Notes on Financial Markets Vol.130

Reference to exchange rate policy by US administration

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Introduction

President Trump's reference to our foreign exchange policy yesterday caused a substantial shock to our markets. I will discuss its implications for our economic policy, and explore its candidate options.

Reasons for the shocks and initial reactions

From the point of views of our markets, there are several reasons for the shock.

First of all, reference to our foreign exchange policy as the criticism was made by President Trump himself. We had thought that it would be a business of Secretary of Treasury, as it would be desirable to play the role as "one voice". Secondly, President Trump further criticized our massive supply of money as part of foreign exchange policy. Our markets seem to think that QQE has been most effective policy among three pillars of Abenomics.

These are why our policy makers have been prompt enough to make some reactions. Vice Minister of the MOF emphasized that our government has not conduct foreign exchange intervention for years. Both Prime Minister Abe and Chief Secretary of Cabinet Office Kan confirmed that monetary easing by the BOJ has been solely intended to pursue the inflation target. It is also interesting to note that Prime Minister Abe explained at the parliament that the FRB also conducted QEs in order to recover from the global economic crisis.

From the viewpoint of the markets, it could also be argued that the current valuation of USD as measured by PPP against major currencies would not seem to diversify from their "equilibrium" levels, taking into account of the differentials of inflation rates.

Potential counter-argument and its implication

While the above lines of thoughts expressed by our policy makers appear to be rational and reasonable, we may need to take into considerations of potential counter-argument by our counterparty.

For example, economic policy suggests that we should put stress on multi-lateral performance of trade account in evaluating costs and benefits to a national economy. Nevertheless, it could make sense to pay intensive attention to bi-lateral performance of trade account when the politics require to highlight the relationships with some specific economies.

Moreover, my friends in the NY markets implied (at my most recent visit in early January) that the international trade by the US may have become more elastic to foreign exchange rates, as the weight of crude oil in their imports decreases (for the obvious reason). It may bring about some good reasons for policy makers in the US to think more seriously about foreign exchange policies by the major trading partners.

In addition, policy makers in the US could still raise the issue of optimal strength of QQE, even if they could accept our basic line of thoughts (ie. the BOJ has conducted the QQE solely for monetary policy purpose). In fact, if our economy would grow at the pace in line with the economic outlook by the BOJ, extremely large scale JGB purchase as well as maintenance of 10YJGB yield target at 0% could cause some discussion whether it would be excessive or not in pursuing the inflation target.

Potential issues of negotiation

All in all, it might not be efficient or effective for us to seek understanding by our counterparty on our line of thoughts as discussed above. Furthermore, we would need to take into account of this special occasion when the new administration would like to show some "hard facts" of economic policy performances to the voters in early stage of presidency.

It is also important to remember the earlier reactions of the US administration to the announcements of increasing scale of business investments in the US by our large manufacturers. While they were appreciated to some extent, they could not remove their fundamental criticism against our trade surplus to a considerable extent.

These considerations would lead to the idea that there may be reasons for our policy makers to be ready for some policy actions that could directly affect the volume of our exports and/or imports. In fact, this is why the forth-coming bilateral meeting of President Trump and Prime Minister Abe has attracted further attention in our markets.

In contrast, it should be noted that offering some financial assistance to the US as our conventional strategy of trade negotiation would not be so meaningful either.

At some previous occasions, implicit commitment to purchase US treasury note to stabilize both funding by the US government and the long-term interest rates would have played a role of some kinds of compromise between the two economies. One important by-product would be to stabilize foreign exchange rate at the same time.

Under the current conditions where international capital flows are favorable to the US financial markets, it is extremely easy for the US government to sustain fiscal deficits without any specific assistance by our investors.

Longer-run expectations

For the time being, our economy would not be in a favorable position in terms of international trade policy against our most important trading partner.

Nevertheless, it could change as the economic conditions in either economy evolves. For example, if and when the US administration executes extremely large scale fiscal stimulus, causing some damage in the confidence in the US fiscal conditions, it could still make sense for us to offer some assistance to restore such confidence. Apparently, the potential options would include some commitment in investing in the US treasury notes by our investors.

As discussed above, executing such options would help ourselves at the same time thanks to the various channels.

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