

## Spreading currency wars should boost dollar, hurt Japan

- **Australia, New Zealand, Sweden join currency wars**
- **Passive currencies – primarily US dollar – should benefit**
- **Acceptance of yen weakness could dissipate**

A previous Comment (*Currency wars => dollar strength*, 23rd January 2013) made the point that, in a world where some countries are actively trying to depreciate their currencies, the ones that do not are those ones whose currencies will be the strongest. (There are exceptions to this rule, notably the euro, whose rate will be more determined by the evolution of the various euro area crises.) Until this week, the 'inactive' group included the US, Canada, Australia, Sweden, Norway and the euro area. This has now changed: the Reserve Bank of New Zealand has intervened against the Kiwi dollar; the Reserve Bank of Australia cut interest rates with a specific reference to the strength of the Aussie dollar; and the Swedish Finance Minister has publicly mused about the problems caused by krona strength. The latter two are the more interesting in that both Swedish and Australian commentators have in the very recent past expressed a clear hands-off approach to the exchange rate and noted how well domestic companies are coping with the strong currency. The RBA cut was also surprising given that the week saw a very buoyant employment report.

As it happens, both the Aussie and the Kiwi dollars have in the short term strengthened again on the back of strong labour numbers. Nevertheless, it is clear that new fronts have opened up in the currency wars. Such developments tend to be followed by further contagion as other countries attempt to depreciate their currencies preemptively. This is likely to have two consequences over the course of the next one or two years, one for the US dollar and a second for the yen and for the success or failure of BoJ policy.

With regards to the dollar, its strength should be even more pronounced. This is partly based on the continued positive growth outlook for the US economy – the current, brief, 'soft patch' notwithstanding; and partly on the fact that the US monetary authorities are unlikely to respond by attempting to talk down or in any other way actively depreciate the dollar.

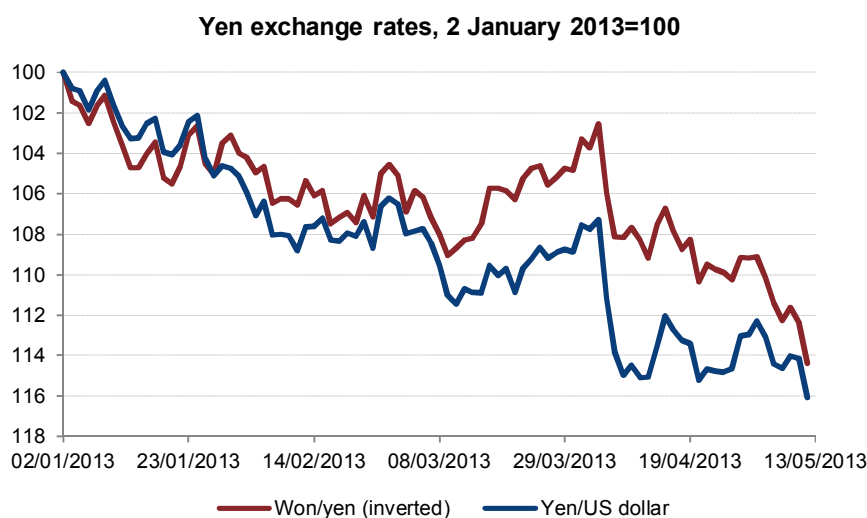
As for the yen, the situation is somewhat more complicated. As noted in a previous Comment (*What next for central banks*, 12th April 2013) the weaker yen is crucial to the success of the Bank of Japan's policy to achieve 2% inflation over the next two years. By contrast, the 'domestic' side of the policy – doubling the monetary base – is likely to have less impact. That is because the relationship between the monetary base and economic activity and eventual inflation is tenuous. Although the BoJ will be buying some bonds from the non-bank private sector – which will boost broad money growth – the government will also sell new bonds to that sector, which at least partly will negate the impact on broad money.

