The Yuan-Yen Currency War

BY CHI LO

At the heart of the fight is the diminishing marginal efficiency of monetary stimulus.

The uncertainty about the effectiveness of "Abenomics" reviving Japanese inflation to a sustainable 2 percent within two years suggests that the yen may soon become another potential force driving the currency war that was started by quantitative easing in the developed world in 2010. The inflation Japan has recently experienced is not the kind that will allow the Bank of Japan to stop its money-printing press. If Abenomics fails to deliver the expected results soon, the yen will likely weaken further and for longer, creating pressure for more competitive devaluation. China is nervous about yen weakness since it adds appreciation pressure to the renminbi at a time when Beijing is pursuing structural reforms which will hurt short-term growth. If China were to retaliate, that would aggravate global market volatility as more Asian currencies are now tracking the renminbi's movement than ever before.

The latent force behind the currency war is the diminishing marginal efficiency of monetary stimulus. The global economy is facing disinflationary/deflationary risks, with China already experiencing outright deflation at the producer price level. The prevailing disinflation and a tail risk of deflation reflect the ineffectiveness of quantitative easing to deliver the intended reflationary results. On the contrary, quantitative easing has had the

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unintended result of transmitting deflationary pressures from the host country to countries that have not pursued quantitative easing. Japan's recent embarking on the quantitative easing trail is likely to prolong this deflation-exporting process. This is making China nervous and raising the risk of another round of competitive devaluation.

DEFLATIONARY CONTAGION

With interest rates at or close to zero, quantitative easing works through two channels to stimulate economic growth: asset price inflation and exchange rate depreciation. When the growth impact of the former is uncertain and unstable, the onus for boosting growth rests with the exchange rate. However, as the exchange rates of countries engaged in quantitative easing fall, they impose deflationary pressures on the countries not pursuing quantitative easing because a rising exchange rate lowers import prices, profit margins, and real wages in the non-quantitative easing countries.

Under normal circumstances, growth should return to the quantitative easing countries at the expense of the non-quantitative easing countries, and deflationary pressures should be transmitted from the former to the latter if the nominal exchange rates of the latter do not adjust. If they do adjust, a currency war ensues. However, in the post-subprime crisis world, quantitative easing has failed to deliver the usual effects of boosting growth and inflation back to normal levels because the broken monetary transmission mechanism has impaired money velocity even after a few rounds of quantitative easing, especially in the United States (Figure 1).

The impotence of quantitative easing highlights the risk that unconventional monetary easing cannot eliminate the deflation threat; it merely deflects deflationary pressures from the quantitative easing countries to the non-quantitative easing countries via currency depreciation. In the United States and the United Kingdom, quantitative easing has only led to temporary and mild inflation without this trickling down to wage gains. Japan may be facing the same challenge. When quantitative easing fails to do its job as expected, the incentive to implement more rounds of quantitative easing becomes bigger, feeding the currency war momentum. Japan may be the next in line to start another episode of the currency war.

JAPAN'S QE CHALLENGE...

The Bank of Japan pledged in April 2013 to expand its balance sheet from 35 percent of GDP to 60 percent in order to achieve 2 percent CPI inflation within two years. As a result, the Japanese yen has weakened sharply, including against the renminbi. More Japanese quantitative easing

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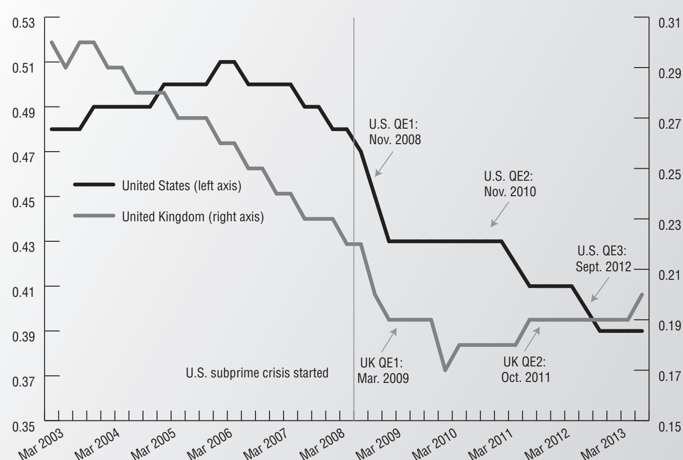
Figure 1: Impaired money velocity*



