rate factors contribute downward pressure on the terms of trade, a greater contribution comes from import price factors, specifically, the global surge in resource and energy prices. In other words, while a weak yen is one important factor behind the decline in real wages, the primary causes are recognized to be (1) rising import prices due to high resource and energy costs and (2) decline in the corporate labor share.

That said, if the increase in import prices can be appropriately passed on to export prices, a deterioration in the terms of trade could theoretically be avoided. To mitigate the impact of rising import prices on household finances, the fundamental key lies in companies' international competitiveness and their ability to pass on higher costs to prices.

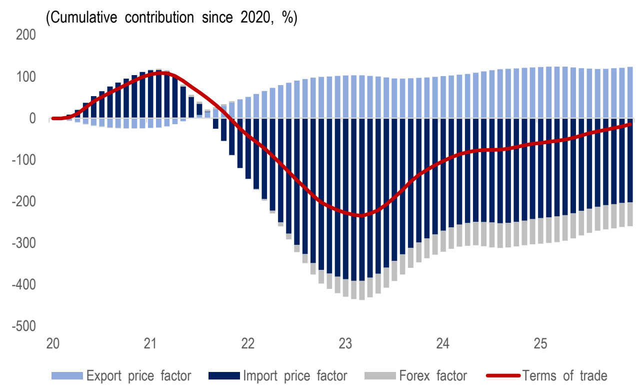
Of course, a weaker yen can worsen terms of trade by pushing up import prices, which in turn lowers households' real living standards. However, attributing the recent decline in household purchasing power solely to the weak yen is an overly simplistic view. We need to take into account the multifaceted effects of external shocks stemming from high resource/energy prices and income allocation issues on the part of companies.

Decomposition of Contribution to Real Wages (cumulative contribution)



Source: Cabinet Office, BOJ, Ministry of Internal Affairs and Communications (MIC), Ministry of Health, Labour and Welfare (MHLW); compiled by Daiwa.

Decomposition of Contribution to Terms of Trade (cumulative contribution)



Source: Cabinet Office, BOJ, MIC, MHLW; compiled by Daiwa.

How to approach yen depreciation?

The benefits of yen depreciation for Japanese companies are no longer as significant as before. Rising global resource prices and distribution imbalances, along with the weak yen, have resulted in widespread and severe increases for household living costs. This has created a situation where a weaker yen tends to be perceived as "bad."

Given this situation, the overall understanding held by Japanese society right now is not determined solely by the pros and cons of exchange rate movements. Over the long term, the extent to which companies can pass on external resource price increases to export prices (= their international competitiveness) and the issue of income distribution (= how much of resulting profits are allocated domestically) have significant impacts. Also, in order to spread the benefits of a weaker yen throughout society, reviewing production bases and supply chains, including the return of businesses to Japan, is also crucial.

Going forward, several structural reforms will be necessary to improve terms of trade and make the Japanese economy more resilient to forex fluctuations. First, it is essential to strengthen the international competitiveness of Japanese companies so that they can pass on rising import prices to export prices, while also creating high-value-added products and services. Second, it is essential to redesign income distribution approaches by redirecting profits toward wages, primarily involving foreign demand-oriented companies, thereby boosting household purchasing power and improving the performance of domestic demand-oriented companies.

Without these measures, if terms of trade deteriorate against the backdrop of yen depreciation and other factors, that would ultimately weigh on household purchasing power in the form of income outflows from Japan and imperfect income distribution. Ahead of the upcoming Lower House election, Prime Minister Sanae Takaichi stated during a campaign speech on 31 January that, "While a weak yen is often criticized these days, it presents a major opportunity for export industries." On 1 February, she then posted on *X* (former *Twitter)*, "We want to build an economic structure resilient to exchange rate fluctuations." However, first and foremost, the promotion of structural changes is crucial.

However, structural changes such as enhancing competitiveness and improving income distribution cannot be realized overnight. Building an economic structure that is truly resilient to exchange rate fluctuations will likely take a long time. At this juncture, the government must enact policies to curb excessive exchange rate fluctuations, thereby mitigating distribution imbalances, while ensuring sufficient time for businesses and households to adapt.

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