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Effect of Revaluation of the Yuan on Japan's Economy

Limited impact on Japan's economy as long as the yen does not appreciate sharply reflecting yuan revaluation

Japanese report: 21 Jun 10

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Summary

- **People's Bank of China announces enhancement of forex rate flexibility:** On 19 June, the People's Bank of China (PBC) announced that it had decided to enhance yuan exchange rate flexibility. Following an end to the yuan's peg to the dollar that virtually started in July 2008, expectations that the yuan will gradually appreciate are growing in global financial markets.

- **Effect of revaluation of the yuan on Japan's economy:** For this report, we examined the impact of yuan revaluation on Japan's economy based on quantitative analysis and reviewed the possibility that inflationary concerns in China might lead to a contraction of Japan's economy. According to our quantitative analysis, should the Chinese yuan rise 5% against the US dollar, Japan's real GDP growth would contract about 0.1 point. This result should be interpreted with a certain amount of latitude. As long as the yen does not appreciate sharply, there is no need to be overly concerned about the effect of yuan revaluation on Japan's economy.

PBC announces enhancement of forex rate flexibility

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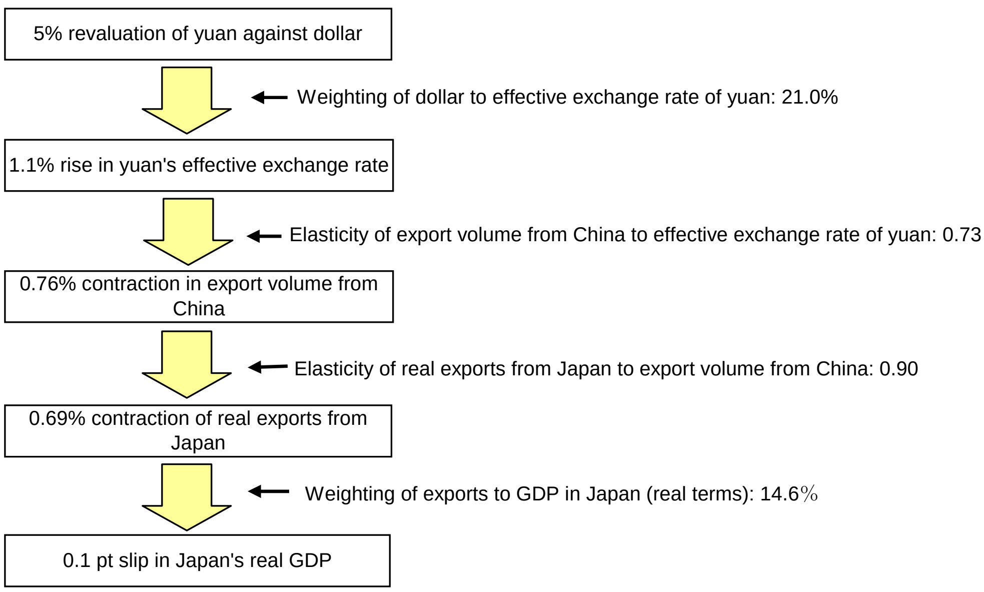
Effect of revaluation of the yuan on Japan's economy

For this report, we examined the impact of yuan revaluation on Japan's economy based on quantitative analysis and reviewed the possibility that inflationary concerns in China might lead to a contraction of Japan's economy. As shown in Chart 1, according to our quantitative analysis, should the Chinese yuan rise 5% against the US dollar, Japan's real GDP growth would contract about 0.1 point. Besides this path, a positive impact can also be imagined, as a decline in China's export competitiveness would enable greater Japanese exports. Thus, this result should be interpreted with a certain amount of latitude. As long as the yen does not appreciate sharply, there is no need to be overly concerned about the effect of yuan revaluation on Japan's economy.

Chart 1

Impact of Yuan Revaluation on Japan's Economy



Souce: Compiled by DIR.

