A weak yen is no panacea but Shinzo Abe needs it all the same

Depreciation is the central bank’s most potent tool. If it falters so could the reflation experiment

It is a truth universally acknowledged that a weak yen is good for Japan. It is a truth mostly unacknowledged – at least in Tokyo, where it is nonetheless secretly understood – that a weak currency is a vital plank of Shinzo Abe’s plans to reflate the economy. The value of the yen has fallen by about 26 per cent against the dollar since it became clear almost two years ago that Mr Abe was set to push a policy of massive monetary easing. That has helped to lift consumer prices towards the Bank of Japan’s inflation target of 2 per cent by virtue of higher import prices. There is only one hitch. A weak yen may no longer be unequivocally good for Japan after all.

There are several reasons for that. One is that Japan’s energy bill has soared as a result of closing down all 48 of its surviving nuclear reactors in the aftermath of the Fukushima disaster in 2011. That has meant importing far more oil and liquefied natural gas, often through costly long-term contracts, a blow to Japan’s balance of trade. The weak yen only makes things worse. As a result, Japan, an economy built on persistently healthy trade surpluses, has slipped into near-chronic deficits. It still records a lot of investment income from abroad, though recently this has not been sufficient to offset a widening trade gap. In August it reported a first-half current account deficit for the first time in almost 30 years.

Another reason that a weak yen may not be manna from heaven is that, contrary to common perception, Japan is no longer an export-driven economy. Exports account for about 15 per cent of output, as opposed to 51 per cent for Germany and 54 per cent for South Korea.

Many of Japan’s manufacturers, including its big car and electronics makers, have shifted production abroad to be closer to demand. More importantly, in common with many advanced countries, Japan’s service economy predominates. The bulk of Japanese are thus employed by companies that are just as likely to benefit from a stronger yen as a weaker one.

Even so, according to Capital Economics, in aggregate corporate Japan is still better off with a weaker currency. Many companies have chosen to repatriate more profits in a weaker yen than to lower prices in pursuit of higher market share. It estimates that two-fifths of Japan’s recent surge in corporate profits is attributable to a weaker currency.

That is not as good as it sounds, particularly in an economy where companies have been hoarding cash for years. Higher profits have not done much for investment. Worse, the impact on consumption has been minimal. That is because real wages have continued to fall. That may be an inevitable side effect of inflation, at least in the initial stages before higher profits are passed on in wages. As Jonathan Allum of SMBC Nikko points out, Mr Abe’s insistence on raising consumption tax by 3 percentage points probably did more damage to household spending than a falling yen.

Either way, for the prime minister – who faces important gubernatorial elections this year and local ones in the spring – it is far from ideal that most voters feel poorer because of an economic policy that bears his name.

Mr Abe is clearly having second thoughts about the virtues of a weaker yen. In remarks after the currency fell to a six-year low of Y110 against the dollar, he said there were good and bad aspects to yen depreciation. As if to underline the point, Haruhiko Kuroda, the Bank of Japan governor whose expansive monetary policy has chiselled away at the yen’s value, was summoned to parliament to explain himself.

All of this poses a dilemma for the future of Abenomics, which began by endorsing a landmark deal between the government and the Bank of Japan to co-operate in order to rid the economy of deflation. Any sign of a rift would rattle markets and weaken the credibility of a reflationary policy that relies to an uncomfortable degree on the power of rhetoric. Core consumer prices are now rising by a modest 1.1 per cent a year. It is far from clear, however, that even this is a permanent state of affairs.
As Mr Kuroda has pointed out, it is no easy matter to re-anchor inflationary expectations after 15 years of falling prices. Everyone knows that a depreciating yen is the BoJ’s most potent tool. If it is seen to falter under political pressure from Mr Abe – by, for example, shying away from another round of quantitative and qualitative easing – the whole experiment in reflation could run aground.

Mr Abe is correct in his hunch that a weak yen is no longer all it was cracked up to be. He is right too that inflation, without a compensating rise in wages, is more popular with macroeconomists than it is with voters. Yet it would be a disaster if he blinked now. Getting to sustainable inflation is the central tenet of Abenomics. A return to deflation would be to throw it all away. Like it or not, a weaker yen is part of the plan.

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