*Approx. by V=PY/M2
Sources: CEIC, BNPP IP Asia

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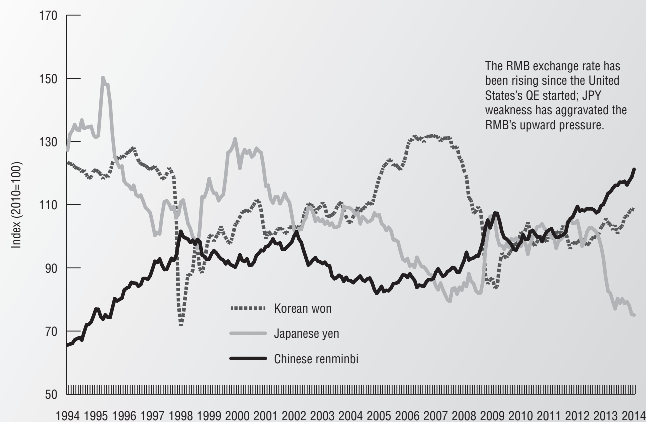
could come if inflation fails to reach and sustain the Bank of Japan's 2 percent target.

The recent rise in Japan's CPI inflation towards 2 percent is not evidence of deflationary pressures retreating, because it is being boosted by import costs and transport fees rather than demand momentum. There has been a lack of wage growth, despite quantitative easing. Indeed, base wage growth (excluding bonus and special payments) has remained negative. The three-percentage-point sales tax hike in April 2014 will push up Japan's headline inflation, but wage growth needs to pick up also in order to achieve a sustained 2 percent inflation rate.

The outlook for fast wage growth in Japan is not good. Some of the large exporters may be able to raise wages, as a weak yen has helped boost their margins. However, most of the small- and medium-sized enterprises, which account for over 70 percent of employment and are mostly domestic-oriented, are not benefiting from a weak yen. Many of them are adversely affected by rising import and transport costs. So the wage growth that is

Figure 2: Renminbi, yen and won trade-weighted exchange rates



Sources: BIS (CEIC), BNPP IP (Asia)

occurring so far may not be strong enough to achieve and sustain the Bank of Japan's 2 percent inflation target.

All this points to a high likelihood of continued quantitative easing by the Bank of Japan to drive down the yen further. This means Japan may have to resort to a "beggar-thy-neighbor" policy for generating growth momentum. Uncertainty over or the failure of Abenomics will also prompt Japanese capital outflows in search of better returns, aggravating the exchange rate appreciation pressure elsewhere and, thus, shifting Japan's deflationary pressures to other countries.

...IS MAKING CHINA NERVOUS

Japan's quantitative easing action has added upward pressure to the renminbi, as the renminbi's real effective exchange rate has been rising sharply while that of the yen has been falling (Figure 2). This is making China nervous, as the yen's weakness represents an external shock just when China's growth is slowing due to structural changes and the People's Bank of China is trying to relax control of the renminbi.

To be fair, the Korean won has also depreciated against the renminbi, as the movement of the won's real effective exchange rate is well below that of the renminbi (Figure 2), and China runs a large trade deficit with both Korea and Japan. But Beijing is more nervous about the yen's weakness not only because the yen has depreciated more significantly against the renminbi, but also because the yen has a much bigger weight (16.8 percent according to the estimates by the Bank for International Settlements) than the won (8.2 percent) in the renminbi's estimated currency basket. So the yen's weakness has a bigger impact in aggravating the renminbi's strength than the won. Crucially, the Bank of Japan has a devaluation bias but the Bank of Korea does not have a quantitative easing policy.

A NEW EPISODE OF CURRENCY WAR

This external currency shock is happening at a time when the People's Bank of China is relaxing control on the renminbi as part of the country's structural reform, which is also reducing China's growth momentum. The People's Bank of China has been steadily reducing its foreign exchange intervention, which is a sign of a significant policy shift towards a market-driven exchange rate, albeit still within the official trading band. As a result, the onshore renminbi spot rate has been trading at or close to the ceiling of the official plus-or-minus-1-percent trading band. While the increase in the renminbi's flexibility is structurally positive for China's foreign exchange reform, it poses a short-term growth risk on the back of an appreciating renminbi. The concern over further renminbi band-widening aggravating the growth risk may prompt Beijing to retaliate against the yen's devaluation. This may be happening already as the People's Bank of China seems to have returned to foreign exchange intervention recently by accumulating more assets. If China upgrades its scale of intervention, it could ignite another episode of currency war.

This could have a far-reaching impact on the regional currency markets because the renminbi has increasingly become an anchor currency in Asia, with the movements of the regional currencies tracking it closely. This presents, in effect, the rise of a "renminbi bloc" in Asia, which comes at the expense of loosening Asian currencies' correlation with the movement of the U.S. dollar and the euro. In other words, a currency war between Japan and China could inflict a downward bias in many of the Asian currencies, all else being equal. ◆

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