MORE LESSONS FROM JAPAN ZIRP AND ASIA

Russell Clark's
Market Views

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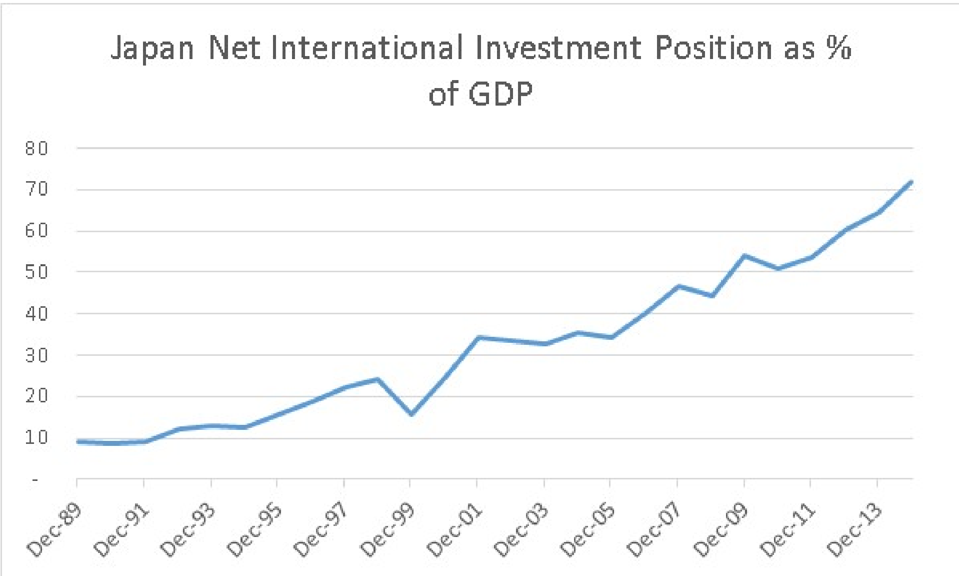
I have long argued that zero interest rate policies (ZIRP) do not create inflation. By suppressing interest rates and printing money, it causes the exchange rate to fall, while making investments overseas more attractive. It particularly makes overseas fixed income investment attractive. This is a very bullish scenario for exporters, as they have a competitive exchange rate, while domestic investors are happy to finance their trade partners' consumption.

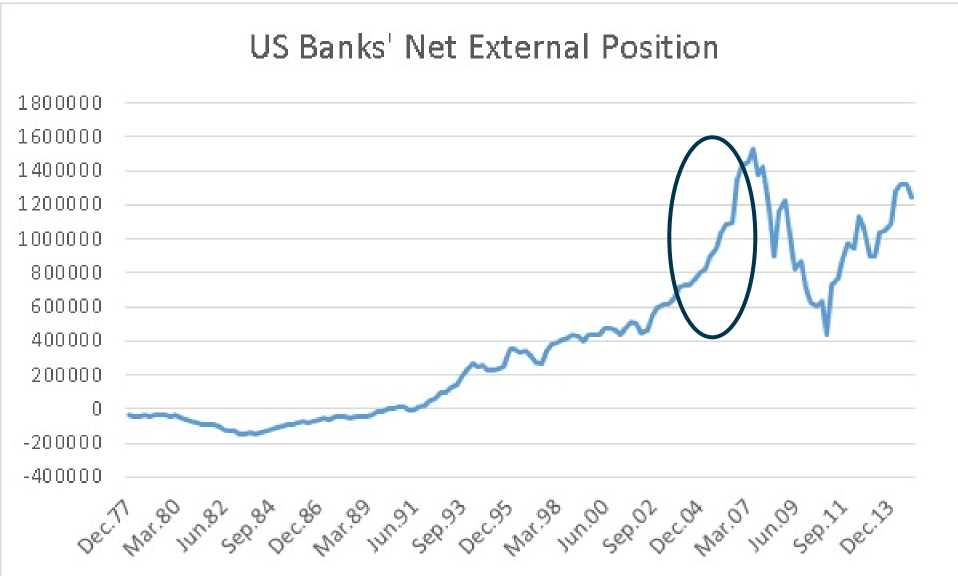
One long term consequence of ZIRP in Japan has been that the Japanese net international position continues to grow. Japan is the largest net investor to the rest of the world in absolute terms.



