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Definitive antagonism between the US and China and clear focus on Japan, resulting in the long-term depreciation of the yen

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Musha Research has argued since its founding in 2009 that the biggest cause of Japan's deflation is the excessive appreciation of the yen brought about by geopolitical factors such as Japan bashing by the US. The ultra-strong yen has destroyed price competitiveness and caused a drastic reduction in yen-denominated wages, which had become extremely expensive in dollar terms. It also led to the rapid transfer of Japanese industrial clusters to overseas. However, under the new geopolitical environment of confrontation between the US and China, I believe there will be a definitive change to this vicious cycle of a strong yen and deflation. I will limit myself to the conclusions in this article and provide detailed verification and analysis in the future.

Definitive antagonism between the US and China with the US core strategy to weaken the Chinese economy

Irreversible hostility between the US and China was evident at the Alaska summit between top US and Chinese diplomats. The US has given notice that it will never tolerate China's foreign expansion and suppression of human rights and will probably draw a red line in the future. Last year, former Secretary of State Pompeo gave a speech in which he called for a fundamental shift in the US policy of appeasement toward China that has continued since 1972 (see Strategy Bulletin No. 257, July 27, 2020), and the Biden administration has taken it a step further. The top priority for the US after COVID-19 is contained is dealing with China. The issue of China will not only be a foreign policy issue but also a domestic policy issue for the US. The presence of a strong foreign enemy will come in handy in resolving domestic divisions, and no doubt stir up domestic public opinion that is hostile toward China. A military encirclement network will be steadily laid out, including the establishment of the quadrilateral security alliance between the US, Japan, Australia and India (known as the Quad), the dispatch of the British and French fleets to Asia, the construction of a missile network to encircle China, and the modernization of US military equipment. Nevertheless, military power cannot be a means of restraining or subduing China, as a 20th century-style all-out war is not an option. It can only curb China's adventurism, such as an invasion of Taiwan.

The only way to avoid China's seizure of US hegemony is to weaken the Chinese economy. This is a long-term strategy that aims to weaken China's economy while suppressing its military adventures through military pressure and stronger alliances.

Clear focus on Japan is natural

The US has clarified the message that Japan is its top priority. This is evident by Prime Minister Suga being chosen as the first foreign head of state to meet with President Biden, Japan being the first overseas destination for US Secretary of State Antony Blinken and Secretary of Defense Lloyd Austin and the holding of Japan-US 2+2 talks.

In this era of antagonism between the US and China, Japan is geographically important for both the US and China, and the outcome of the struggle for US-China hegemony will be determined by which side Japan takes. Of course, Japan does not have the option of tying up with China, but the US has no choice but to treat Japan well. Second, Japan's role is also important from an economic perspective. It will be essential that Japan has an increased presence in Asia.

One of the economic risks that has suddenly emerged for the US is its total dependence on China, South Korea, and Taiwan for the production of semiconductors and high-tech hardware,the oil of our time. The US is 60% dependent on South Korea, Taiwan, and China for the supply of semiconductors, and almost 100% dependent on these three countries for the production of smartphones. The reason for this is that the high-tech clusters that had been concentrated in Japan have shifted to Korea, Taiwan, and China as a result of Japan bashing and the extremely strong yen. China, South Korea, and Taiwan are potential battlegrounds in the era of US-China hostility, and they are in a critical situation where a single disturbance could cut off high-tech supply from these three countries.

Japan bashing by the US and the excessive appreciation of the yen have made the division of labor in Asia extremely dangerous for the US. The US should fix this. The only way to build a safe high-tech supply chain is to invite high-tech production, such as semiconductors, to the US and to encourage the return of the high-tech cluster to Japan, a safe zone in East Asia.

The key is foreign exchange, the biggest contributor to Japan bashing and a weaker Japan is the strong yen

The key to rebuilding the international division of labor and the supply chains is the foreign exchange rate. While tariff-based trade agreements can only bring about a price difference of a few percent, exchange rates can easily change the price difference by 10 to 20%, or even 30%. The price difference will be used to rebuild the international division of labor and supply chains. The extremely strong yen caused by the trade friction between Japan and the US destroyed the overwhelming presence of high-tech production in Japan and encouraged a shift to South Korea, Taiwan, and China.

The US, which is aware of this successful experience, will clearly make use of foreign exchange policies to rebuild its international division of labor and global supply chain. The first will be to induce the appreciation of the yuan to kill China's price competitiveness; the second will be to induce the appreciation of the currencies of South Korea and Taiwan, which now have large trade surpluses and control the world's semiconductors; and the third will be to promote the depreciation of the yen in order to return the high-tech cluster to Japan, which now has no trade surplus.

The four-year trend of yen appreciation against the dollar may be over

The yen has weakened since the beginning of the year. The progress in vaccination, the clear US economic recovery and rising US long-term interest rates are ending the dollar's depreciation since 2020 and causing a shift to a stronger dollar. The yen has weakened against the dollar from the ¥102 level at the beginning of the year to the ¥109 level, but it has also weakened against Asian currencies. The interest rate differential between Japan and the US is widening, and the US dollar currency hedging costs that held back Japanese investment in US Treasuries in 2019-2020 are falling sharply, improving the profitability of investment in US Treasuries. If a trend in the interest rate differential plus dollar depreciation becomes evident, it could lead to a revival in the so-called Mrs. Watanabe's dollar investments.

What is more important, however, is to determine the desirable exchange rate from the perspective of the national interest of the US, the reserve currency nation. Considering the geopolitical factors mentioned above, it is clear that the appropriate exchange rate for the US would be a stronger yuan, a stronger Korean won, a stronger Taiwan dollar and a weaker yen.

If the yen reaches 120 to the dollar, the Japanese economic landscape will change. Japan, which is the most undervalued country in the world, will become even cheaper. Tourists will flood into Japan. The competitiveness of Japanese products will increase. The rate of increase in corporate profits will jump due to the conversion of overseas profits of Japanese companies into yen and the increase in the value of dividends and technical guidance fees from overseas subsidiaries.

Wage growth will increase in Japan due to tight supply and demand and a weaker yen, which will make Japanese wages even more undervalued. As the yen weakens, Japanese prices, which are already undervalued, will become even cheaper, and prices will rise toward international levels according to the law of one price.

The vicious cycles of the lost 20 to 30 years will all turn into virtuous cycles

The vicious cycle under the strong yen is: a strong yen -> deterioration of Japan's competitiveness and decline in demand -> deterioration of labor supply and demand -> reduction of yen-denominated wages (to maintain price competitiveness in dollar terms) -> deflation.

The future virtuous cycle is: a weak yen -> improvement of Japan's competitiveness and increase in demand -> tight labor supply and demand -> increase in yen-denominated wages (=correcting the gap with international wages and securing a talented labor force) -> inflation.

Antagonism between the US and China will be a geopolitical windfall for the Japanese economy.