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Japan's Choice Will Weaken Yen But Fail Economically

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Japan's central bank chief insisted Friday that his aggressive new monetary policy is aimed solely at restoring growth by giving the Japanese economy a dose of inflation. It's not, he said, about weakening the yen.

But sadly, a softer currency is pretty much all the Bank of Japan will deliver. Both growth and inflation--at least the broad-based form of consumer-price inflation that Japan needs--will be hard to come by.

Notwithstanding Bank of Japan Gov. Haruhiko Kuroda's denial of any explicit intent to weaken the yen, a sliding currency is an unavoidable outcome of his plans for a massive monetary expansion and is central to the paradigm-shifting strategy. But it is a wrongheaded approach for tackling Japan's decades-old scourge of deflation and slow growth. And that's because it's likely to deliver the wrong kind of inflationary pressures.

Inflation comes in two forms. The first is demand-pull inflation, a more benign force that's a byproduct of increased demand and economic growth. The second is cost-push inflation, a troubling, growth-killing phenomenon that arises out of the cumulative impact of higher input costs.

It's the latter that Japan's policies are apt to produce.

Japan's economy is not in balance. It relies primarily on exports to drive growth with few incentives to stimulate domestic spending. It is a culture built on saving, not spending, and breaking that psychological barrier will be a Herculean task, one that depends on elected government officials instituting structural reforms, not on the BOJ cranking up its printing presses.

Japan hopes to stimulate spending by driving domestic prices higher. By creating the expectation of future inflation, the theory goes, people will do the opposite of what they are doing under the current deflationary situation, a scenario in which they defer spending in the belief that falling prices will make shopping cheaper in the future.

But because the depreciating yen is creating cost-push pressures rather than demand-pull inflation, that positive outcome is harder to generate. The sought-after virtuous circle of rising prices, spending and incomes will be elusive while a more vicious circle of rising input costs, falling incomes and stagnant spending lands in its place.

A weaker yen will raise input prices for Japanese producers, especially for energy and other commodities that resources-starved Japan must import in massive quantities.

Even if final prices are increased, companies won't be able to pass on the higher costs to consumers. Without a commensurate increase in incomes across the board, this one-time inflation effect won't be sustained in the way the authorities need. Consumers will see their purchasing power eroded and will pull back or divert discretionary spending. Growth will be the victim.

But what about the coming Japanese export boom, you may ask. Well, with demand weak in the global economy, exporters can't sufficiently pass on higher input costs to overseas customers and so will suffer margin compression even if a weaker yen helps boosts their market share. That in turn will limit their ability to create jobs, pay higher wages and stimulate growth and spending.

In fact, competing overseas companies will likely cut prices to mitigate Japan's new currency-driven advantage and to protect market share, even at a cost to their own margins. They may even petition their governments for higher tariffs or subsidies or, in a worst case, lobby them to embark on their own competitive devaluation strategies.

The U.S. case is telling. A weaker dollar--the byproduct, not the supposed intention, of the Federal Reserve's "quantitative easing" policies--has not produced inflation or higher interest rates, and that's within an economy of spenders. The policy has raised equity and other asset prices but hasn't produced a broad-based wealth effect that spurs expenditures. QE may have prevented deflation, but it hasn't ignited the spark of inflation.

Japan already has deflation. And it's an entrenched, psychological phenomenon that cannot be easily broken, especially if the rest of the world is in the throes of deleveraging. Quite simply, global forces will depress prices and constrain Japan's ability to raise them domestically.

So under current policies the Japanese economy is doomed to stay its painfully weak course until global demand picks up. Only then will classic monetary stimulus efforts be effective. Until then, the country needs fiscal reforms, a shift in the government's mix of tax and spending policies that reorients its economy toward domestic consumption. That's the way to properly kill deflation.

Still, for currency traders betting on a weaker yen, the good news is that the expected failure to make those reforms will one way or another see their wishes fulfilled. Just don't expect the Japanese economy to spring back to life.

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