

The Causes and Impacts of the Depreciation of the Japanese Yen

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Abstract: This paper analyzes the causes of the yen's depreciation since the COVID-19 pandemic and examines its potential impacts on both the Japanese domestic economy and the international landscape. In the post-pandemic era, global productivity has significantly declined, leading to rising prices and ushering in an era of low growth, high inflation, and elevated interest rates. This has presented unprecedented challenges to the development of national economies. The paper first highlights Japan's critical economic position in the post-pandemic context and then analyzes the causes of the yen's depreciation from three perspectives: the divergence in U.S. and Japanese monetary policies, global economic conditions, and Japan's domestic economic environment. Finally, the paper discusses the effects of the yen's depreciation, noting that while it has contributed to an increase in net exports and an improvement in deflationary pressures, the persistent rise in domestic living costs, driven by higher commodity prices, remains a central challenge to Japan's long-term economic growth. In conclusion, the depreciation of the yen amid global financial volatility highlights the intricate interplay between domestic economic policies and international financial markets. Japan's experience underscores the complexities faced by advanced economies in a highly interconnected global economy, where shifts in major currencies and monetary policies can have far-reaching implications for economic stability and growth.

Keywords: Yen's depreciation, Japan economy, economics, international economy.

1. Introduction

According to data from the International Monetary Fund in 2023, Japan's GDP has dropped from the third to the fourth largest in the world. This decline reflects the economic challenges Japan faces, particularly the impact of prolonged economic stagnation. Despite the slowdown in Japan's economic growth, its per capita GDP in 2023 remained at \$34,000. By the World Bank's classification, Japan still qualifies as a high-income country. As a major developed nation and the world's third-largest economy, Japan maintains a stable business environment, a vast consumer market, and robust global competitiveness, holding a significant position in the international economy.

Due to Japan's long-standing outward-oriented economic development model, foreign trade constitutes a large proportion of its total trade volume. In 2023, Japan's import and export volume reached \$16 billion, a year-on-year increase of 7.9%. As a member of the World Trade Organization and the Organization(WTO)for Economic Cooperation and Development(OECD), Japan has signed multiple free trade agreements and maintains strong economic cooperation with countries such as

China and the United States. Bilateral trade between China and Japan reached \$3,000 in 2023, with particularly close exchanges in the electronics, electrical machinery, and semiconductor industries. This indicates that the Japanese yen, as an important international currency, plays a significant role in global trade and transactions, generating substantial foreign exchange.

Entering the third quarter of 2024, global financial market volatility has intensified. As the world's primary reserve currency, fluctuations in the U.S. dollar exchange rate profoundly affect the global economy. Adjustments to U.S. Federal Reserve monetary policy, geopolitical risks, and differences in key monetary policies all influence the rise and fall of the dollar index. In response to the uncertainty surrounding the Federal Reserve's policy and the instability of the dollar index, the Bank of Japan announced in April of this year that it would maintain its current monetary policy, keeping the policy rate target between 0-0.1%. Consequently, the yen continued to depreciate, allowing Japanese products to be sold overseas at lower prices, thereby enhancing the international competitiveness of Japanese goods. At the same time, fluctuations in the dollar exchange rate have had some negative effects on the export demand of East Asian countries, which has also impacted exports. Globally, exchange rate fluctuations may lead to an increase in global debt, making the economic environment more unstable and affecting global supply chains and international trade patterns. For Japan, a country reliant on foreign trade, exchange rate fluctuations are detrimental to its stable and long-term economic development.

The Federal Reserve's continued interest rate hikes have driven the dollar index upward, altering global capital flows and causing significant depreciation of other currencies, including the yen. This article, set against this backdrop, will explore the causes and effects of yen depreciation.

2. Causes of Yen Depreciation

2.1. Differences in U.S. and Japanese Monetary Policies

Since 2020, in response to the pandemic, countries have implemented loose quantitative policies. Labor force shortages, reduced production output, and declines in actual household income have led to decreased consumption of non-essential goods, while attention to essential goods has increased. This shift in demand has caused a surge in demand for certain essentials, such as food and energy, while supply shortages have triggered a series of inflationary issues.

By 2022, the actual inflation level in the United States had far exceeded its benchmark, with the Consumer Price Index (CPI) reaching 9.1% in June, and consecutive months of CPI above 8%, breaking a nearly 40-year record [1]. The continuously rising inflation levels have lowered the standard of living for American residents, widened the wealth gap, intensified social conflicts, and sharply decreased U.S. debt. To control inflation, the U.S. has resorted to interest rate hikes to reduce the money supply. Additionally, the war has driven up the prices of commodities, with U.S. West Texas Intermediate (WTI) crude oil prices reaching a nearly ten-year high of \$123.7 in 2022, and a year-on-year increase of 9.91% in 2024 compared to 2023. The rise in commodity prices has directly exacerbated currency depreciation, necessitating Federal Reserve interest rate hikes to boost the dollar index and ensure the dollar's competitiveness in the international market.