The problem with QE is that the credit flows tend to be inflationary for the recipient country, while at the same time a devaluing yen creates extremely deflationary conditions for the recipient's exporters. Eventually, the credit flows are no longer strong enough to offset the deflationary force of a weak yen, and the recipient currency begins to devalue. This causes yen to strengthen, and the Japanese banking system to suffer some credit losses. Deflation then tends to return to the Japanese economy. We can observe Japanese credit flows via BIS data (see next chart). In the mid 90s, Japan was the biggest lender and investor to Asia.

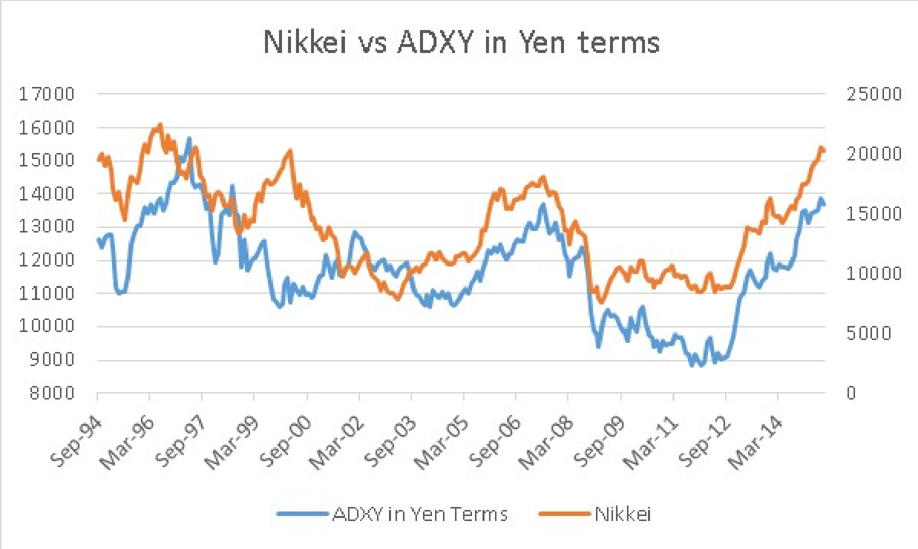
1995 through to 1997 saw the yen weaken against the dollar, and most other Asian currencies as they were on a dollar peg. This was a period when Asian banks saw a big increase in foreign currency debt (a positive number above indicates that Asian banks have more foreign currency loans than deposits).

In a similar vein, the yen devaluation that occurred from 2003 to 2006 caused a surge of Japanese investment into US fixed income assets. We can see this by the surge in the US banks net external position before the financial crisis.

