is too specific to Japan, and the inability of the Japanese economy to reform and open up will keep the yen from wielding the same kind of influence as the dollar and the euro, even though the yen is one of the most widely traded currencies in the world. In fact, it is far more likely that the dollar will continue to be the benchmark in Asia insofar as Asian economies rely heavily on the U.S. market for a lot of their exports.

However, the real wild card in Asia is the Chinese yuan. The Chinese decided to delink the yuan-to-dollar peg in 2005 and widened the trading band in 2007. These adjustments have had very little impact, and many countries insist that China is still practicing currency manipulation. Further changes will probably have to be made to the currency to avoid a major trade war with Europe and the United States. But clearly China is moving forward in its efforts to establish the CNY as one of the major currencies in the world. The trend will continue to lead to greater flexibility in exchange-rate regimes, whether as managed floats or as freely floating currencies. Even countries that lock on to the dollar will float against every other currency in the world as the dollar floats. Capital controls will continue to fall, and currencies will move more freely from country to country. If the federal stimulus packages in the United States ignite long-term budget deficits and higher inflation, the dollar will come under even greater pressure in the global economy, and it could fall in value significantly. If it does, this could give impetus for a greater role of the Chinese yuan in the global economy and a diminishing importance of the U.S. dollar. ■

CASE

Welcome to the World of Sony—Unless the Yen Keeps Rising[53]

2008 was a pretty tough year for Sony, and 2009 didn't seem to be getting much better. The global economic crisis not only resulted in a huge drop in demand worldwide, it also roiled the foreign currency markets. By mid-2009 and the release of Sony's first-quarter 2009 financial results (Sony, like most Japanese companies, has a fiscal year that ends on March 31), the yen was trading at ¥94.7 per dollar, an increase in value against the dollar which was trading at ¥90.9 at the beginning of 2009, and ¥110.5583 on August 15, 2008, shortly before the crash of the global economy. The crazy currency swings had a devastating impact on Sony and all other major MNCs in Japan. What will the future bring?

The Past

Before attacking the future, let's look at the past—especially from the perspective of the Japanese yen. In the post–World War II years, the yen was extremely weak against the dollar, trading at ¥357.65 in 1970. That hardly seems possible with today's high rates (remember that the lower the USD/JPY exchange rate, the higher the value of the yen against the dollar). Sony, founded in 1946 as Tokyo Tsushin Kogyo Corporation, officially became known as Sony Corporation in 1958, the year its stock was first listed on the Tokyo Stock Exchange. It also became the first Japanese company to list American Depositary Receipts (ADRs) on the New York Stock Exchange in 1961 and finally listed its own shares on the NYSE in September 1970.

In those early years of operation, Sony had the luxury of operating in a currency that was not only weak against the dollar, but also highly controlled by the government. Japanese foreign-exchange policies favored companies and industries that the government wanted to succeed, especially in export markets. With a cheap yen, it was easy for companies to expand exports rapidly.

The First Endaka

From its 1970 high, the yen steadily strengthened until 1985, when it *really* shot up in value. Due to economic problems in the United States, the dollar began to fall during the latter part of

1985, and the yen ended at ¥200 per dollar by the end of 1985. By the latter part of 1986, the yen was trading at ¥150, a steep rise from its historical highs. The Japanese called this strengthening of the yen *endaka,* which literally translates "high yen." *Endaka* resulted in serious problems for Japanese exporters and potential pain for the entire Japanese economy, which was very dependent on international trade. However, one upside to *endaka* was that imports were cheaper, and Japan relied heavily on imports of virtually all commodities. Thus its input costs fell, even as it found its export prices rising.

The strong yen was due primarily to a strong Japanese economy, large trade surpluses, and the largest foreign-exchange reserves in the world. In addition, Japan had low unemployment, low interest rates, and low inflation. But cracks began to show in the Japanese economy. A combination of a drop in the stock market, a rise in inflation, and a real estate bubble hurt the Japanese economy and confidence in the yen. The governor of the Bank of Japan raised interest rates in December 1989, but the resulting furor forced him to stop raising rates. Since the interest rates in the United States were higher, investors pulled money out of Japan and put it into U.S. dollars to take advantage of higher returns. This drop in demand for yen and rise in demand for dollars pushed up the value of the dollar against the yen, and the yen closed out 1989 at ¥143.45, whereas it was ¥125.85 only a year earlier.