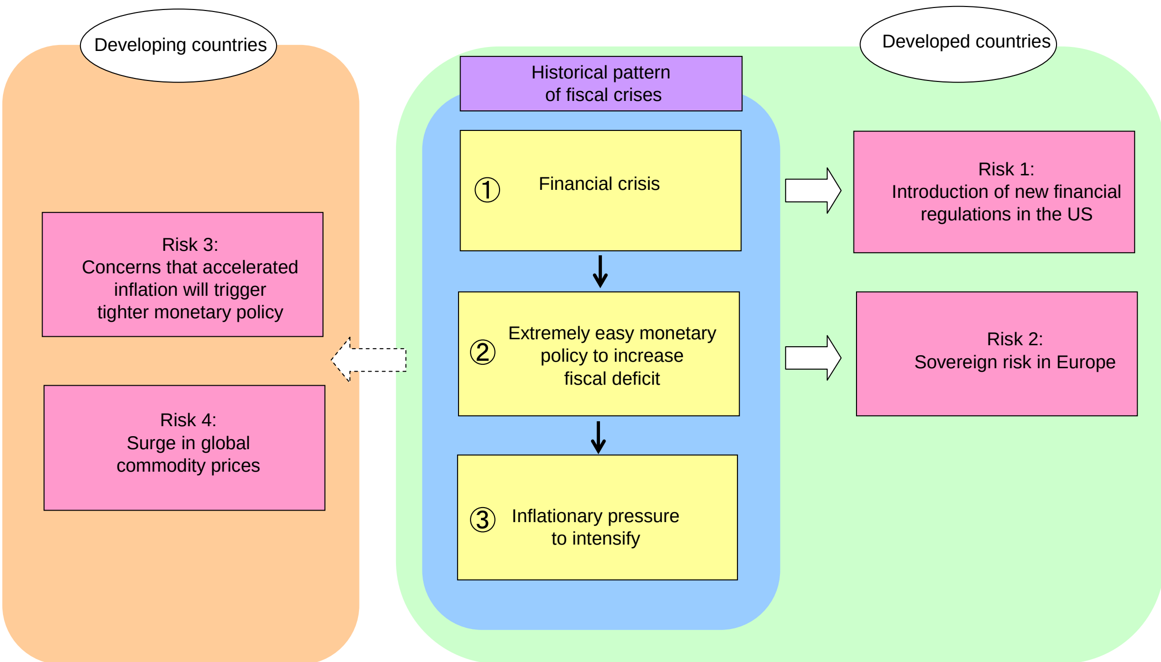
How should global financial market turbulence be understood?

In our main scenario we anticipate that Japan's economy will continue to expand at a moderate pace, supported by recovery of the world economy. At the same time, we have pointed out downside risks attaching to the world economy. In our report issued last week, we reviewed our risk scenario and examined the history of global financial crises over the last hundred years or so to study the reasons for the repeated turbulence seen in global financial markets in recent years (see A Precipice in Front, A Wolf Behind; Repetitive Pattern of Global Financial Market Turbulence, 15 June 2010, Mitsumaru Kumagai). The examination led us to identify a pattern where (1) financial crises are followed by (2) the expansion of fiscal deficits and (3) increased inflationary pressure. Recent global risk factors (new financial regulations of the Obama administration, European sovereign risk, concerns of monetary tightening in China) can be placed within this framework without exception.

Risks not passing issue but expected to smolder over medium/long term as disruptive factors for the world economy

Thus, with the occurrence of (1) a financial crisis, the Obama administration is examining new financial regulations (Risk 1). Also, European sovereign risk (Risk 2) fully corresponds to (2) extreme monetary easing and the expansion of fiscal deficits. Although China was relatively immune to the financial crisis that began in 2008, its stimulative fiscal and monetary policies have heightened concerns that inflation will lead to monetary tightening in China (Risk 3). While this is a possibility that has greatly diminished at the present moment, should commodity prices increase (Risk 4), terms of trade may worsen for Japanese companies. Whether inflation will occur or not in the future will require further examination. In historical terms, however, it will be worth bearing in mind that global inflationary pressure arising in the next three to five years is a possibility that cannot be ruled out. To conclude, the risks that are currently shaking global financial markets are not a passing issue but are expected to smolder over the medium/long term as disruptive factors for the world economy.