In contrast to the U.S., Japan, to overcome persistent deflation since the 2008 global financial crisis and achieve its 2% inflation target, introduced "Abenomics," centered around three "arrows": qualitative and quantitative easing of monetary policy, flexible fiscal policy, and structural reforms to promote economic growth. Through these comprehensive measures, Abenomics aimed to stimulate economic growth [2], raise price levels, and overcome prolonged deflation. In April 2013, the Bank of Japan (BoJ) introduced Quantitative and Qualitative Monetary Easing (QQE), announcing large-scale purchases of Japanese government bonds (JGBs) and other assets, including Japanese stocks (ETFs). The BoJ also extended the maturity of JGB purchases [3]. In January 2016, it introduced

negative interest rates, applying a negative interest rate to excess reserves held by commercial banks at the central bank. Generally, banks earn interest when depositing reserves at the central bank, but under negative interest rates, they incur fees, encouraging banks to actively expand lending to businesses. The divergence in U.S. and Japanese monetary policies has made the trend of yen depreciation difficult to reverse.

2.2. Global Economic Conditions

According to the World Bank's Global Economic Prospects for 2024, while the near-term outlook for the global economy has improved, it remains weak by historical standards, with nearly 60% of economies expected to grow below the average rate of 2010. Given persistent inflationary pressures, central banks worldwide remain cautious about easing monetary policies, and global economic growth is expected to be nearly half a percentage point lower than the average level of 2010-2019. Downside risks dominate the global economic outlook, including geopolitical tensions, prolonged high interest rates, and climate-related disasters.

In an environment of rising global interest rates, global credit conditions are tightening, with many developing economies facing debt crises, and financial pressures in developed economies potentially leading to broader spillover effects [4]. The continued rise in interest rates poses adverse financial consequences for Japan, even raising the risk of a financial crisis. Japan's domestic economy, struggling to recover, is unable to withstand the pressure, and the yen's depreciation shows no signs of improvement.

At the same time, geopolitical conflicts have also had a significant impact on economic development. Although the global economy is far better equipped to handle major oil price shocks than in the 1970s, the ongoing conflict in the Middle East and the disruption caused by Russia's invasion of Ukraine have led to surges in global energy commodity prices. Higher energy prices reduce real incomes, raise production costs, tighten financial conditions, and severely limit the policy space of energy-importing countries. In Japan's case, following the outbreak of the Russia-Ukraine conflict, Japan's clear anti-Russia stance led to strict controls on trade with Russia, resulting in a complete halt to imports from Russia. Many companies had to seek alternative supply channels, leading to price fluctuations, particularly in domestic oil prices, which have continued to rise. The government's subsidy burden has increased significantly, and electricity supply issues have followed [5]. As an outward-oriented economy highly sensitive to fluctuations in the international financial environment, Japan has struggled to cope with rapid changes in external conditions, and its domestic economy continues to face pressure. Moreover, frequent natural disasters related to global warming have exacerbated global economic instability, offering no favorable external conditions for the recovery of the yen.

Against the backdrop of a global economic downturn, creating a favorable environment for development is difficult, significantly increasing the challenges of capital circulation and import-export trade. Japan's economic weakness persists, and the yen's situation has not improved.

2.3. Japan's Domestic Economic Conditions

Japan's economy has somewhat recovered, but overall, the recovery remains weak. The external environment of Japan's economy has deteriorated due to the global economic slowdown and the impact of the COVID-19 pandemic. The international commodity market has seen price surges due to the Ukraine crisis, leading to increases in energy and food prices. The combination of yen depreciation and imported inflation has continuously shrunk Japan's trade surplus, sharply expanding its trade deficit, with the current account surplus falling to historic lows. Additionally, personal consumption accounts for a significant portion of Japan's GDP and is a crucial driver of Japan's

economic growth. However, the shock of the COVID-19 pandemic severely disrupted social activities, causing a significant drop in demand. Consequently, personal consumption has been greatly affected, resulting in notable fluctuations and contributing to the instability of Japan's economic environment, further exacerbating the trend of yen depreciation [6].

3. Impact of Yen Depreciation

3.1. Domestic Economic Impact

The Federal Reserve's interest rate hike policy and Japan's active monetary easing policy have caused the yen to continuously depreciate against the U.S. dollar, widening the interest rate differential. This exchange rate trend has had a significant impact on Japan's economy: while the depreciation of the yen has boosted Japan's export competitiveness, benefiting export-oriented companies, it has simultaneously increased import costs for businesses and consumers, negatively affecting imports. As the yen depreciates, Japanese export products become noticeably cheaper, thereby enhancing the competitiveness of export companies, such as those in the automotive, electrical machinery, and inbound tourism industries, which have all seen significant gains, making substantial contributions to Japan's exports. According to World Bank data over the past five years, Japan's export volume of goods and services, despite a decline in 2020 due to the pandemic, quickly rebounded afterward, rising from -11.6% to 11.9% within a year.

