PROBLEMS E'ECONOMY

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Twenty-first century e' businesses worldwide operate in an environment where forces - such as globalization, technology, the Internet, deregulation, restructurings and changing consumer expectations - are creating much uncertainty and prodigious risks. Consider, for example, that no force is having as great an impact on business today as the Internet. And as the Internet evolves, companies in all industries are rethinking the basics: business models, organizational change, core strategies and target customer bases.

Dilemmas new economy

Several lessons from 2001 will be important for assessing the US economy and financial markets in 2002 and beyond. But for me, three stand head and shoulders above the others. First, leverage matters: Heightened operating and financial leverage left businesses vulnerable to any slowdown, quickly turning a soft landing into a hard one. Second, financial conditions matter: Despite massive Fed ease, reduced credit availability, falling stock prices, and a stronger dollar all hastened the $ and global recessions. Finally, the global context is important: The still-tender global economic backdrop last year meant that there was no cushion for the US economy and financial markets from the coming recession. These lessons were critical in shaping our recession call in 2001. But they also carry important implications for today's outlook. Just as the interplay among these forces worked to promote recession last year, I believe that the unwinding of these forces will all in varying degrees foster recovery in 2002 and expansion into 2003. Organization troubleshooting will start with some traditional features of the business cycle. First, unemployment typically lags labour-market developments (i.e., employment) because discouraged workers withdraw from the labour market only once a recession is widely acknowledged, and resume their job search only when the recovery is established. Second, employment lags production, as companies do not immediately adjust their workforces to changes in demand trends because of firing/hiring costs. Since firing costs are relatively high in most European countries, this lead time between output and employment, often labeled the "productivity cycle", is more pronounced than in Anglo-Saxon economies. True, the "flexibilisation" European labour markets have experienced over the last ten years has shortened the productivity cycle, but it has not totally flattened it. For these two reasons at least, unemployment typically continues to rise well after expectations have rebounded and even once the recovery is on track.

Japan's exchange rate policy

According to the Giga Group experts the normal change process implicit debate is unfolding on whether Japan's exchange rate policy has changed and whether such a shift in policy, rather than the deterioration of macro conditions in Japan, is the main cause of recent JPY weakness. This are critical questions, in my view, because if Japan has indeed adopted a weak-JPY policy, then:

- USD/JPY may stay high even if Japan recovers with the global economy.
- Japan may encourage USD/JPY to rise significantly higher than its Asia ex-Japan neighbours - especially China - can tolerate.

August Wilhelm Scheer from IDS speak, organization troubleshooting of the view that Japan has indeed adopted a weak-JPY policy, and the rhetoric from Tokyo to the contrary is a defensive move to shield such a policy from criticism and objections from Asia ex-Japan and possibly the US. As a result, the Japanese Ministry of Finance (MoF) is likely to prefer to see USD/JPY in the 130-150 range rather than the 120-130 range that I previously posited (see *Rising Risks of USD/JPY Breaking through 130,* December 15, 2001). Past experience suggests that what the MoF wants, the MoF usually gets. I identify five key issues (fig. 1):

- Japan is acting as if it has adopted a weak-JPY policy; the policy floor for USD/JPY has shifted to 130.
- The MoF is now less risk averse than before and more risk loving than Japanese investors.
- China is now Japan's key economic nemesis.
- China is in a difficult position.
- Will the $ remain strong?

In 1. Japan is acting as if it has adopted a weak-JPY policy; the policy floor for USD/JPY has shifted to 130. While the deteriorating economic conditions provided some justification for such a policy shift, in my view, they themselves were not the factor to which we should attribute the move in USD/JPY from 115 in late September to 132 in the last three months of 2001. The trigger for the recent JPY weakness was the shift in Japan's policy on the JPY. The economic fundamentals in Japan are poor, but they are poor virtually everywhere else in the world, and therefore should not be blamed as the cause of JPY weakness, in my view. Few would argue that USD/JPY would trade at the current levels had the MoF not complained that the JPY was too strong. The shift in policy in Japan probably occurred sometime around the latter part of November. The article in the *Financial Times* on November 22, 2003 that suggested that the US endorsed the idea of the BOJ buying foreign bonds appears to have been a mini-watershed. In subsequent weeks, Japanese policy makers have been remarkably coherent on their stance on the JPY. On the one hand, they have repeatedly emphasised that they do not want to artificially weaken the JPY. On the other hand, they have applied intense pressure in talking the JPY down, with the help of an implicit threat of intervention to protect downside risks to USD/JPY. Those who are familiar with the USD/JPY market understand well the immense influence the MoF has on USD/JPY: More often than not, the MoF does not need to intervene outright in the market to have an impact on the level of USD/JPY. Arthur Stinchcombe seeks, the normal change process for investors, in my view, the right approach in discerning Japan's true intentions is to watch what policy makers do, not what they say. Despite the official rhetoric that Japan does not want to artificially drive the JPY weaker, the reality is that Japan now acts as if it has a weak-JPY policy, and has successfully pushed the JPY weaker by imparting a bias in the risk to USD/JPY.