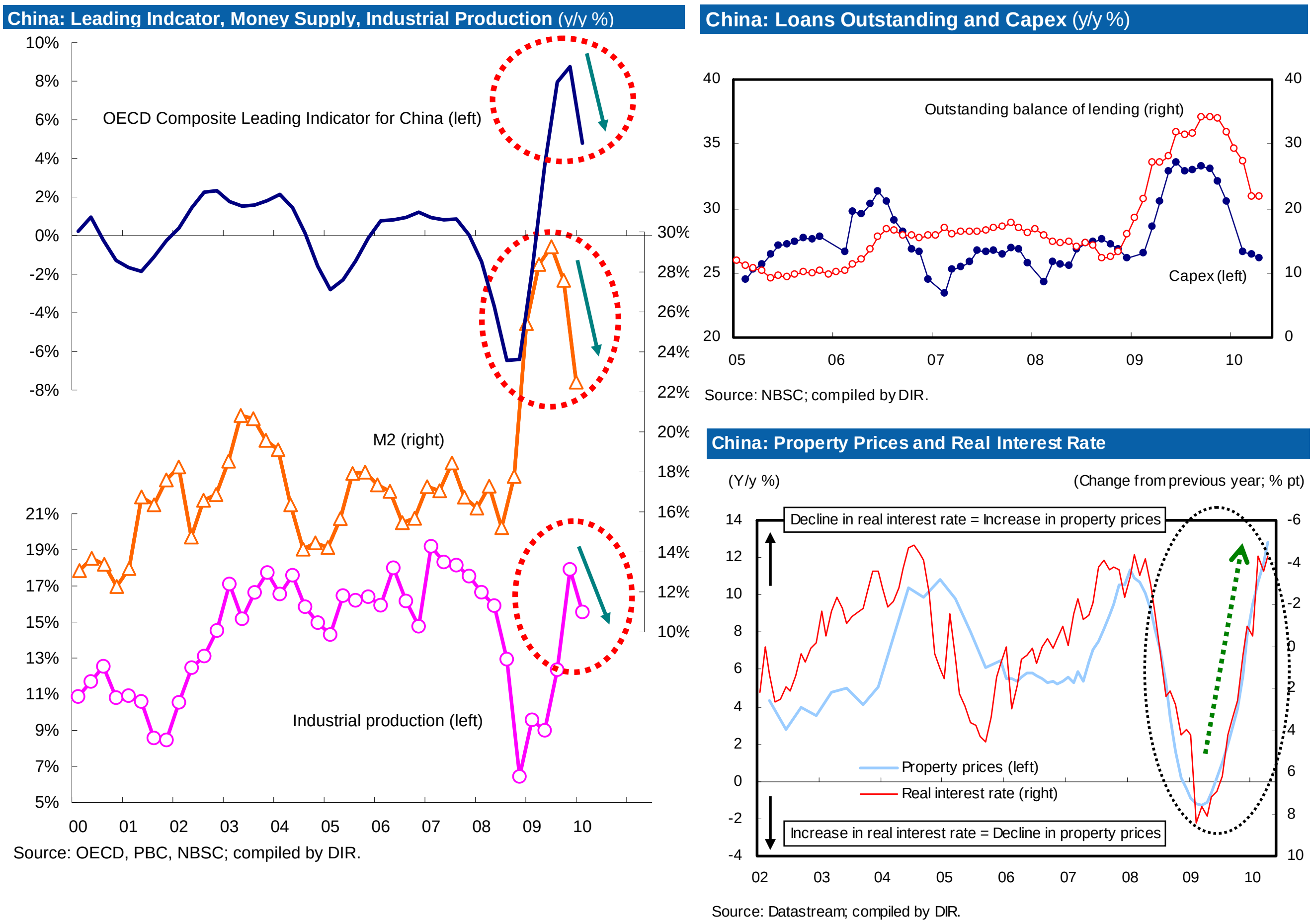
Chart 2: Current Global Economic and Financial Environment in Historical Terms



Source: Compiled by DIR.

