Japan actions risk igniting currency war
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Devaluation is becoming a habit in an economy that has lost its edge

Last month the Bank of Japan boosted its quantitative easing efforts to try to revive sagging growth. But it has prescribed the wrong medicine. Worse still, its misguided policy risks sparking dangerous currency wars.

The yen has plunged 20 per cent against a trade-weighted basket of currencies since Prime Minister Shinzo Abe unveiled his plans to breathe life into the economy in late 2012. Since the BoJ’s unexpected announcement of extra QE on October 31, the currency is down 5 per cent against the dollar and the renminbi. Devaluation is becoming a serial habit in an economy that over the past 20 years has lost half of its global export market share.

But the demise of Japan’s world-class export machine does not stem from an overvalued exchange rate. The economy has lost its edge in innovation. Industry is saddled with a bloated, obsolescent capital stock. Ageing employees swell the corporate ranks. Deflation in Japan is the symptom of this structural malaise, not its cause.

If anything, falling prices have supported real consumer incomes. Deflation has also allowed the government to prop up the economy by running big deficits without the bond market punishing its profligacy with higher yields.

Consumer demand in Japan is weak because too much income flows to companies and not to households. Corporate profits as a share of GDP in Japan are much higher than in the US, while companies enjoy abnormally large depreciation allowances. They are flush with cash that employees, shareholders and the taxman could put to better use.

Abenomics, the prime minister’s solution to Japan’s stagnation, consists of monetary reflation, yen devaluation, fiscal stimulus and structural reforms. The latter, Abe’s “third arrow”, remains so far in its quiver, while more QE and a weaker currency do not address Japan’s core problems. Indeed, yen depreciation exacerbates Japan’s main structural shortcoming, a lack of consumer spending power, by boosting business income. Mr Abe has form here: Tokyo has not only offered tax incentives to companies but has raised the consumption tax, which it wants to increase further.

As for QE, printing ever more money to buy government bonds has little chance of generating real growth without structural reforms. Nor is QE needed to ease the paydown of private sector debt, which is not excessive in Japan. The upshot is that Japan risks generating cost-push inflation but no growth, a dangerous mix. With most of Japan’s government debt owned internally, Abe’s folly would not matter much to the rest of the world if global consumer demand were not so weak. But that is not the case.

The US is the only major economy that has restructured aggressively since the crisis. Household debt is back down to sustainable levels, while the government has reduced its primary deficit to a level that will stabilise the public-debt-to-GDP ratio. The US has regained relative labour competitiveness and the shale revolution is delivering cheap energy. Real GDP growth should remain above trend for a couple of years. But do not count on an import boom. The recovery will be based on America producing more at home of what it consumes. The US will no longer be the consumer of first resort for emerging markets.

The growth model in China has changed irreversibly. Beijing engineered an investment binge in 2009 to counter the export shock of the financial crisis, only to find it could no longer throw money at unproductive capital without racking up debt too fast.
Over the past three years, growth has slowed sharply and domestic demand even more so. Meanwhile, the renminbi has become overvalued, crippling China’s corporate sector and ushering in an investment downturn. Beijing will not succeed in rebalancing growth towards consumer spending without structural reforms. Yet those reforms will be deflationary, calling for the cushion of a cheaper currency.

Which brings us back to Japan. With Tokyo going for beggar-my-neighbour devaluation and the eurozone eyeing a low exchange rate through its version of QE, Beijing will be under pressure to join the currency wars. South Korea will seek to cheapen the won.

Ultimately, though, these economies will discover serial devaluation is not a solution in a world still marked by a global savings glut. The US for now remains the only bright spot. But falling currencies worldwide point to further dollar strength. The hope must be that the greenback does not overshoot so fast that it cripples the US economy too.

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