Bad yen falling

John Mauldin | Mauldin Economics | 26 November 2014

> I see a bad moon arisin', I see trouble on the way. I see earthquakes and lightnin', I see bad times today.
>
> I hear hurricanes ablowin', I know the end is comin' soon. I fear rivers overflowin', I hear the voice of rage and ruin.
>
> Don't go 'round tonight, well, it's bound to take your life. There's a bad moon on the rise.
>
> – "Bad Moon Rising," John Fogerty, Creedence Clearwater Revival, 1969

As I write [23 Nov], the yen is 117.8 to the dollar, having fallen modestly from the mid-118s yesterday. Shinzo Abe was nominated to be Japanese prime minister for the second time on 26 September, 2012 and it was clear that he would win. He implemented a program that has since come to be called Abenomics. Japan was suffering from a 35% loss of competitiveness vis-à-vis their most important trading competitor, Germany, because of a rather steep rise in the yen (for reasons we will examine later). For the first time in generations, Japan's trade deficit had gone negative. The interest-rate market was beginning to bounce around, which was a death knell for Japan. Abe made no bones about it – he would replace the controlling members of the Bank of Japan with members who agreed with him that massive quantitative easing should be undertaken.

In Figure 1 below, notice that as it became clear that Abe would win, on cue, the yen began a nosedive from 75 to the dollar to slightly over 100 to the dollar and then went sideways for about a year and a half. The Halloween 2014 announcement by the Bank of Japan to double down on its quantitative easing started the recent frozen-rope-like plunge, taking the yen almost straight down to 118 and on its way to 120 in very short order. Goldman Sachs has forecast that the yen will be at 130 by the end of 2015, 135 by the end of 2016, and at 140 by the end of 2017. That rhymes with the prediction of my friend Kiron Sarkar, whose target is 125 in the first half of 2015.

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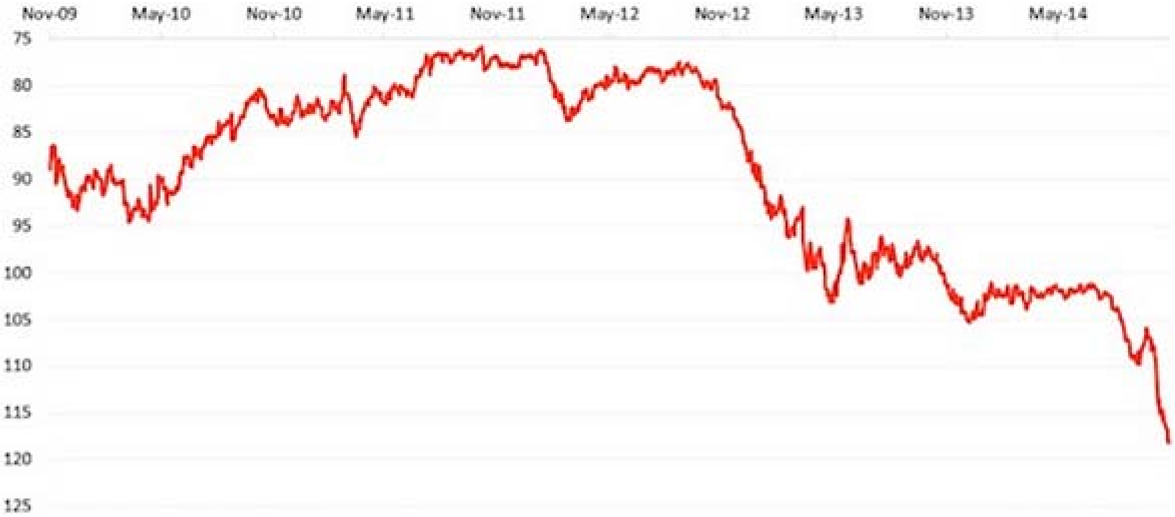
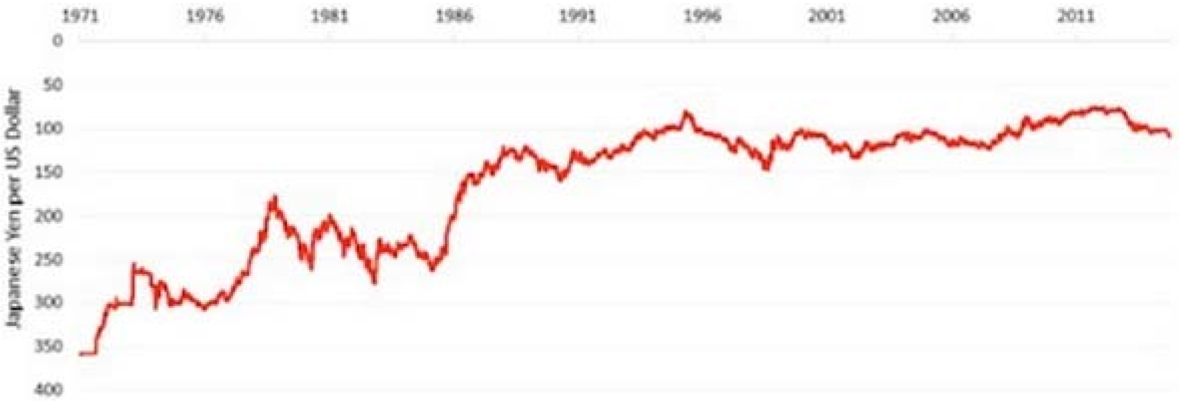
Figure 1: The Yen has depreciated by more than 40% since Abenomics announced
(USD/JPY exchange rate, November 2009 – November 2014)



Sources: Bloomberg

Make no mistake – the Japanese are not at all concerned that the yen is going to 130 or 140 or 150. While we tend to see the recent move as precipitous, it may be helpful to walk in the other man's shoes, so to speak, and see the currency move from the long-term Japanese perspective. A little over 40 years ago, the yen was at 350 to the dollar. Less than two decades ago it was at 150. Then it strengthened all the way to the mid-70s. Even if the yen were to eventually fall to 200, as I predict it will, that's not even a 50% reversal.