However, as it becomes clearer that the main or even only way Japan will achieve inflation is through the weaker yen, this could accelerate the yen's downward move as foreign and domestic capital leave Japan. As it happens, a rough estimate implies that the pass-through from exchange rate movements to eventual inflation is about 5%; on this basis, once the yen has fallen to around ¥107-110/US\$1, it will actually have

Stein Brothers (UK) Ltd.  
Telephone: +44 (0)7768 094 340  
Email: [gabriel.stein@steinbrothers.co.uk](mailto:gabriel.stein@steinbrothers.co.uk)

Any persons or organisations taking decisions on the basis of facts and opinions in this comment do so at their own risk. Stein Brothers (UK) Ltd. accepts no liability whatsoever for the consequences of such decisions. Stein Brothers (UK) Ltd. does not give any form of investment advice and does not accept liability for any losses that arise from positions taken in securities or asset classes.

fallen about 40% from its peak, which should suffice to eventually bring about 2% inflation. This rate is already within striking distance. However, there is always an amount of overshoot in currency movements; and it is likely that the Japanese authorities' response to weaker currencies elsewhere would be to try to depreciate the yen even further. Crucially, Japan's success through a weaker yen is not only dependent on the yen/dollar exchange rate, but also on how the yen fares against other currencies, not least against competitors like the won. So far this year, the yen/won rate has tracked the yen/dollar one; but a more active stance on behalf of the Bank of Korea could change this.



Lower import prices – a consequence of other currencies falling against the yen – will make it more difficult for the BoJ to reach the 2% inflation target. Moreover, weaker competitor currencies threaten any revival of activity through stronger exports. Hence, extension of the currency wars directly threatens Japan's hopes of achieving its targets. Concerns that the BoJ policy may fail – or at least not succeed as well – will be bad news for Japanese equities.

There is also another factor. So far, the international community has been prepared to accept the Japanese policy. It is – rightly – felt that a stronger Japanese economy will contribute more to the world economy than the impact of a weaker yen will have on other countries' trade. But, if yen weakness turns to rout and if other countries begin to play a more active role in depreciating their own currencies, what is accepted for one country to some extent may no longer be acceptable if it involves a much greater fall and many more currencies weakening. This is not just a question of the attitude of the United States, but also and perhaps more importantly, those of Japan's neighbours. Just as the Japanese response to weaker currencies elsewhere is likely to be further attempts to bring down the yen, so the reaction among other currency warriors to that weakening will be further depreciation, leading to a vicious and non-productive circle of currency warfare. Far from stimulating growth (an idea that has been put forward in some quarters), this is likely to dampen activity.

Stein Brothers (UK) Ltd.  
Telephone: +44 (0)7768 094 340  
Email: [gabriel.stein@steinbrothers.co.uk](mailto:gabriel.stein@steinbrothers.co.uk)

Any persons or organisations taking decisions on the basis of facts and opinions in this comment do so at their own risk. Stein Brothers (UK) Ltd. accepts no liability whatsoever for the consequences of such decisions. Stein Brothers (UK) Ltd. does not give any form of investment advice and does not accept liability for any losses that arise from positions taken in securities or asset classes.



Things may not get that far. Given the growth outlook in, eg, Australia and Sweden, it is difficult to see how the central banks there could seriously consider a Japanese or Swiss-style exchange rate policy. But the mere fact that they have moved from a policy of benign exchange rate neglect to one of active concern is bad enough.

Gabriel Stein 2013-05-10

[gabriel.stein@steinbrothers.co.uk](mailto:gabriel.stein@steinbrothers.co.uk)

Stein Brothers (UK) Ltd.  
Telephone: +44 (0)7768 094 340  
Email: [gabriel.stein@steinbrothers.co.uk](mailto:gabriel.stein@steinbrothers.co.uk)

Any persons or organisations taking decisions on the basis of facts and opinions in this comment do so at their own risk. Stein Brothers (UK) Ltd. accepts no liability whatsoever for the consequences of such decisions. Stein Brothers (UK) Ltd. does not give any form of investment advice and does not accept liability for any losses that arise from positions taken in securities or asset classes.

Registered office: 45 Chesilton Road, London SW6 5AA. Registered in the United Kingdom, registration number 08186233.