Both the United States and Japan were worried about inflation in the early 1990s, and they tried to coordinate exchange-rate policies, but the United States didn't want to push down the value of the dollar too much and lose its own fight against inflation. The United States and Japan tried to get the central banks of Germany, the United Kingdom, and other countries to intervene in the markets and sell their currencies for yen in order to strengthen the yen. But there wasn't much they could do to move the market given that interest rates were driving market psychology.

In the ensuing years, many factors influenced the yen/dollar exchange rate, including a weak U.S. economy (favoring a drop in interest rates), the Persian Gulf War (which favored the dollar as a safe-haven currency), a rise in Japanese interest rates relative to U.S. interest rates, and a lack of agreement among G8 countries in 1993 about whether the yen was too weak or about right.

A Second *Endaka*

As if one *endaka* were not enough, a second one hit in 1995, when the yen rose to ¥80.63 per dollar. Toyota announced that a one-point increase in the yen eliminated $111 million in dollar-denominated profits from their U.S. operations, and exporters were having a difficult time figuring out how to remain competitive in export markets. As they did with the first *endaka,* Japanese companies looked for ways to cut costs and remain competitive. During that period, the Japanese economy was in a recession, so the Bank of Japan dropped interest rates to stimulate demand, and the yen fell against the dollar, favoring exporters once again.

Competitive Pressures

During these decades of currency swings, Sony kept moving along as one of the premier companies in the world in consumer electronics, games, music, and movies. The wide array of product innovations earned Sony a premium in the market. However, competition began to step in. Korean companies, like Samsung and LG, began to produce cheaper products that rose in quality as each year went by. Samsung began to develop a reputation for innovation in electronics, which threatened Sony. In addition, Samsung and other competitors to Sony began setting up plants offshore, especially in China, to improve their cost advantage even more. Some of Sony's Japanese competitors, including Toshiba and Panasonic, responded by reducing their exposure to a strong yen by moving plants overseas, such as to Indonesia and the Philippines, and increasing the dollar-based imports of parts. By 2003, Toshiba was manufacturing 30 percent of its products outside Japan, compared with only 17 percent in 1995.

From the beginning of 2003 until the end of 2004, the dollar continued to weaken against both the euro and the yen. In an attempt to strengthen the dollar, the Japanese central bank spent a record 20 trillion yen in 2003 and 10 trillion yen in the first two months of 2004. Despite the efforts of the Japanese authorities, the yen rose 11 percent against the dollar in 2003 and continued to strengthen through 2004. The Japanese finance ministry stopped its foreign-exchange intervention in March 2004, but the dollar's continued weakening against both the euro and the yen at the end of 2004 sparked new threats of intervention by the Japanese and Europeans. A senior Japanese finance ministry official said, "It is natural for Japan and Europe to act when the dollar alone is falling. If the (dollar's) movement affects the European economy and the Japanese economy, we should defend ourselves."

Fast-Forward to 2008

The collapse in the housing market in the United States and the ensuing credit crisis that hit in 2007, followed by the bankruptcy of Lehman Brothers and the U.S. government takeover of global insurer AIG in September 2008, had a devastating impact on the global economy. The U.S. stock market crashed, followed by similar crashes around the world, and investors pulled funds out of risky emerging markets and placed them in safe-haven assets. Who were the major beneficiaries? The U.S. dollar and the Japanese yen! The euro dropped against both the dollar and the yen, and the Chinese yuan wasn't a factor because its currency is fixed against the dollar rather than flexible and subject to normal market forces. Although China is a good bet for foreign investment, the yuan is not an investment currency like the dollar and yen due to currency controls and lack of liquidity.

Why did this happen? In the case of the U.S. dollar, the market reaction was a standard flight to safety, which often happens when global events get scary, even when the U.S. markets started the collapse. The size of the U.S. economy and political stability, even in the face of a presidential election in November 2008, tend to make the United States an attractive place for investment. Thus the fear factor seemed to be a critical vote for the dollar during the crisis. This is a short-term phenomenon, however, and will eventually be replaced by economic fundamentals. With the slowdown in the U.S. economy, export-dominated countries, especially emerging markets, were expected to suffer. Also, the credit crisis that the United States was going through was expected to expand to other countries. The euro is obviously a strong and important currency, but it lacks a strong central government that can coordinate a response to economic crisis. The European Central Bank can influence interest rates, but that's about all. Another thing that came out of the crisis is that the euro tends to be very sensitive to the U.S. stock market. When the market was falling, so was the euro. When the market began to recover, so did the euro. Thus the dollar has been up and down depending on what news was most important. When the crisis was the news, the dollar was strong. When the news favored a recovery of the U.S. economy, money flowed into equity markets, both in the United States and abroad, seeking for higher returns and causing the dollar to drop in value.

