



Japanese should buy yen

Intervention in currency markets is a bad thing: China's fixed exchange rate, for example, has created a dangerous global imbalance. But Japan now has the chance to get rid of the unnecessary foreign currency reserves it built up in previous interventions and boost the weak yen at the same time.

The yen now trades around ¥120 to the dollar and has fallen even further against the euro. Its trade-weighted index is at an eight-year low. The falling yen upsets Japan's competitors because it makes their own industries less competitive. It also increases the risk of a sharp and disorderly rise in the yen at some point in the future.

On fundamentals the yen looks cheap. The normal yardstick – purchasing power parity – means little because Japan's non-tradeable sector is so inefficient. But profitable exporters and large trade surpluses point to an undervalued currency. Trade surpluses normally push a currency up, not down. The yen is falling, however, because returns on capital in Japan, with interest rates at 0.25 per cent, are low. The result is sales of yen in order to invest in higher-yielding assets overseas.

Some of these sales are carry trades: hedge funds borrowing in yen to buy higher-yielding currencies like sterling. Their scale is hard to judge because many deals are done using derivatives. But Japan's domestic investors are probably just as important: high street banks in Tokyo advertise time deposits in pounds, euros and dollars. Japanese corporations, meanwhile,

can buy foreign assets more easily than foreigners can buy in Japan.

The fall in the yen is not a pressing economic problem, despite efforts by some European officials to put it on the agenda of the G7 finance ministers' meeting later this week. But with some simple measures Japan could boost the yen and its economy at the same time.

The Bank of Japan should not raise interest rates: given weak economic data and the lack of inflationary pressure that would be folly. But it could start to reduce the \$875bn in foreign exchange reserves it built up in earlier years to stop the yen appreciating.

Those reserves are dead money that the BoJ could better employ elsewhere: other central banks, like that of China, would love such an opportunity. But most of all, selling down reserves would demonstrate to the world that Japan's currency interventions work both ways, and that it is interested in the stability of the yen rather than in keeping it permanently undervalued.

Selling reserves would be a one-off measure: the long-term solution is more domestic consumption, which would lead to higher interest rates and a lower trade surplus. That means getting Japanese corporations to reduce their high levels of saving, perhaps by exposing them to takeovers, or changing the corporation tax to favour dividends. But for now, carefully managed sales of Japan's foreign exchange reserves would do a lot of good. ■