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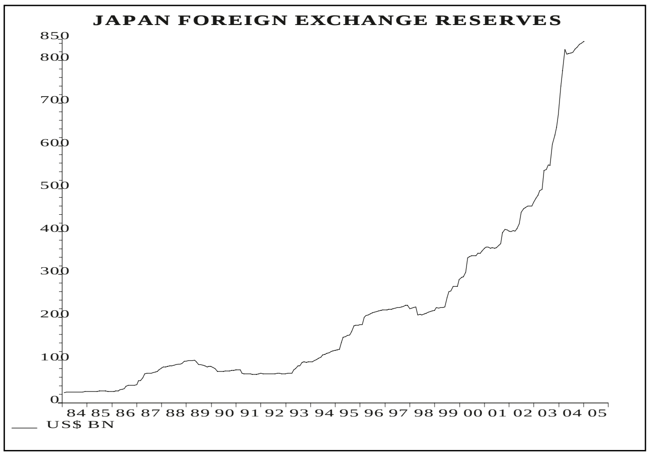
THE PRESSURE ON THE YEN BUILDS

The US strategy of trying to talk the US$ down against the floaters to precipitate a realignment against some of the managed Asian currencies may be starting to work. While the risk of intervention by the Bank of Japan cannot be ruled out, the US$ has fallen to a new low against the yen this week. The US administration's ploy has been quite cunning. The immediate point of least resistance has self-evidently been against the euro, and the US does run a significant trade imbalance vis a vis Europe. But the necessary adjustment in the trade-weighted value of the US$ is never going to materialise unless the Asian countries can be persuaded to accept a substantial revaluation too. By letting the US$ slide against the euro, the US administration has succeeded in bringing European officials ‘onside’. The challenge of cajoling Asian countries to accept more flexible currencies will be a lot easier if the G7 countries are singing from the same hymn sheet. If the BoJ does decide to intervene, it may prove much harder to pressurise the Chinese into breaking the peg. Increasingly, therefore, it seems the BoJ will have to hold back, allowing the yen to break through Y/US$100 and move quickly up towards Y/US$90.



The US Administration's Plan Is Working

European policy makers are starting to complain. ECB Chief Economist Otmar Issing and Governor Jean-Claude Trichet both weighed in last week with strong criticisms of Asia's attempts to manipulate their currencies. The Bank of Canada's senior deputy governor, Paul Jenkins, added to the chorus of criticisms. The US strategy is clearly paying dividends. A consensus is emerging within the G7, ahead of the February 4-5th gathering of finance ministers in London.

It has been clear for some time that officials in Washington were happy to talk the US$ down, knowing that in all likelihood the floaters would initially have to take the brunt of the adjustment. This strategy served two purposes. Firstly, Europe is running a record trade deficit with the US. The shortfall vis a vis Euroland hit US$83.3bn during the year to November. The bilateral imbalance with the UK was US$10.3bn over the corresponding period, just shy of the record US$10.4bn set in the year to June. A weaker US$ against both the euro and sterling is justified by the basic trade fundamentals, if not on the grounds of purchasing power parity. Secondly, it helped cement G7 opposition to the unwillingness of Asian countries to let their currencies float freely. There are certainly sound strategic reasons for wanting to bring the Europeans 'onside'. The dispute over defence exports from the EU to China has put further strain on relations between Washington and Brussels. The Airbus and Boeing spat has been deferred, but remains an obvious point of contention. At least this is one area where European and US officials may be able to reach some common ground.

In this respect, the recent movements in the Y/US$ rate are significant. The yen is being squeezed up, partly in response to the rhetoric of European officials. The BoJ will have to choose whether to fall into line with the other G7 countries and accept some appreciation of the yen, or to intervene again. The BoJ has essentially been out of the market since March. Foreign reserves have climbed by US$17.9bn over the past nine months, but that reflects the accumulation of interest on its asset holdings. Indeed, the trade-weighted yen has actually fallen over this period, suggesting there has hardly been a compelling case for intervention anyway. The

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real test of which way the BoJ will jump lies ahead.

In essence the Japanese authorities face a choice. If they intervene, it will undermine the sense of unity within the G7 and make it harder to confront the Chinese government over its peg. Intervention might succeed in the short run in capping the rise in the yen against the US$, but the benefits of that would have to be set against the long term costs of hindering a very necessary revaluation of the renminbi. Confirmation that the People's Bank of China (PBoC) Governor Zhou Xiaochuan and Finance Minister Jin Renqing plan to attend the meeting in London has been seen as a sign that China will be willing to make a positive statement about its intention to float the renminbi. But perhaps a better indication of their stance was provided by the PBoC Governor's declaration that the level of China's reserves was not "unreasonable". The rise in reserves posed a challenge for monetary policy, he noted, "but it has not yet become too great a difficulty". Furthermore, the large foreign exchange reserves were described as "necessary". The message is clear and simple. A pegged currency, the ability to accumulate reserves to help repair the balance sheets of the banks, and in turn facilitate the strategy of export-led growth remain central to Chinese economic policy.

Japan's position is not too dissimilar to that facing the US in the early 1970s. The strategy of export-led growth had been pursued with such verve and effectiveness by the Japanese government through the 1950s and 1960s, that the Y/US$ rate - set at an artificially low level of Y/US$360 to support the country's postwar reconstruction - had become increasingly untenable. And once the yen was forced to float in the summer of 1971, it began a long cycle of appreciation that eventually saw it rise by more than 300% against the US$ over the next three decades or so. Now the tables have been turned, and it is China's pursuit of export-led growth that poses a competitive threat that can only be countered by currency realignment. Postponing the day of reckoning will not only make the inevitable adjustment that much harder. For the Japanese, it will also be more difficult to reverse the persistent deflation in durable goods and secure price stability. In the US, the inflation risks are obviously skewed in the opposite direction. The falling US$ has already pushed durables inflation into positive territory. Regardless of whether the US$ falls more against the floaters or declines against the renminbi, the short term impact on inflation will be unfavourable. Whichever route the G7 countries choose, the pressure for some sort of additional devaluation in the US$ cannot be avoided.

However, there is another compelling reason why the US may prefer a united G7 to 'force' through a revaluation of the renminbi. The breakdown of the Chinese trade numbers shows an extraordinary dichotomy between the surpluses it generates vis a vis the G7 countries, and the deficits it has incurred against other trading blocs. China is running large trade deficits against the Middle East, Latin America and Australia, among others. This pattern reflects the country's voracious appetite for raw materials, which shows no sign of abating. In effect, China is using its bi-lateral surpluses with the G7-bloc to fund its growing deficits with commodity producing nations. The latest set of trade numbers show that oil imports into China rose by 132.7% y/y in November. Part of that reflected the rise in prices, but even the volume figures posted a gain of 48.1% y/y. Imports of primary goods outside of oil rose 85.7% y/y. Iron ore imports, for example, were up 121.2% y/y in US$ terms. Any shift in the currency peg has to be seen in the context of the broader policy aim of slowing Chinese demand for raw materials. Otherwise, the negative terms of trade effects that have effectively helped squeeze real disposable incomes in the US - and to a lesser extent in other G7 countries - will intensify during 2005. The US$ is going to have to fall further in trade-weighted terms. But a realignment against the renminbi might arguably have the added benefit of capping the rise in raw material prices. The renewed surge in oil prices, with crude nearly touching US$50 again yesterday, should certainly be seen as a warning in this context. All eyes will be on the Bank of Japan in the coming weeks.