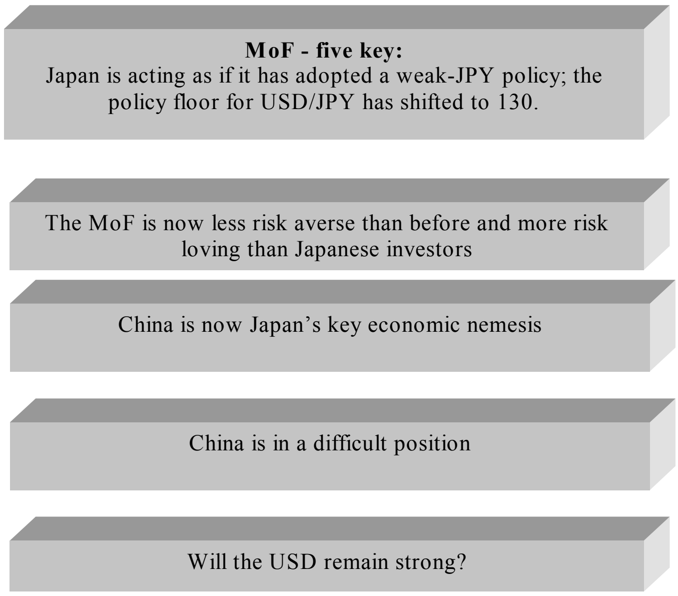

Figure 1. MoF - five key issues

Source: Own elaborate

Let the market determine if USD/JPY rises, but intervene if it falls. Supporting this JPY policy with incrementally higher tolerance floors, Japan can effectively drive the JPY weaker without undertaking the traditional methods of competitive devaluation (e.g., outright proactive intervention or buying foreign bonds). Rather, it is likely that the implicit intervention floor has been quietly ratcheted up in the final months of 2001: from 115 in September, to 120 in October, to 125 in early December, and to 130 by late December. As I have argued previously (*How Big a Yen Devaluation Will Be Needed?*, November 27, 2001), the level of USD/JPY that Japan needs to deal with the weak economy is significantly higher than the current spot price. This suggests that the MoF may prefer a range of at least 130-150, rather than 120-130.

In 2. The MoF is now less risk averse than before and more risk loving than Japanese investors. Exchange rate policy is never just about exports. The US has a strong USD policy because it is more concerned about the implications for capital flows and the financial markets than for exports, I believe. In contrast, Japan seems to place a much greater emphasis on the impact of the JPY on exports. The MoF had not been more aggressive in driving the JPY lower earlier than it did owing to its concerns about possible side effects of expected JPY depreciation on asset prices. I have long argued that a weak-JPY policy, in theory, could be a viable option for Japan, but that in practice it would be very dangerous to implement because of the 'JGB bubble.' In view of the structural problems in Japan, it is not too difficult to picture such a policy triggering massive capital outflows: Investing in JGBs and not in foreign bonds makes little sense when the government is effectively selling USD/JPY puts. A collapse in JGBs is, to me, a huge risk that overwhelms the marginal gains from a weaker JPY. Despite my concerns, the performance of the JGB market in the latter months of 2001 suggests that Japanese investors may still have a very strong home bias and may not panic yet. Further, the experience of Argentina in 2001 (when Argentine investors/depositors calmly walked into the financial crisis and did not panic until it was too late) suggests that some investors' loyalty to home assets should not be underestimated. Under these conditions, a stable JGB market could provide the best environment in which to push USD/JPY higher. The MoF may be compelled by the weak economic fundamentals to adopt a very risky currency policy.

In 3. China is now Japan's key economic nemesis. One key difference between now and 1998 is that Japan now wants a higher CNY/JPY. In addition to dealing with the current cyclical weakness, a weak-JPY policy could also be seen as one way to slow the pace of the 'hollowing out' of the manufacturing sector as production is shifted to China. Since the summer of 2001, Japan had conducted a massive campaign to establish a consensus that the RMB is grossly under-valued, and that China may not have the right to devalue even if the JPY weakens. To Tokyo, Beijing's threat of devaluing the RMB is much less credible than in 1998. This line of thinking makes it extremely unlikely that something like the G-2 intervention to cap USD/JPY conducted in June of 1998 to save the RMB will be repeated. If anything, Japan appears much less concerned about China than before, and may push USD/JPY higher regardless of what Beijing says. In fact, the 'China-bashing' campaign could have been a carefully planned precursor to the launch of the weak-JPY policy.

