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Kuroda's move will unleash copycat loosening

With the announcement by Haruhiko Kuroda, the Bank of Japan's new governor, of the doubling of the monetary base within the next two years at most, the Japanese authorities committed to do "whatever it takes" to achieve their newly assigned objective — an inflation rate of 2 per cent. Two questions should be raised. First, why such a drastic step up in monetary expansion? Second, will it work?

The official answer to the first question is: to end the deflationary trend that has affected the economy for more than a decade, including in recent years. From 2007 to 2012, the price level as measured by the gross domestic product deflator fell by nearly 7 per cent in Japan, against an increase of about 8 per cent both in the US and the eurozone. Deflation can produce recessionary effects if it induces economic agents to postpone consumption and investment decisions in the expectation of benefiting from lower prices in the future.

Accordingly, the 15 per cent change in relative prices observed in recent years between these leading industrial regions should have generated widely divergent economic performances. On the contrary, looking at GDP per capita, which adjusts for population growth, Japan outperformed the US and the eurozone in the past five years. The country's unemployment has almost fallen to pre-crisis levels, and jobless rates are still far higher in the other two areas. According to most recent forecasts, in the next two years Japanese income per head will grow at the same pace as that of the US, in spite of a continued fall in the price level. Overall, the Japanese economy does not seem to be that hindered by falling prices.

The real problem might, in fact, be how to tackle Japan's 250 per cent – and rising – debt-to-GDP ratio, which needs to be financed at a sustainable interest rate. Having the central bank buy a large chunk of the debt certainly makes the task of the government easier, independently of whether the inflation rate is negative or positive.

The answer to the second question – will it work? – depends on the use made by investors of the central bank liquidity received in exchange for government bonds. If they suddenly decide to step up consumption and investment, aggregate demand may rise beyond potential growth, creating inflationary pressure. However, the impact of a marginal reduction in long-term interest rates on the propensity to consume of an ageing society with high savings levels should not be taken for granted.

Another possibility is that investors will use the new liquidity to purchase assets with higher yields. Given the scarcity of such assets in Japan, investors can be expected to look to foreign markets. It is no surprise that the first impact of the BoJ announcement was to cause the yen to sharply depreciate against other leading currencies and to decrease yields on US Treasuries. Such an effect is likely to encourage further capital outflow in the future, when the new policy is implemented.

A continuous depreciation of the yen would certainly help bring about a higher domestic inflation rate, as imported goods would become more expensive. In addition, exports would be more competitive in foreign markets, contributing to higher employment in Japan, higher demand and hopefully higher inflation over time.

To sum up, the effectiveness of the BoJ’s new policy in achieving a higher inflation largely relies on the impact it has on the yen exchange rate. This result will depend, however, on one assumption — that central banks around the world will not react to the BoJ move. This in itself raises a few questions.

First, will central banks in other Asian countries accept an appreciation of their currencies against the yen, and the attached deflationary effects, in a period of economic weakness? It is safe to assume that monetary authorities elsewhere on the continent will try to step up foreign exchange interventions in order to increase the monetary stimulus for their own economies. In that case, foreign exchange reserves should be expected to rise further to record highs in coming months.

Second, how will emerging markets’ central banks react, in particular in Latin America and eastern Europe, where economies have sharply decelerated? The incentive might be to further loosen monetary policy with a view to avoiding excessive capital inflows and an appreciation of their currencies.

Third, how will the BoJ’s new policy impact on the US Federal Reserve exit strategy from quantitative easing? Several Fed policy makers were recently pointing to the possibility of a gradual phasing out in the course of the next few months. However, if the appreciation of the dollar against other Asian currencies creates a new threat to a still fragile US recovery, it would be fair to expect that the phasing out will be further postponed. Asset purchases might even be stepped up if needed, to keep to the commitment of doing whatever it takes to bring unemployment down (so long, that is, as inflation is well anchored, as it seems to be).

Fourth, how will the Bank of England react? Probably in the same way as the Fed, except that instead of postponing the phasing out, the new BoE asset-purchase programme would be accelerated.

Finally, if the yen depreciates substantially against the euro, will that not seriously threaten economic growth in Germany, Japan's greatest competitor in the high-end manufacturing sector, possibly undermining the only part of the eurozone that still hopes to escape from the European recession? Under these circumstances, would it not be fair to assume that a long-awaited consensus in favour of a further rate cut would quickly emerge in Frankfurt? There might even be room for some more aggressive non-standard measures aimed at avoiding a deeper than expected recession.

As the ECB has repeatedly stated recently, while the exchange rate is not a target for monetary policy, it certainly affects growth and inflation. The euro exchange rate might seem to be in line with the historical average, but is certainly overvalued if measured in terms of relative cyclical conditions.

All in all, the assumption that the other central banks will passively observe the BoJ's new policy and the weakening of the yen may prove unrealistic. It might be more reasonable to expect that the Japanese announcement will be followed by a round of monetary easing around the world. These reactions will partly compensate for the initial impact of the BoJ's decision on the yen exchange rate.

However, the less the yen depreciates, the less the BoJ's policy will be effective in raising inflation and thus achieving its target. This has been the experience since the start of the crisis, when Japan led the way to a generalised increase in central bank monetary base. The BoJ's balance sheet started rising from 20 per cent of national income in 2008 to 30 per cent in 2011. The Fed and BoE followed, from 5 per cent to more than 15 per cent during the same period; and the ECB from 15 per cent to 30 per cent.

The lesson drawn from this generalised development – at least from the Japanese side – was not that extreme monetary expansion is ineffective in tackling the problems faced by advanced economies, but rather that much more is needed. If this lesson is shared by others, we might have just started a new spiral of sharp liquidity injection around the world. The consequences are difficult to forecast, but the risk that the seeds of the next crisis have been sewn should not be underestimated.

It cannot really be called a currency war, because each central bank takes its own decisions primarily with the aim of achieving price stability in its own jurisdiction. But if each monetary decision has an impact on other parts of the world, through the exchange rate channel, it will inevitably lead to a chain reaction. It is the same type of reaction that a tariff increase provokes – and we know from the experience of the 1930s what it might do to the world economy.

So, it might not be a currency war. But the first salvo has just been shot.

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