What about the yen? Interestingly enough, the yen also became a safe-haven currency during the crisis, along with the dollar. Obviously, the yen is the most important currency in Asia, because Japan has the second-highest foreign-exchange reserves in the region and the world, just after China, but it is a freely convertible currency with high market liquidity and is also an important trading currency. Also, with Japanese interest rates so low, many investors were borrowing in yen and investing their proceeds abroad to get access to higher returns. When the crisis hit, the money quickly left the emerging markets and returned to Japan, a practice called *carry trade.* Whenever volatility in currency markets goes up, investors unwind (reverse) their trades, which gave strength to the yen.

The markets also demonstrated that the yen and U.S. stock market were inversely related. When markets are less risk-averse, stocks gain in value and the yen drops in value. When markets are more risk-averse, stock prices fall, and the yen trades higher. To illustrate that point, in July 2009 when the stock market started to climb, the yen fell against the dollar, although the fall was not dramatic or large.

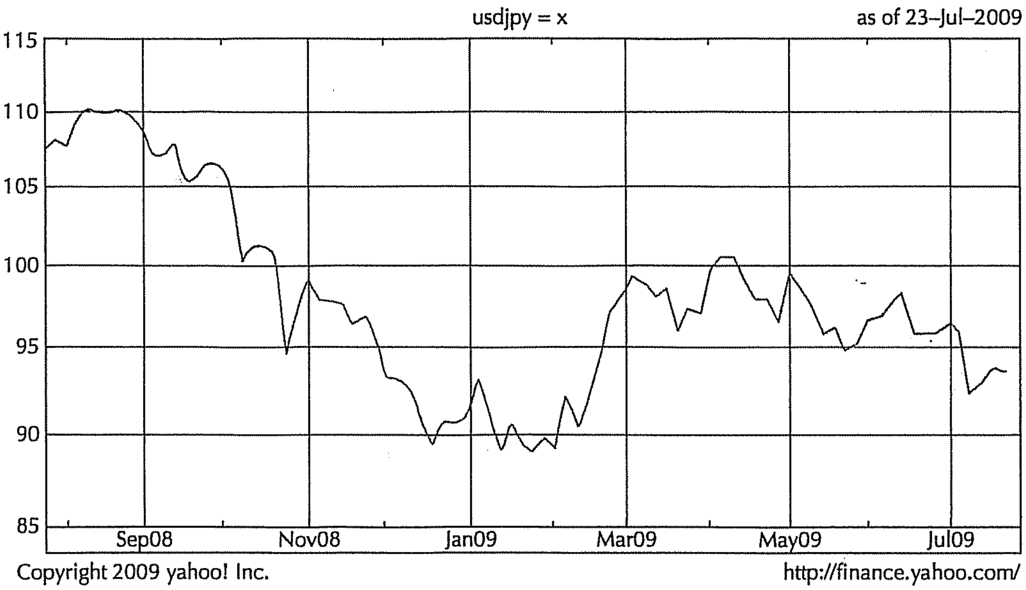

FIGURE 10.4 USD/JPY (number of yen per dollar), year ended July 23, 2009

This illustrates how the yen steadily strengthened against the dollar during the initial phases of the global financial crisis, the only major currency in the world to do so. However, it briefly weakened early in 2009 and then floated back and forth, creating problems for Sony and other large Japanese MNCs.

What Does All This Mean to Sony?

In 2008, Sony generated 23.2 percent of its sales in Japan, 25.1 percent in the United States, 26.2 percent in Europe, and 25.5 percent elsewhere. Thus Sony was well diversified geographically, operating in some countries where the local currency was weaker and others where the local currency was stronger than the yen. Sony was also targeting the BRIC countries for future growth.

According to Sony's 2008 annual report, in addition to targeting global markets for sales, Sony was taking advantage of production outside of Japan. In the electronics division, about 50 percent of its FY production was in Japan, and the rest was spread out elsewhere. About 60 percent of its Japanese production was destined for other regions. China accounted for about 15 percent of total annual production, of which 70 percent was for export markets. The rest of Asia accounted for 10 percent of total annual production, with approximately 60 percent destined for Japan, the United States and Europe. The Americas and Europe accounted for the balance of about 25 percent of total production, most of which was for local markets.

