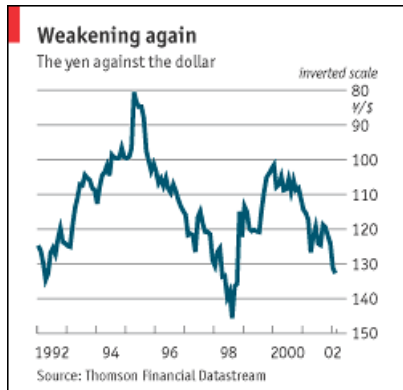


Japan's tough choice

Jan 14th 2002

From The Economist Global Agenda

Japan is mired in a deflationary spiral. Having spent billions on an apparently fruitless fiscal stimulus, a devaluation of the yen seems to be one of the few tools left to stimulate the economy. However, China and South Korea are both warning against devaluation, and it could bring as many problems as it solves



JAPANESE policymakers are in a real fix. They seem to have tried almost everything to deal with the persistent deflation in the world's second-biggest economy, but failed. Interest rates are close to zero. They have pumped trillions of yen into the economy—in fact, they have issued so many government bonds that their credit rating is threatened. But deflation persists. And so, it appears, the only thing left is devaluation. In December, the yen weakened by 7% against the dollar. This month it fell still further, to ¥133.4 against the dollar, a 39-month low, raising suspicions that devaluation is already government policy.

Japan's problems are acute indeed. The Nikkei stockmarket index stands at little more than a quarter of the level of its 1989 peak. The country has been in recession for the past year and national income is expected to shrink again this year. Industrial production withered by 13% in the year to November. Consumer prices, which have been falling since 1999, are expected to continue to decline this year. Throughout the 1970s and 1980s, it appeared as if inflation was the only evil. But deflation comes with its own problems. For one, consumers hold off spending because they know their money will be worth more tomorrow. Demand falls. Companies lay off workers, making consumers even warier about spending, and demand falls again. In Japan, there are two other problems: real interest rates, that is interest rates after inflation, become very high, and deflation swells an already heavy debt burden in real terms.

AFP



Takenaka implies "sell"

Japanese unemployment is at an historical high of 5.5%. On top of this, there is believed to be much hidden unemployment across the economy. The actions taken so far seem to have had little effect. Japanese consumers have refused to increase

their spending, and the Japanese savings rate remains among the highest in the world.

That is why devaluation, once taboo, is openly on the table. The idea is that it would help in two ways. First, it would make Japanese exports more affordable overseas, boosting demand for them. And foreign goods would become more expensive in Japanese terms, thus breaking the deflationary cycle and pushing down real interest rates. This is the reasoning that has led Ministry of Finance officials to countenance a weaker yen. On January 8th, Haruhiko Kuroda, a diplomat, said that the level of the yen was "not worrisome". He suggested that the yen's fall to date was a correction of earlier strength. Heizo Takenaka, the economics minister, has also conspicuously refrained from talking up the yen, saying that the weakening of the yen was consistent with economic fundamentals. However, policymakers do appear alarmed at the speed of the yen's decline, and seem to be trying to put a floor under its fall. Speaking in London on January 11th, Mr Takenaka said he felt that the yen "is not very far from fundamentals." And on the same day, Takeo Hiranuma, Japan's trade minister, said that the yen was nearing appropriate levels of around 135 per dollar.

Japanese policymakers seem to have persuaded their American counterparts to accept this weaker yen, although this is not wholly palatable to Americans because it could aggravate the trade imbalance between the two countries. American manufacturers are already grumbling that the weaker yen is helping their Japanese rivals. However, American officials seem to have accepted that a weaker yen is the price to be paid to enable Japan to undertake serious and long-delayed structural reform, especially of the banking sector.

Speaking after meetings with top American officials on January 8th, Mr Takenaka claimed that they would tolerate significant weakness in Japan over the next two years as the price of longer-term growth.

However, the Japanese establishment is not united behind the weak yen policy. Rumours that the Bank of Japan would start buying foreign bonds to drive the yen down were initially behind the yen's recent decline. However, the Bank has explicitly rejected such a policy and its governor, Masaru Hayami, has tried to stem the yen's fall.

AFP



Hayami has his doubts

The dilemma facing Japan is that a weak yen could create as many problems as it solves. It is not clear that it would stimulate demand any more than low interest rates did. Morgan Stanley, an investment bank, estimates that demand for Japanese products is remarkably inelastic, meaning that the yen might have to fall to ¥200 to the dollar to stimulate national income by as little as 1%. And that assumes that the currencies of its trading partners do not decline too. Most Asian currencies look cheap against the yen, but a devaluation on this scale would be far more likely to trigger other devaluations across the region.

A really weak yen would have negative consequences far beyond Asia. A round of competitive devaluations would transmit deflationary pressures to America and Europe, pushing inflation dangerously close to zero. If there is a weaker yen, America and Europe need to respond with further monetary easing to make sure that the effect is not simply to shuffle Japan's deflation elsewhere. More importantly, Japan has to recognise its key problem is not an overvalued yen but a banking system crippled by bad loans. Economic recovery will probably come if Japan does not find a way to tackle that mess. A weaker yen can only provide a brief respite to help the authorities to take on that tough task.