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GLOBAL MARKET COMMENT: DEVALUING THE YEN

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Devaluing the Yen—The Limits of Monetary Policy

Japan has almost exhausted all options to resuscitate its economy. It has boosted government spending, but the government debt to GDP ratio now stands at about 130%. The Bank of Japan (BOJ) has pushed interest rates down to nearly zero, but credit demand remains negligible. It has flooded the banking system with liquidity, but deflation is running at -1.0% for the year ended July 31. Aggressive quantitative easing seems to be the only untried policy measure in the BOJ's arsenal.

Quantitative easing comes in many shapes and sizes. Its overall purpose is to stimulate aggregate demand by targeting the quantity of money, rather than interest rates. In Japan, aggressive quantitative easing includes the monetization of government debt by expanding the BOJ's program of purchasing Japanese Government Bonds (JGBs) from commercial banks. The central bank could also buy the debt of corporations that have low credit quality or finance the disposal of non-performing loans.

Another form of quantitative easing is depreciating the yen, a policy option advocated by several prominent economists. The BOJ[1] could depreciate the yen by selling the currency in the foreign exchange markets. To have an impact, however, this operation must be "unsterilized," which means allowing the proceeds of the sales to flow into the domestic economy rather than using them to buy foreign currency assets like U.S. Treasuries. According to conventional economics, this would weaken the yen, providing a boost to exports and increasing inflation expectations by raising the prices of imports and consumer goods. The problem with this—and quantitative easing in any form—is that the logic of economics may not apply in a liquidity trap[2] or within a dysfunctional banking system.

Why A Lower Yen Might Not Help

There are several reasons why a lower yen may not jumpstart Japan's economy. First, higher import prices have only a small impact on consumer prices. In order to benefit in any meaningful way from increased exports and higher import prices, Tokyo would have to slash the value of its currency. Morgan Stanley estimates that in order to increase consumer prices by 1.0%, the yen would have to fall

[1] The Ministry of Finance is officially authorized to carry out foreign exchange transactions. Foreign currency transactions by the BOJ are limited to certain situations, though the law's wording may be vague enough to allow it to implement these transactions. The two ministries need to coordinate their foreign currency policies, but such cooperation is difficult in the present political atmosphere.

[2] In a liquidity trap, monetary policy has no effect on aggregate spending because changes in the money supply have no effect on interest rates.

40% against the U.S. dollar (US$). Even Andrew Smithers, one of the most vocal and persuasive proponents of yen devaluation, acknowledges that the yen must fall to ¥180/$ to increase exports and reverse deflation. As of August 31, the exchange rate was ¥119/$, and so Smithers' proposal requires a 51% drop in the yen's value. (See Table A.)

This leads to the second problem with yen depreciation. Assuming that Tokyo is willing to implement such a policy, its neighbors would certainly react by devaluing their own currencies. This would not only reduce or nullify the potential benefits for Japan of a lower yen, but it would also imperil the region's economic stability. A lower yen would intensify competitive pressure on Asia's export industries that compete directly with Japan by eroding export-pricing power. As trade prices fell, other economies would have to devalue their currencies or risk losing market share. Given the current global economic climate, aggregate demand for these products would probably remain unchanged, which means that lower currency values would do little to boost export revenues.

A vicious cycle of competitive devaluations could push Asia into a deflationary spiral. Largely due to the sharp decline in export prices from China, the countries of the region have already suffered enormous deflationary pressures that have forced most of them to lower the value of their currencies. (See Table B.) Most have fallen one-third in value against the Chinese renmimbi since the 1997-98 Asian crisis. In fact, there is the danger that *regardless* of what happens with the yen, a cycle of competitive devaluations may break out in today's environment. If the US$ continues to fall and global demand remains weak, Asia's export-oriented countries may be forced to depreciate their currencies in order to maintain market share in the United States.

A third impediment to yen devaluation is Japan's dysfunctional banking system, which may negate the usually positive relationship between money supply and the value of the currency. Even if the BOJ were to increase the money supply through nonsterilized yen selling, the intended effect could be nullified by private sector buying of the yen as struggling companies sell foreign assets in order to shore up their balance sheets before the mark-to-market accounting requirements come into effect. In addition, because the money multiplier is unstable, increases in the monetary base would not necessarily increase inflationary pressures, and therefore might not lead to yen weakness.