One major effect of the strong yen and the global slowdown was the sharp drop in exports from Japan. In January 2009, for example, exports dropped 49 percent compared with January 2008. As exporters found their sales falling, they cut orders from their suppliers, so there was a ripple effect in the Japanese economy, affecting both production and employment. These events caused a sharp contraction in the Japanese economy as GDP fell 12.1 percent in the fourth quarter of 2008 compared with the fourth quarter of 2007, and many experts felt that Japan was going through its worst recession since World War II. Deflation was also affecting the Japanese economy again, and consumers were delaying purchases hoping that prices would continue to fall, and companies were hesitant to invest more.

The strong yen was also hurting Sony's financial statements. As Sony translates U.S. dollar or euro financial statements into yen, net assets and earnings will be worth less in yen, dragging down Sony's consolidated results. The only way to offset this drop is to sell more and improve profit margins, both of which are hard to do in a slow global economy. From a cash-flow point of view, Sony's operations abroad are remitting dividends back to Japan, but they are worth less yen as the dollar and euro weaken against the yen. One silver lining is that the purchasing power of the yen rises as it strengthens compared with other currencies, so everything it imports into Japan for its manufacturing is cheaper. The same would be true for anything manufactured outside of Japan, thus reducing costs and hopefully increasing margins. As long as Sony is invoicing its exports in dollars to customers worldwide, it needs to match the dollar revenues with dollar expenses through investing more in the United States or in other countries in Asia, like Taiwan, where components such as flat panel displays are cheaper and where Sony can invoice its purchases in dollars.

One big challenge Sony faces is its competition from other Asian companies such as Samsung. Sony has to carefully watch the value of the yen against the Korean won to see what its competitive position is. If the yen rises against the won and other Asian currencies, Sony risks losing market share to other Asian companies because it will not be price competitive. This is forcing Sony to move offshore faster and localize production in other markets it hopes to penetrate. Sony has a lot of strengths, but it also has a lot of challenges that it will have to resolve in the future. ■

QUESTIONS

1. Why did the contraction of the U.S. and Japanese economies and the rise in the value of the yen hurt Sony's exports from Japan?
2. In what other ways has the strong yen affected Sony's bottom line? What would be the effect of a weak yen?
3. Given the instability in the currency markets, why do you think it is important for Sony to manufacture more products in the United States and Europe and to also buy more from suppliers in other countries in Asia?
4. What are the major forces that affected the Japanese yen prior to the global financial crisis in the fourth quarter of 2008? What has had the greatest impact on the yen since then, and where do you forecast the future value of the yen?

SUMMARY

- The International Monetary Fund (IMF) was organized in 1945 to promote international monetary cooperation, to facilitate the expansion and balanced growth of international trade, to promote exchange-rate stability, to establish a multilateral system of payments, and to make its resources available to its members who are experiencing balance-of-payments difficulties.
- The special drawing right (SDR) is a special asset the IMF created to increase international reserves.
- The IMF started out with fixed exchange rates but now allows countries to choose how fixed or flexible they want their exchange rates to be.
- The euro is a common currency in Europe that has been adopted by 12 of the first 15 members of the EU, and was adopted by 16 total countries by the end of 2009, with other new EU members working to meet the convergence criteria.
- The Chinese yuan is poised to be one of the most influential currencies in the world as it strengthens its institutions and the regulatory structure and trading capacity of its banks and other financial institutions.
- African countries are committed to establishing a common currency by 2021, but many obstacles may prevent them from accomplishing this objective.
- Currencies that float freely respond to supply and demand conditions free from government intervention. The demand for a country's currency is a function of the demand for its goods and services and the demand for financial assets denominated in its currency.
- Fixed exchange rates do not automatically change in value due to supply and demand conditions but are regulated by their central banks.
- Central banks are the key institutions in countries that intervene in foreign-exchange markets to influence currency values.
- The Bank for International Settlements (BIS) in Switzerland acts as a central banker's bank. It facilitates communication and transactions among the world's central banks.
- A central bank intervenes in money markets by increasing a supply of its country's currency when it wants to push down the value of the currency and by stimulating demand for the currency when it wants the currency's value to rise.
- Many countries that strictly control and regulate the convertibility of their currencies have a black market that maintains an exchange rate more indicative of supply and demand than the official rate.
- Fully convertible currencies, often called *hard currencies*, are those that the government allows both residents and nonresidents to purchase in unlimited amounts.
- Currencies that are not fully convertible are often called *soft currencies* or *weak currencies*. They tend to be the currencies of developing countries.