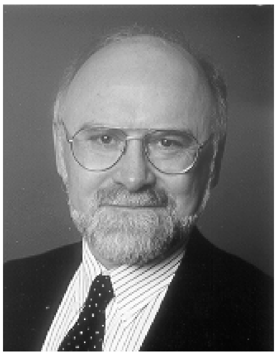
Editorial



Wolfram Schrettl, PhD,
Head of the Department of
International Economics, asks:

'Against the yen:
a rejected one-way bet?'

For quite some time now, economists from Paul Krugman to Lars Svensson, but also editorial writers and even the present (as well as the previous) finance minister of Japan have all been leaning ever more heavily on the Bank of Japan (BoJ) to act resolutely against deflation. Not that the BoJ is not moving. It is even moving in the right direction. Money market interest rates have been lowered all the way down to zero, and a mild form of inflation targeting has been introduced. Deflation, however, continues unabated.

Small wonder, say the critics, given that the BoJ has been balking at just about every individual step. In other words, it was always 'too little, too late.' Right now, it is the call for full-fledged inflation targeting that is being rejected by BoJ board members. Their argument is that corporate and bank sector restructuring, not monetary policy, should revitalize the economy. (No explanation given of why the two should be mutually exclusive rather than complementary.) Moreover, BoJ points to the lack of success of its zero interest rate policy and to the excess reserves that are sitting unutilized in Central Bank accounts. This, according to BoJ, is evidence of the futility of monetary policy under the given circumstances and, for that matter, is also in line with textbook wisdom: 'you cannot push on a string.' Tellingly, however, the Bank concedes that it has not yet fully exploited the possibilities for monetary loosening. Further steps in that direction, so the argument goes, would entail the risk of rising long-term interest rates. In particular, the BoJ is rejecting calls for heavy direct buying of long-term government bonds.

The hope of those despairing about the BoJ is now focusing on the exchange rate of the yen. A strong devaluation, according to the recommendation, could turn the Japanese economy around. Until recently, however, the markets saw an appreciating yen. Given the extremely low Japanese interest rates, the rush into yen may appear surprising. The markets, even in the absence of a Tobin tax (R. I. P.), seem dismissive towards the invitation, implied in the interest rate gap, to move against the yen. As far as the dollar is concerned, the gap is apparently still too small to quell concerns about the unsustainable US current account deficit.

Fortunately, the rush into yen that may seem like a problem could actually be part of the solution. If the BoJ maintains its recent policy of leaving interventions in the foreign exchange market unsterilized, then this would amount to the much-desired further monetary loosening (while possibly also being face-saving for the BoJ). Interestingly, according to most recent reports at least, capital appears to be rushing out of Japan again. It is not clear at this point where that capital is heading. However, the BoJ's implicit guarantee to prevent a further appreciation of the yen may indeed amount to a one-way bet which, in combination with the positive interest rate gap between Europe and the US, begs the question of why the smart money is not accept-

ing that bet and is thus rushing into euro, if worries about the US current account deficit really make the dollar less attractive.

Leaving aside the possibility that a move in that direction is already happening, two residual risks stand out in the euro area. One is the introduction of euro bills and coins next January. Although markets expect this to be a Y2K-type problem, i.e. one that will disappear within the first few weeks of 2002, they nevertheless prefer to wait and see. The other risk is EU enlargement. Again, however, all serious experts dispel the lingering concerns and even associate sizeable net gains and no extra financial burden with enlargement. So this factor also should not really stop Japanese (and other) investors from moving into euro. One may well wonder, then, whether, come spring, that one-way bet offered by the BoJ will remain unutilized for very much longer.