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Preventing global deflation by stopping the rising yen

Use foreign exchange market intervention to supply liquidity to the world

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Harmful shifts in assets bring about a stronger yen

Some movements of assets are normal while others have negative consequences. Shifting assets to sectors with higher returns is normal because this process maximizes economic efficiency. Negative shifts occur when investors give up on pursuing higher returns and move assets solely for the purpose of preserving principal. Adopting this stance blocks economic growth. However, from any standpoint, the current strength of the yen does not appear to be contributing to constructive asset movements that seek higher returns. With almost no demand for investments, the ample supply of capital cannot be used effectively. This explains why investors choose to channel their money to Japan, where long-term interest rates are below 1%. This is nothing more than pure speculative demand. The only explanation is that investors are basing their actions on the premise of a self-fulfilling appreciation of the yen.

The yen's strength symbolizes the "global deflation scenario"

Harmful asset movements are probably occurring because global financial markets are once again starting to factor in a "global deflation scenario." At the same time, concerns are emerging about the sustainability of the U.S. economic recovery. Fears of another drop in housing prices are surfacing due to the absence of a recovery in employment. There are also concerns about slowing economic growth in China, renewed financial instability in Europe and other problems. As a result, it appears that financial markets worldwide have once again started to factor in a "global deflation scenario." If this is true, the yen's appreciation will continue as a reflexive response to this situation.

The reflexive response of a deepening crisis sparking a stronger yen

Japan is becoming less competitive in relation to South Korea, Taiwan and other nearby Asian countries. Since Japan's trade surplus has declined considerably, there is no reason for the yen not to trade at its 2009 purchasing power parity (OECD, GDP basis) of ¥115 to the U.S. dollar. But the yen has become the world's strongest currency. Every time there is a financial crisis, the yen appreciates on its own. According to OECD statistics (June 2010), the yen is overvalued by more than 41% in relation to the U.S. dollar based on purchasing power parity. The euro is overvalued by 6% in relation to the U. S. dollar. On the other hand, the Korean won is undervalued by 25% in relation to the U. S. dollar and the Chinese yuan is undervalued by more than 40%.

The primary reason that investors prefer the yen, which is the currency of a weak country, is the yen's high effective interest rate because of deflation. Both Japan and the United States have interest rates that are virtually zero. But the yen's effective interest rate is about 2% higher than for the dollar because of the difference in inflation. Japan's weak economy is bringing down prices. Deflation then makes the yen even stronger, which makes the Japanese economy still weaker. This is the negative cycle that has trapped Japan. The second reason for the yen's strength is the firm belief that Japan's regulatory agencies like deflation. The third reason is that the yen has been the world's strongest currency for the past 20 years. Yen speculators have constantly been rewarded as a result.

Use foreign exchange market intervention to increase global liquidity

By exerting downward pressure on Japan's economy, the yen's strength is having a direct impact on Japanese stocks, the weakest link in the world's financial markets. Furthermore, a strong yen may cause deflation in other countries by soaking up capital from around the world. This is why the rising yen is one milestone for deflation in Japan as well as the entire world. Consequently, yen speculation must be suppressed so that Japan can return capital to the world. This is essential to ending the negative cycle leading to worldwide deflation. As an illustration, let's assume that Japan intervenes in foreign exchange markets by buying ¥30 trillion ($350 billion) worth of U.S. Treasury securities. Treasury securities. Making these expenditures would provide enormous support for the additional monetary easing measures that the Fed is currently considering. Consequently, establishing a coordinated international program to block the yen's appreciation would be beneficial to Japan's ego and for the entire world.

Japan's massive ¥30 trillion intervention to block the yen's appreciation in 2003 produced a stream of liquidity from Japan to other countries. This liquidity also energized the global economy but produced an asset bubble as well. In other words, Japan's intervention in foreign exchange markets contributed to international monetary easing. This will happen again if Japan can use foreign exchange intervention without monetary easing to lower the yen's value, supply yen-based liquidity and ultimately raise prices of Japanese stocks. Accomplishing this feat would probably make a big contribution to preventing deflation on a global scale.

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