Figure 2: The Japanese Yen has a LONG way to fall
(JPY per USD exchange rate, 1971 – 2014)



Sources: Bloomberg

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Japanese industry has had to suffer the yen's rising almost fourfold over the last 40 years. If the dollar were to rise as much, there would be much weeping and wailing and gnashing of teeth, and the usual suspects in the Senate would be up in arms about currency manipulation. Japanese businesses just cut costs and improved quality and competed heads up. Oh yes, it's been nasty for the last two decades as their nominal GDP has been flat, but their corporations are still some of the most competitive in the world. You put a currency devaluation wind at Japanese corporations' backs and watch how competitive they become. Cue serious worry from businesses located in Germany, Korea, and China.

For new readers, let me briefly describe what is happening in Japan. Japan's debt-to-GDP ratio is roughly 250%. If interest rates were to rise by 2%, it would take 80% or more of their tax revenues just to pay the interest. That is not a working business model. Therefore, they can't allow interest rates to rise. The only way they can accomplish that is for the Bank of Japan to become the market for Japanese government bonds (JGBs). And that in fact is what has happened. When the Bank of Japan momentarily withdraws from the 10-year JGB market, nothing trades. The Bank of Japan IS the market today.

The strategy for dealing with the Japanese debt is threefold:

1. They have to create a positive nominal GDP, which means they need at least 2% inflation and 2% real growth. They have had neither for over 20 years, so this is not going to be easy. They have tried "modest" amounts of quantitative easing in the past. The only way they can create inflation is to undertake massive quantitative easing through monetary printing. However, if you do that, you are in effect going to lose control of the value of your currency. It's one of the basic laws of economics - you can control either price or quantity but not both.

2. They need to move an enormous amount (70%?) of that debt onto the balance sheet of the Bank of Japan, thereby effectively erasing it. To point out that a move like that has never been successfully executed in the history of the world, or at least not without significant economic upheaval, is not stretching the point. The Japanese are embarking upon one of the greatest economic experiments in human history. They are doing experimental surgery on their economic body without benefit of anesthesia. See the note below on the willingness of the Japanese population to endure pain.

3. They need to slowly balance their budget so that at some point, far off in the future, they will be able to actually allow interest rates to float at a level where they will be able to manage the debt, which means they have to run a primary surplus (at a minimum) in their budget. Given that they are running 7% deficits (and have been for some time), that point in time is well into the future. Abe himself does not project a balanced budget until 2020. And given the nature of the experiment they are

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> conducting, you can have absolutely zero confidence in any budget projections that far out. Maybe it happens, maybe it doesn't.

If you live in Japan, you really should be taking precautions. If you don't live in Japan, you should be anticipating what this is going to do to you. This is not Zimbabwe or Argentina printing money – Japan is important to the global economy. What they do affects everything.

With the recent increase in quantitative easing, the Bank of Japan is now monetising more than double the amount of the deficit that the government is producing. That means they are slowly moving the debt onto the books of the Bank of Japan, perhaps in the range of 7% to 8% per year. If they can actually begin to reduce their fiscal deficit, then, at the level of quantitative easing they are currently doing, the amount of actual debt monetisation will begin to rise slowly, to perhaps as much as 10%, rising to 15% a year over the very long haul. This would get them to the point where they could withdraw from their QE program and allow the market to set interest rates.

This is something you must understand – this process is going to take many, many, many years. They are not going to stop quantitative easing next year or the year after or the year after that. If they don't get the inflation they need, we will get another "shock and awe" announcement from Haruhiko ("just call him Colin" [Powell]) Kuroda, which will have every bit as much impact as the original shock and awe campaign did in Iraq in 2003. And while it won't be as physically destructive, let us be clear – this is central banks at war. And there will be collateral damage. And, most central banks, especially those of the emerging markets, only have a knife to bring to a gunfight.

Why would the Japanese people tolerate the value of their currency dropping by more than half, increasing the cost of energy and other imports? The answer to that is a point that my friend Louis Gave makes time and time again, as he did in a missive this week:

> With Japan in the middle of a triple-dip recession, and Japanese households suffering a significant contraction in real disposable income, it might seem at first that Prime Minister Shinzo Abe has chosen an odd time to call a snap election. But that conclusion would ignore the two iron-clad rules of investing in Japan that we never tire of repeating:
>
> Rule #1: Never underestimate the amount of pain that the Japanese will willingly bear, as long as the pain is taken together, and is seen to be borne for the good of the community.
>
> Rule #2: Never underestimate the willingness of Japanese policymakers to test Rule #1.

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