Conversely, the prices of imported goods have increased. According to World Bank import price data, Japan's import prices have surged since the yen began depreciating in 2021, rising from 86.3 points to 189 points within a year. Due to its small land area and poor resource endowment, Japan heavily relies on imported raw materials and energy, making it highly sensitive to global price and exchange rate fluctuations. As import prices increase, this is quickly reflected in the rising costs of domestic goods and services. The consumer price index (CPI) for all items, excluding fresh food and energy, has remained positive over the past three years, indicating that rising import costs are being passed on to consumers. Japan's CPI has been rising since 2021, highlighting that the increased import costs are significantly burdening Japanese consumers' living expenses while also driving up production costs for Japanese companies, thereby shrinking their profits.

In the energy sector, the aforementioned factors have driven up the prices of commodities such as crude oil and natural gas. Since Japan relies on imports to meet its domestic energy needs, this results in manufacturers continually raising the prices of finished products to protect their margins, effectively passing on the higher costs to consumers. Rising crude oil prices increase the raw material costs for industries such as chemicals and textiles, affecting many downstream sectors. Over time, price increases gradually transmit from upstream to downstream, impacting various aspects of daily life. For example, in agricultural production, rising oil prices drive up the cost of fertilizers, leading to higher food production costs and ultimately pushing up agricultural product prices, which in turn affects food prices. Faced with higher prices for essentials such as food, people are forced to allocate a larger portion of their budget to these necessities, spending more on the same products, which reduces their savings. This decline in the savings rate could potentially lead to higher inflation rates but may also, to some extent, help Japan escape the shadow of deflation.

3.2. International Economic Impact

As one of the reserve currencies, the yen significantly influences international investment, trade, and debt. Firstly, yen depreciation lowers Japan's production costs, significantly reducing Japanese companies' incentives to relocate facilities abroad to cut costs, thereby reducing Japan's outward direct investment. This decrease affects the financing of companies in other regions, hindering economic vitality [7]. Secondly, yen depreciation lowers the dollar prices of Japanese export products,

making them more competitive internationally, which could impact the East Asian export market. Since yen depreciation lowers the costs of importing products from Japan for other countries, capital tends to flow towards Japan, with many East Asian countries increasing their profits by importing lower-cost semi-finished products, which, in turn, boosts East Asian economic development [7]. Lastly, yen depreciation eases the debt repayment burden for other East Asian countries that use the U.S. dollar as a benchmark, positively affecting East Asian economic growth [7].

However, yen depreciation can also trigger competition between currencies, leading to financial market volatility. For example, China, as the hub of the East Asian supply chain, has an industrial structure similar to Japan's. The yen's depreciation inevitably affects the competitiveness of China's export products, prompting the Chinese yuan to depreciate as well to maintain trade balance. Similarly, the South Korean won, already impacted by the Federal Reserve's continuous interest rate hikes, faces homogeneous competition with East Asian countries, especially in sectors like steel, machinery, and semiconductors, forcing it to continuously depreciate to enhance the international competitiveness of its products [8].

4. Conclusion

In conclusion, the post-pandemic era has seen the global economy struggling with inflation, leading central banks worldwide, particularly the U.S., to accelerate interest rate hikes and pursue continued tight monetary policies. However, Japan remains deeply affected by deflation. Since the introduction of Abenomics, quantitative and qualitative monetary easing under negative interest rates has been vigorously implemented, effectively boosting corporate profits and addressing economic stagnation by raising potential inflation. Concurrently, the global economic downturn has also exerted significant pressure on Japan's domestic economic recovery. Supply chain disruptions caused by the pandemic, along with the energy and food crises resulting from the Russia-Ukraine conflict, have led to volatile inflation levels, significantly raising Japan's living costs, making the yen's continuous depreciation an inevitable outcome.

Yen depreciation has had a substantial impact both domestically and internationally. The competitiveness of export companies has significantly increased, showing signs of recovery. On the other hand, the prices of imported goods have risen, with energy and food prices remaining high, affecting Japanese consumer behavior. High living costs are forcing Japanese citizens to reduce savings, opting instead to increase consumption or borrowing to meet daily expenses. This behavior may, at the macroeconomic level, indirectly drive-up overall demand, helping to raise price levels and potentially leading to higher inflation rates, which could help Japan escape deflation. Internationally, as an important reserve currency, the yen's depreciation has profoundly influenced the direction of global capital flows. With the lower dollar prices of Japanese goods gaining favor in international markets, many East Asian countries are willing to import lower-cost semi-finished products to increase their profits, leading to capital concentration in Japan and stimulating East Asia's economy. Moreover, yen depreciation has also spurred currency competition, as Japan, a key East Asian economy, has prompted the depreciation of other major East Asian currencies to ensure the competitiveness of their export companies and markets, though this has also triggered significant economic volatility.

Overall, Japan, as a highly export-oriented economy, is extremely sensitive to fluctuations in the international market and financial environment, quickly capturing and responding to these changes. The significant import dependency within its economic structure means that the yen exchange rate is a direct reflection of international instability, and the recent continued depreciation of the yen is clear evidence of this phenomenon.

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