This raises a larger point: aggressive quantitative easing may generate dangerous side effects. For instance, diminished fiscal discipline may increase the market risk premium, while impairing the BOJ's balance sheet. Inflation may benefit debtors, but it is not necessarily good for depositors and financial institutions. Finally, higher inflation expectations could prompt an exodus from JGBs, putting upward pressure on interest rates and adding to already onerous debt service costs.

In short, the solution to Japan's economic problems is not as simple as some commentators have argued, nor the efficacy of yen depreciation assured. Nevertheless, the failure of conventional fiscal stimulus, the growing evidence of widespread deflation, and the impending crisis posed by mounting government debt all indicate that the authorities must attempt to reflate the economy by any means possible, including currency depreciation. For investors, this suggests that distressed debt—aggressive disposal of which must be included in any concerted reflation effort—and investments that benefit from inflation may both present interesting investment opportunities.

Table A

JAPANESE YEN RELATIVE TO THE U.S. DOLLAR

January 31, 1965 - August 31, 2001

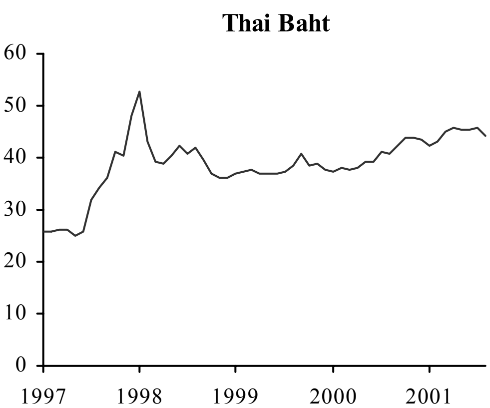
Source: Datastream International.

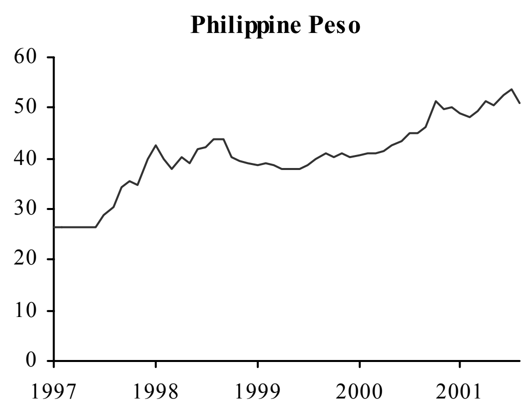
Note: Graph based on monthly data.

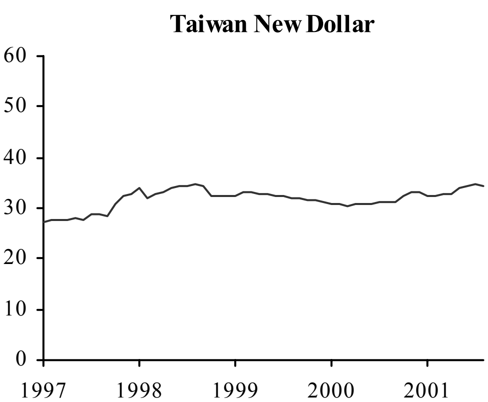
Table B

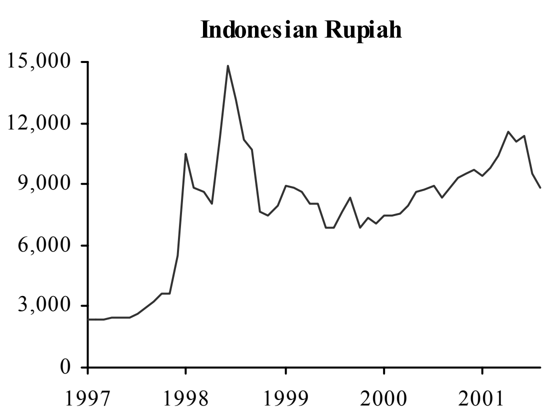
ASIAN CURRENCIES AGAINST THE DOLLAR

January 1, 1997 - August 31, 2001









Source: Datastream International.