

Deflation and exchange rate
 Will easing the money supply bring efficiency?

Monthly Economics Overview

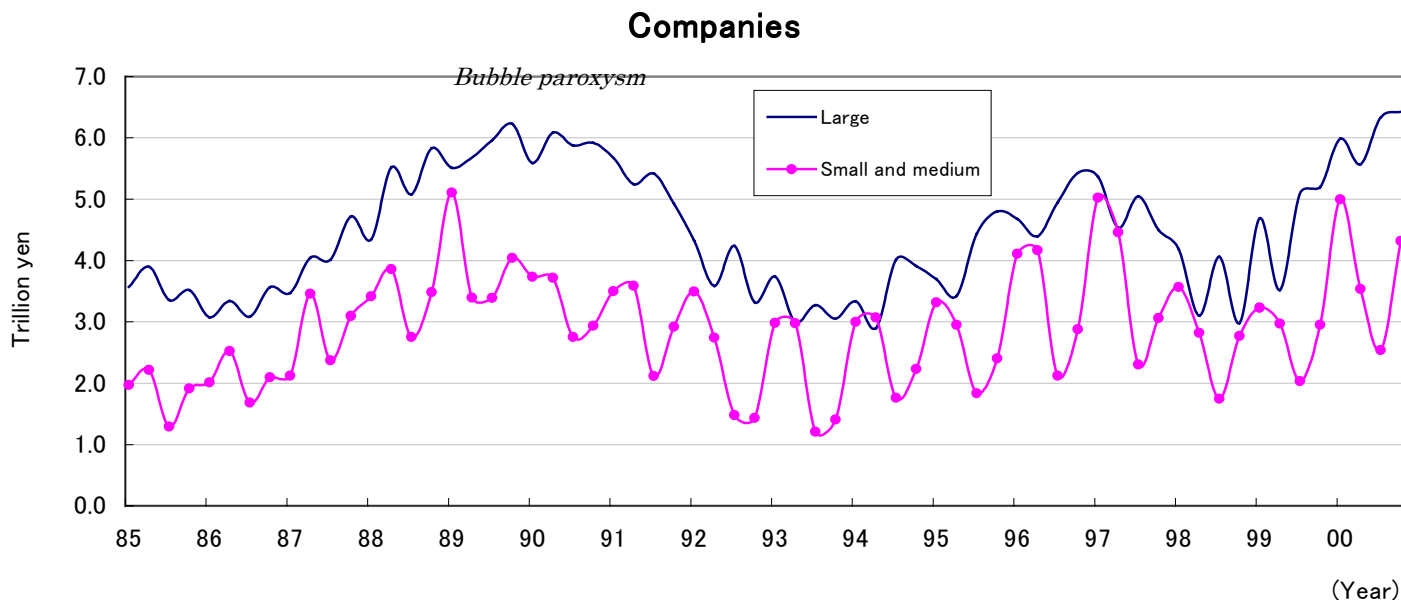
Staff Writer: Eiji Enomoto

Translation: Olivier

"Along with large companies, profitability of middle-small companies shows an important improvement still in process. (...) The profit of the large non-manufacturing companies is surpassing its historical highest level, whereas the profit of manufacturing and middle-small size non-manufacturing businesses is approaching its previous historical peak."

If you were asked which country this analysis is referring to, you would certainly not be able to answer easily. In fact this analysis is in regard the Japanese situation. That Japanese companies are reaching the same level of profit as during the 80's is hard to believe but it is true!

But if Japanese companies are presently outperforming the level of profit they had during the



bubble period, then what is wrong with Japanese economy? The answers continually invoked are the problems of bad debt and structural reform. We must absolutely solve those two problems. Nevertheless, as a doctor, we cannot find the appropriate medication if we cannot recognize the symptoms and determine the cause of the disease.

As far as we are concerned, the main factors that make the patient exceptionally weak are identified: deflation and the increasing value of the yen. We have been told that the surgery is coming; that the constitution is going to improve. The truth is that for ten years the government and the Bank of Japan have been completely disoriented and the measures taken by them inappropriate. In economics a clear distinction is usually made between "good deflation" and "bad deflation", but it does not necessarily mean that a "good deflation" is actually a good medication for a weakened organism. Thus, the decision by the Bank of Japan to ease the money supply is fundamental and we interpret it as a highly important signal.

This measure will probably not result in significant improvement to the Japanese economic situation before at least two years. But we can also expect that the exchange rate will play a determining part in its success. In fact, Japanese deflation is higher on the side of exchange effect than on the one of demand deficiency. The Economic theory tells us that the exchange rate has a converging impact on average purchasing power, but the value of the Japanese yen is far from the range of being applicable to this theory. According to the calculation of the World Bank, Japanese yen is overvalued by approximately 30%, compared to Chinese and Indian currencies which are undervalued respectively by 25% and 20%. This is the main cause of Japanese deflation.

Will easing the money supply result in an inflationary spiral or will it contribute to adjust the exchange rate that will enable Japanese economy to succeed in its structural reform? The next two years will probably give us an answer.