Inflationary concerns in China	The biggest downside risk that the world economy faces is that inflation could lead to monetary tightening in China. This is an extremely serious risk factor that could trigger the hard landing of the world economy.
Pace of China's economic expansion to slow	Signs are appearing that China's economic expansion is about to slow. As Chart 3 shows, major leading indicators of the Chinese economy—composite leading indicator, money supply (M2)—have clearly peaked (left graph). Also, as the growth of lending slows, fixed asset investments are decelerating (upper right graph).
Are real estate prices at a dangerous level?	The lower right graph suggests that real estate prices have reached a dangerous level in China. In historical terms, real estate prices and real interest rates have an inverse correlation in China. As the ascent of prices works to reduce real interest rates, real estate prices are climbing at an unprecedented pace.

Chart 3 Growth Pace to Slow in China



China to strengthen monetary tightening stance

There can be no doubt that China will of necessity strengthen its monetary tightening stance. PBC raised its reserve requirement ratio by 0.5 points in January 2010, the first time in one year and seven months. Since then it has raised the reserve ratio two more times.

Little likelihood that China will tighten monetary policy to point of overkill

For the time being, however, we believe there is little likelihood that China will tighten monetary policy to the point of overkill. Chart 4 portrays a possible schedule for macroeconomic policies in China. In 1H 2010, following the lifting of the reserve ratio, the yuan was virtually revalued on 19 June. Should the stability of the US economy be confirmed, PBC can be expected to raise interest rates. In contrast, the timing for the full-fledged restriction of the aggregate amount of loans, which would greatly slow the Chinese economy, will likely be 2011 or later.

Chart 4

China's Likely Monetary Policy Schedule

1H 2010: Hike in deposit reserve requirement ratio; yuan revaluation

Mid-year to 2H 2010: Policy interest rate hike?

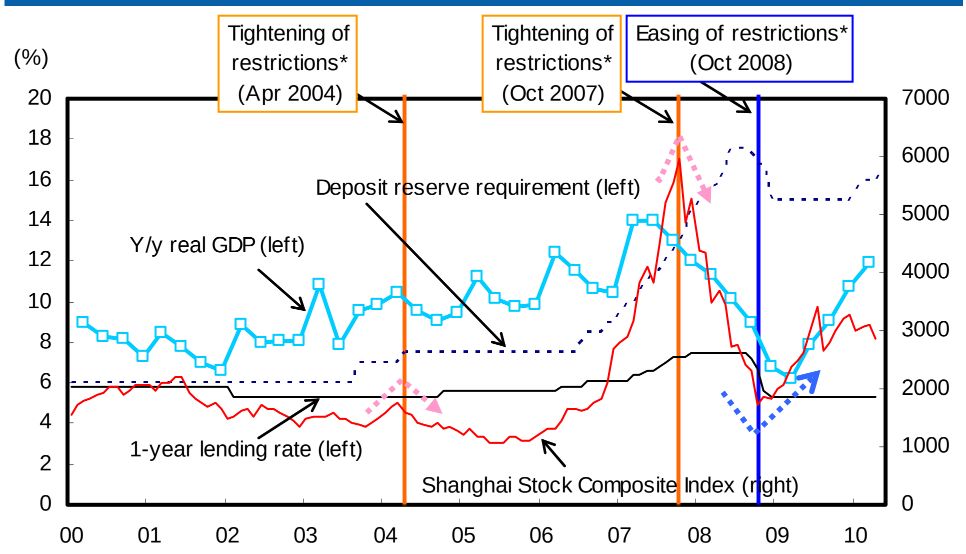
2011 and onward: Restrictions on aggregate amount of loans?