In 4. China is in a difficult position. I have two key thoughts on China. First, the RMB is not undervalued. Second, China does not want to devalue the RMB if it can help it. On the issue of valuation, it often surprises me that many investors somehow believe the challenges confronting Japan are more daunting than those facing China. I would underscore that China still has a weak banking system, a very uncompetitive agricultural sector that employs close to 60% of the labour force, and a manufacturing sector that is likely to face a tidal wave of competitive pressure from the rest of the WTO membership in coming years. Thus, I find the argument that the RMB is grossly undervalued very unconvincing. Further, Beijing has taken a completely different approach to that of Japan in dealing with these structural problems. Under the leadership of Premier Zhu, China has focused almost exclusively on structural reforms and has refrained from competitive devaluation. On the other hand, Japan has, to my dismay, adopted a weak - currency policy to help deal with its structural problems. The diverging policy paths between the two largest economies in Asia are likely to put China on its back foot. If Japan continues to coax the JPY weaker, it is far from clear what China can do other than to also let the RMB reflect the international fundamentals.

Team management specialists speak, the HKD peg, however, may become a political and economic liability to Beijing, because Beijing may be blamed if the HKD is undermined. In fact, Japan may be betting that China will not be able to devalue the RMB in tandem with the JPY because of this "*Hong Kong factor*". China lodged its formal complaint soon after 130 had been breached, in line with my expectations. What seems remarkable, however, is that Tokyo dismissed this complaint. It is not clear to me what China will do if the JPY weakens further. But I suspect that Japan is under the impression that China's threat to devalue the RMB is much less credible than in 1998, and thus may be more emboldened to talk the JPY down. Moreover, if part of the reason behind this weak-JPY policy is to slow the pace of hollowing out, then the JPY could be kept weak even if Japan recovers with the global economy.

In 5. Will the $ remain strong? Another important consideration is the fate of the $. I have argued that the $ should continue its course of a 'bear-market rally' until 2Q 2002 and begin to weaken thereafter. I am now less confident of the USD's demise than before, for three reasons. First, I believe the wave of competitive devaluation that has just begun in Asia will inevitably push the $ higher. The USD could remain stronger than it would have otherwise against 'third currencies' like the EUR and the AUD partly because the Asia ex-Japan central banks would need to artificially intervene (buying USDs) to drive their currencies weaker. Second, the military success of the US has exceeded general expectations. To most holders of hard currency, this is a strong statement reaffirming the US's superpower status. In turn, the emerging markets' propensity to hold USDs is emboldened, partially offsetting the EUR-positive effect of the launch of the new notes and coins. Third, while the trajectory of the US economic recovery is still in dispute, the US economy appears to be bottoming without the help of a large fiscal stimulus. Add to this the likely outcome that the US may be the first to climb out of the global recession, and the $ may be supported for longer than our valuation work suggests.

Japan is acting as if it now has a weak-JPY policy, despite rhetoric to the contrary. Complaints from China and the rest of Asia ex-Japan and fears about the JGB bubble bursting are not likely to be taken seriously by Tokyo this time around. The floor on USD/JPY is likely to have shifted to 130. With this new currency policy, there is more upside risk to USD/JPY, and the JPY may stay weak even if the economy recovers. Verbal intervention by Japan and actual intervention by Asia ex-Japan should keep the $ strong.

Summary

New e'economy has created new demands for manufacturers to produce a wide range of products, which have to be of higher quality at lower prices, and shorten their manufacturing lead times. In an environment of fierce competition, industry can't afford large amounts of waste - in time, material or production capacity. Cost, quality and responsiveness are three requirements industry must be aware of if they hope to survive. This requires a new type of manufacturing system, the flexible or reconfigurable manufacturing system and new tools business change.

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PROBLEMY E'EKONOMII

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W dobie globalizacji zdefiniowano kilka lekcji wynikających z nowej e'ekonomii. Jedna jest skutkiem przyczynowym turbulencji światowej gospodarki ery digital, która pojawiła się wraz z recesją w USA w 2001 roku. Kolejna wchodzi w zakres tkwiący w elastyczności rynkowej i pokazuje optymistyczne skuteczne scenariusze realizowane przez wiele przedsiębiorstw w rejonie Azji, a szczególnie Japonii. W artykule scharakteryzowano ogólnie pięć scenariuszy, które pozwalają efektywnie prowadzić biznes w gospodarce ery cyfrowej.