

## The yen

**Let it fall?**

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**Talk returns of devaluing the yen, as a way to break Japan's deflation**

OVER the past week the yen has begun to slip, after hints that the American government may at last be willing to tolerate a fall in its value against the dollar. A depreciation has always been ruled out by the Bank of Japan. "No matter how much water is poured on a dead plant, it simply will not grow," said the central bank's governor, Masaru Hayami, a few months ago. Monetary policy, he has argued, can do no more to revive the economy until a dysfunctional banking system is cleaned up, and businesses are restructured.

Desperate times, though, call for desperate measures, and the economic news is grim. In the year to October, industrial production fell by 11.9%, while retail sales fell by 4.9%. Persistent deflation in Japan creates new bad debts in the banking system almost as fast as old ones are being written off. It encourages households to put off spending. And it increases the real burden of both public- and private-sector debt. This week two credit-rating agencies downgraded the country's long-term debt.

Foreign economists have long urged the Bank of Japan to pursue aggressive "quantitative monetary easing"—that is, to print money. This the central bank has done since the spring, but only half-heartedly. Injecting any more liquidity into the system, it argues, will do little if banks will not lend. Certainly, two of the usual channels through which monetary policy takes effect are blocked: interest rates can go no lower, and banks saddled with bad loans are reluctant to lend more. All the same, a third channel, the exchange rate, remains open. A cheaper yen would boost exports and, through higher import prices, presumably push up inflation.



Foreign-exchange intervention to lower a currency is far more effective than intervention to support one. In supporting a currency, the central bank quickly runs out of reserves. To send the yen lower, the Bank of Japan could print unlimited amounts of yen to buy dollar bonds. (In theory, this requires the agreement of the Ministry of Finance, which officially controls foreign-exchange reserves.)

Lars Svensson, at Princeton University, favours a big depreciation of the yen to push up prices. He proposes that Japan should first set a target for the level of consumer prices, one that would rise over time to allow for a small positive inflation rate. Japan should then use intervention in the foreign-exchange markets to push the yen sharply down, and to hold it down until prices reach their target level.

A price-level target differs from an inflation target, which other economists propose. If inflation one year undershoots its target, that is ignored in setting policy the next year. On the other hand, if prices fall below the target level, this must be made up in future years—more effective, in principle, for breaking persistent expectations of deflation.

Mr Svensson argues that the yen needs to be pushed to an undervalued level, from which the public would then expect an appreciation of the real exchange rate. With the nominal exchange rate held down by intervention, this could only come about through a rise in prices, creating expectations of future inflation and so reducing real interest rates.

Would it work? Mere mortals may not understand the link between the exchange rate and inflation. If expectations about inflation are not significantly altered, and policy has to work through the direct impact on consumer prices alone, a huge fall in the yen would be needed, since imports are equivalent to less than 10% of Japan's GDP. Economists reckon that the yen would need to fall to ¥170-180, from ¥124 today, to lift inflation to 1-2%.

It is unlikely that America would tolerate such a drop—and nor would the rest of Asia. Chinese officials have repeatedly expressed concerns about a sharp fall in the yen, though they are surely exaggerating. Japan's imports from China have risen strongly, and Chinese and Japanese exports do not really compete.

Nonetheless, at home and abroad there seems scant appetite for a cheap yen. Japan's Ministry of Finance said this week that it had no intention of driving down the yen by buying American Treasury bonds. At the Bank of Japan's October monetary-policy meeting, Nobuyuki Nakahara, one of the independent members of the bank's policy board, proposed that the bank set a price-level target and examine ways to buy foreign bonds. He was voted down, by eight to one.

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