



By: Koichi Hamada

Japan should raise interest rates more aggressively



On a recent visit to Sapporo, the city on Japan's northern island where my parents came from, my wife and I found gentle people, mild autumn days, and excellent food.

As tourists who live and work in the United States, we also enjoyed very low prices: lunch at a high-quality restaurant cost only about \$20 per person.

While that was convenient for us, like so many other tourists who have headed to Japan to take advantage of favorable exchange rates, the cheap yen (yen yasu) has been hard on Japan's economy.

To understand the pressure Japan is under, it is worth looking at the purchasing-power-parity equilibrium exchange rate—the rate at which a representative basket of goods and services would cost the same across two countries.

This month, the OECD reports a PPP equilibrium exchange rate between Japan and the United States of around 93 yen per dollar.

That is a far cry from the actual yen-dollar exchange rate, which has been hovering in the **150–160 range**.

This means that goods produced in Japan cost much less than goods produced in the US.

As a result, Japanese exporters enjoy high demand and strong profit margins, but importers are under severe pressure.

The weak yen also hurts Japanese consumers, as it creates strong incentives to raise prices: With imported goods more expensive, domestic producers know that their output will find buyers, and importers might pass their mounting costs on to buyers.

Plaza Accord

Japan used to have the opposite problem. In the early 1980s, it was a dominant economy experiencing strong growth.

But the 1985 Plaza Accord, under which major economies agreed to take coordinated action to strengthen their currencies vis-à-vis the US dollar, **changed everything**.

After the accord was implemented, the PPP exchange rate was higher than the actual exchange rate, reaching almost double in 1995.

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The strong yen (yen daka) persisted for decades, contributing to chronic deflation and stagnant growth.

During this period, a visit to Tokyo strained tourists' pocketbooks, Japanese goods found few customers abroad, and Japan's once-formidable industries struggled.

The situation deteriorated further around the 2008 global economic crisis, when the US embraced monetary easing.

In the decades after the Plaza Accord, Bank of Japan (BOJ) governors (with the possible exception of Toshihiko Fukui) consistently failed to loosen monetary policy in line with changing economic conditions. Deflationary pressures intensified.

When circumstances change, policy must change too

After returning to power in 2012, Prime Minister Abe Shinzō sought to turn things around with an economic-reform package (I served as an adviser), which came to be known as Abenomics.

This package included a recommendation for monetary expansion, which then-BOJ Governor Haruhiko Kuroda embraced.

Now, conditions have changed. After the COVID-19 pandemic, the US experienced a surge in inflation, which forced the US Federal

Reserve to abandon monetary expansion and raise interest rates.

As the dollar strengthened, and the US-Japan interest-rate differential widened, the yen depreciated in value, and deflationary forces gave way to inflationary pressures.

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When circumstances change, so, too, must policy. For the BOJ today, this means pursuing monetary tightening in order to reduce the domestic money supply, and raising the interest rate.

To some extent, Japanese policymakers seem to recognize this. After keeping the short-term interest rate around **1% for some time**, the BOJ raised its **policy rate** to 1.25% last month.

This is high for Japan (the highest in 31 years, to be precise). But with the US short-term money market pushing the **interest rate** close to 4%, and more **US rate hikes** likely, it is not nearly enough.

Speculators continue to exploit the interest-rate differential via the so-called carry trade (borrowing cheaply in yen to invest in higher-yielding assets abroad).

Raising interest rates more aggressively

Under the gold standard or a fixed exchange rate, if a major country pursued monetary expansion, another, weaker country might need to reduce its money supply and raise its interest rate.



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Under a flexible exchange-rate regime, however, an expansion in one country should be met with a (moderate) expansion in another, just as tightening should be met with tightening.

We know that US Treasury Secretary Scott Bessent and Japanese Finance Minister Katayama Satsuki are communicating about fiscal and monetary matters.

Ultimately, however, monetary policy must be pursued autonomously, with BOJ Governor Kazuo Ueda doing what is best for Japan's economy.

Under the current circumstances, that means reducing the money supply and raising interest rates more aggressively.

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