Japan: how much higher will the yen go?
Ian Rowley

A supercharged currency could derail a Japanese recovery. Toyota and other exporters hope for relief, but the government seems unworried.

After suffering through a year's worth of Lehman shokku ("Lehman shock"), Japan is getting back on an even keel. The Japanese economy contracted at a double-digit pace between October and March but is growing again, rising an annualized 2.3% between April and June. The Nikkei 225 stock index has stabilized at around 10,000, almost 50% higher than the two-decade lows experienced in March. And while the business community has not greeted the new Democratic Party of Japan government with high expectations, so far Prime Minister Yukio Hatoyama has at least made no major missteps.

Yet one problem that shows few signs of receding is the strength of the Japanese currency. The yen, which surged last fall in response to the economic crisis, remains stubbornly high, particularly against the dollar. In recent weeks the yen has hovered close to January's 13-year high of 87.10 to the dollar, causing market watchers to speculate that the currency could close in on the 1995 all-time high of 79.75. Daisuke Uno, chief strategist at Sumitomo Mitsui (8316.T), expects the currency to barrel its way through that barrier. He told Bloomberg News on Oct. 15 that the dollar may weaken next year to a record-setting 50 yen. "The dollar's fall won't stop until there's a change to the global currency system," Uno told Bloomberg.

Even if the yen doesn't get to that level, more strengthening would hammer Japan's ailing exporters, since economists say that an appreciation of every 10 yen cuts corporate profits by about 15%. The currency, combined with slumping demand, is a big reason Toyota (TM) expects to post losses for a second straight year. "If the yen were to go to 70, you could switch off the lights in Toyota City," says Jesper Koll, CEO of Tantallon Research Japan.

A win for Korea's won

Making matters worse for the Japanese, their rivals in Korea, such as Hyundai Motor and Samsung Electronics, don't have the same worries. In the last two years, while the yen has surged by more than 25% against the dollar, the won has weakened against the greenback by 20%.

As painful as the strong yen is, though, Japan's new government has so far been unwilling to take steps to weaken it. Finance Minister Hirohisa Fujii implied at a press conference Oct. 7 that the government doesn't intend to intervene in the currency markets. "We would consider taking some kind of measures if the foreign exchange market moves abnormally," he said, but "we are now at the stage of monitoring the market calmly."

What gives? One likely reason for the DPJ's inaction: Intervention by Japan alone would likely have a minimal impact. Much of the current yen strength against the greenback, for instance, stems from the weakness of the dollar worldwide. Without a clear commitment to a stronger dollar from Washington, "it's hard to think of anything the DPJ could do," says Kyohei Morita, an economist at Barclays Capital in Tokyo.

Indeed, to a large extent the new ruling party is not unhappy with the current situation. "The DPJ prefers yen appreciation," says Nomura Securities economist Takahide Kiuchi.

"They think a stronger yen is good for consumers." The DPJ campaigned on vows to create a more balanced Japanese economy, one less beholden to exports for growth and instead more reliant on consumer spending. By making imported goods cheaper, a stronger yen would hurt exporters but benefit consumers.

Of course, the risk of ignoring the strong yen is that exporters, wary of lost competitiveness at Japanese plants, will begin moving production offshore, shedding jobs and undermining household income. So far, though, there are few signs of that happening. To be sure, automaker Nissan (NSANY) will transfer Japan production of a subcompact to Thailand next spring, and Honda (HMC) has delayed the production of two new auto plants in Japan, but none of the country's nine major automakers has said it will permanently shutter a domestic plant. Although Toyota plans a temporary closure of a production line at its Takaoka plant that makes the Vitz and other subcompact cars, the company insists it has no plans to take more radical action.

A revived carry trade?

Despite the burden of overcapacity and underused workers, a wait-and-see approach might not be such a bad idea. Japanese exporters have been gradually increasing output in recent months as global demand, aided by stimulus packages, has stabilized. Meanwhile, having been caught out badly when demand slumped and the yen surged, exporters have undertaken huge cost-cutting measures. And as painful as the strong yen is at the current level, it is at least a little more stable. The yen rose, almost unchecked, from 110 in August 2008 to below 90 in January, but despite the recent spike to below 90, it has generally floated between 90 and 100 throughout 2009.

Despite the extreme warnings of another yen surge, there might also be some relief in sight. Economists are already predicting the return of the yen carry trade, with investors borrowing money in Japan and investing in higher-yielding assets overseas. For much of this decade, with the Bank of Japan keeping interest rates at near-zero levels, investors borrowed yen cheaply and then converted the currency into investments with higher returns. That depressed the yen, which reached a 22-year trade-weighted low in real terms against other currencies in 2007. But the trend reversed suddenly with the onset of the global financial crisis as other countries slashed interest rates and investors backed away from riskier investments.

However, in the months ahead, central banks around the world—with the notable exception of the Bank of Japan—are expected to begin moving away from low-interest-rate policies as the global economy edges out of recession. On Oct. 6, Australia's central bank became the first to act, raising its core interest rate from 3% to 3.25%.

With Japanese gross government debt approaching 200% of gross domestic product and consumer prices continuing to fall, though, the Bank of Japan is likely to act much slower than counterparts elsewhere. The core consumer price index, a measure of price changes which excludes volatile fresh food prices, fell 2.4% in August, compared with a year earlier. That was a record decline for the fourth month in a row. Richard Jerram, an economist at Macquarie Securities (MQG.AX) in Tokyo, projects the U.S. Federal Reserve may begin raising interest rates in the next six months, but he doesn't expect Japan to follow until deflation is in retreat—something he doesn't see happening until at least 2012. "The story for next year should be carry trade," says Jerram. "Japan will not be raising rates due to deflation while other major economies move, so I think that takes the yen lower." For Japan Inc.'s big exporters, that's a tonic that can't come soon enough.

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