China's economy unlikely to slow sharply until full-fledged restrictions placed on aggregate amount of loans in 2011 or later

The point we want to stress is that China's economy is unlikely to slow sharply until 2011 or later when the placement of full-fledged restrictions on the aggregate amount of loans becomes probable. Chart 5 portrays the relationship between China's monetary policy, the economic growth rate, and stock prices. It should be evident from the chart that such market-oriented operations by PBC as raising the policy interest rate or increasing the reserve ratio are extremely limited in their tightening effect. One should fully bear in mind that, as long as China does not earnestly turn to restrictions on the aggregate amount of loans, monetary policies will likely have only a limited impact on the economy or on financial markets.

Chart 5

Monetary Policy, Economic Growth, and Stock Prices



Source: NBSC, PBC, CEIC Data; compiled by DIR. * restrictions on aggregate amount of loans.

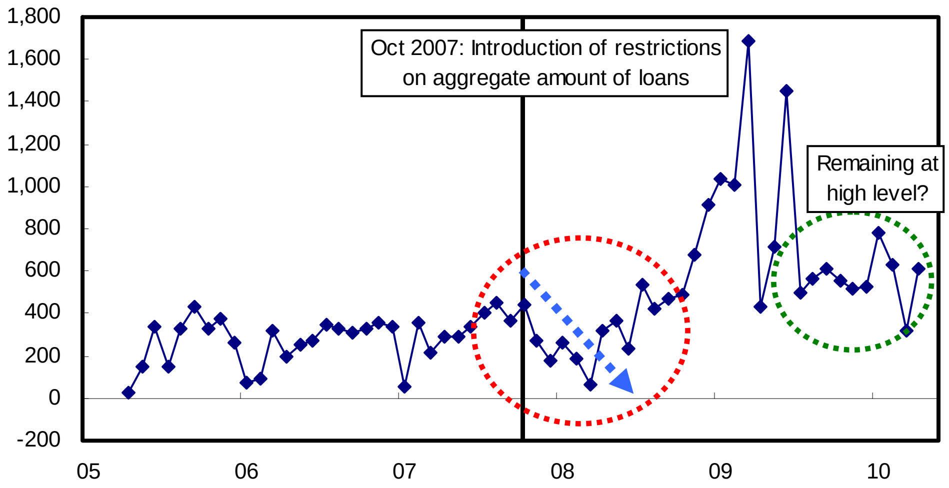
Current policy not full-fledged restrictions on aggregate amount of loans

We are frequently asked by investors as to whether current Chinese policy can be properly considered restrictions on the aggregate amount of loans. Compared to full-fledged restrictions effected in October 2007, current monetary tightening differs in two aspects. First, quantity. Chart 6 shows the amount of bank lending in China (seasonally adjusted by DIR). When full-fledged restrictions started in

October 2007, bank lending fell to an all-time low. In comparison, current tightening is extremely mild. Second, current policy differs in terms of quality. In the October 2007 restrictions on aggregate loans, loans were capped to all industries (macro restriction). Currently, however, restrictions are limited to loans to the real estate industry (semi-macro restriction). Since Expo 2010 Shanghai China is being held this year, there is little likelihood that China will tighten monetary policy to the point of overkill unless (1) crude oil prices surge or (2) a livestock epidemic gives way to higher food prices.

Chart 6

China: Amount of New Loans (Yuan bil; SA)



Source: PBC; compiled by DIR. SA by DIR.

Inflation warrants attention in China

The crucial factor determining the outlook for China's economy is the inflationary trend rather than the economic trend. To begin with, China's economy has exhibited vulnerability to inflationary pressure. Indeed, a remote cause behind the Tiananmen Square incident was rising inflationary pressure. When general prices began to rise, policy measures that the government introduced were unable to hold down inflation, which created political and social turbulence and then brought about an economic hard landing. Minor inflationary pressure in China has been one factor driving the global economy. This situation, however, could mark a turning point. Thus, going forward we will continue to closely monitor the inflationary trend in China.

Abbreviations in sources (alphabetical order): NBSC: National Bureau of Statistics of China; OECD: Organization for Economic Co-operation and Development; PBC: People's Bank of China.