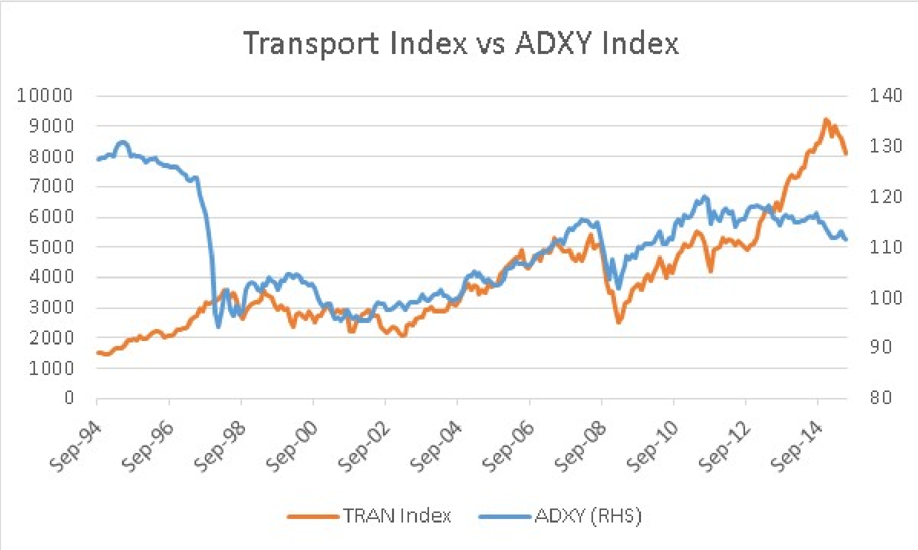


In Asia Pacific Banks' Net External Position chart, we can see that the Asian bank net external position has ballooned far above the levels seen previously. I suspect this is related to the fact that the entire western world now have ZIRP. Furthermore, we have seen sustained devaluations of western currencies and yen against Asian currencies. Unfortunately BIS data tends to be lagging indicator. I have found however, that relative currency movements tend to be good lead indicator.

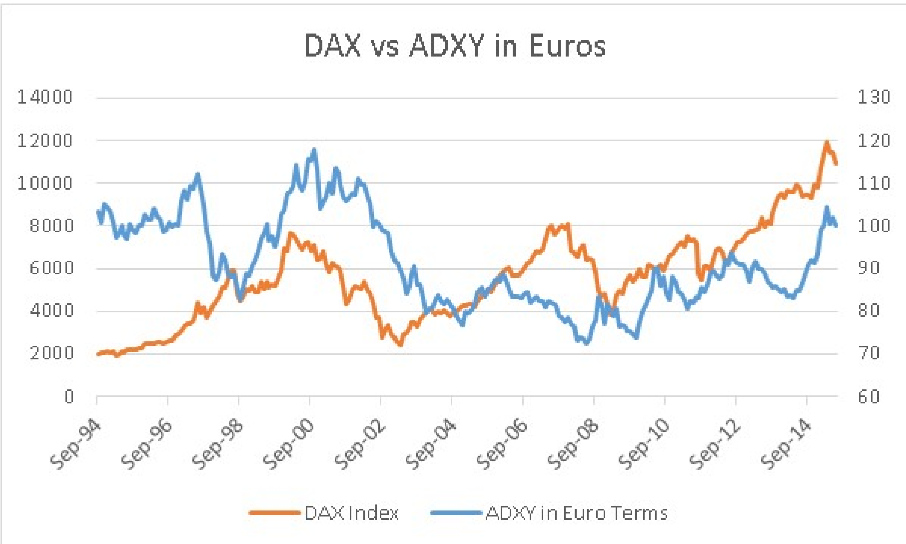
The Nikkei tends to be highly correlated to the movement of yen versus Asian currencies, with the exception of 1999 during the dot com bubble.



Other parts of the western equity markets are also starting to show correlation to ADXY. In the US, we find that Asian currencies and the Dow Jones Transport index had a close correlation until 2012. I suspect the growth of US oil production gave a boost to the Transport index. It seems to me that the old relationship is reasserting itself.



The recently begun QE program from ECB has weakened the Euro versus Asian currencies, which has been bullish for the DAX. Previously there seemed to be little relationship, but that seems to have changed recently.



Referring back to the Asian Bank Net External Position graph, we can see that there has been a build-up foreign debt in Asia ex Japan. While most countries in Asia have a free floating currencies, the Chinese Yuan is still pegged to the US dollar. It seems likely that if China devalued it would take most Asian currencies with it, collapsing the ADXY Index. I suspect market conditions would be similar to the Asian financial crisis.

To gauge how large an effect this might have, at the end of 1996, the total GDP of Asia was around 3 trillion USD, or 63% of Japan's GDP or 40% of US GDP. Now Asia has a combined GDP of 16 trillion USD, or 345% of Japanese GDP or 94% of USD GDP. In my view the Asian Financial Crisis pushed Japan back into recession and deflation. Should Asia suffer a similar crisis again, I suspect its size would push even the US into a recession and deflation.

INFORMATION

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