EDITORIAL

Abe's legacy may be the one thing that most Japanese don't want

THE phrase "smack of firm government" is often used by those wishing to justify taking a strong line. But for Japan Prime Minister Shinzo Abe, the smack has become a slap in the face.

From the moment he came to office at the end of 2012, Mr Abe saw himself as a strong leader. But strength lies in leading by example rather than pushing others to do what they do not wish to do, and Mr Abe has courted an inevitable public backlash in assuming that the position of elected leader confers upon him a kind of automatic right to do whatever he wishes.

The public is feeling not just smacked but positively battered by the barrage of policy initiatives pursued by Mr Abe, mostly in his own name rather than that of a collegial government. Now, he is having to backtrack on some of his hurried initiatives. The most high profile has been the fiasco over Tokyo's proposed Olympic Stadium, a monstrosity if ever there was one, both in terms of appearance and cost. The design has been scrapped and Japan, as Mr Abe confessed, has had to go back to the drawing board. This could be forgiven if it were an isolated example of poor judgment by a man anxious to make his mark with a high-profile project. But rushed and often arbitrary decisions seem to be becoming the hallmark of the Abe administration.

Last week, the government said that it was suspending construction of a controversial US air base on the island of Okinawa for one month in order to allow time for talks between the central government and island authorities opposed to the facility. The delay appears designed mainly to deflect attention from a much more contentious debate over proposed changes to security laws.

These will raise Japan's military profile in and perhaps beyond Asia and relate to issues on which Mr Abe appears determined not to compromise. They have provoked rare mass demonstrations by many thousands who claim that the nation is being led back down a road towards potential military conflict. The smack of firm government is clearly in evidence while Mr Abe offers only minor sops to public outrage. Not surprisingly, his popularity and that of his Cabinet has plunged to the lowest level since he came to office and there is anecdotal evidence that some members even of Mr Abe's own party might like to see rival candidates emerge next month when the party elects (or re-elects) a president, who then becomes prime minister.

This fall from grace has to do not only with the new security laws and the suggestion of "change by stealth" in Japan's war-renouncing Constitution but also with the new and rather draconian new Official Secrets Act that Mr Abe championed shortly after coming to office. He has also been a strong advocate of the Trans-Pacific Partnership, which is far from popular in certain sectors (not least agriculture).

The novelty of Abenomics, meanwhile, has faded as results show scant signs of living up to its early promise. Even Mr Abe's "womenomics" policies appear increasingly to be a gimmick rather than a sustained push for change.

In short, he seems to be overreaching himself in ambition and under-reaching in achievement. His only legacy may turn out to be one that polls suggest that most people do not desire – a Japan where checks and balances on exercise of central power are diluted.

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China may continue yuan depreciation

The decision and timing to devalue the currency are determined by cyclical management issues, which have been made worse by the recent stock market crash. BY THIERRY APOTEKER

AT first sight, the sudden (and unexpected, at least for some) decision of the People's Bank of China (PBOC, China's central bank) to allow a 1.9 per cent depreciation of the renminbi early this week may seem completely unrelated to the turbulence and crash in China's equity market over the past two months.

Indeed, the devaluation was the technical result of a change in the way the currency value is set daily, from a PBOC morning fixing around which it was allowed to fluctuate by +/-2 per cent to a fixing determined by 35 large Chinese banks that are market makers in foreign currency markets. It is therefore a positive step in the progressive financial liberalisation policy that Chinese authorities are progressively engineering.

But make no mistake: The decision and the timing are determined also by cyclical management issues, which have been made substantially worse by the recent stock market crash.

Many observers of the Chinese cyclical path tend to forget that the country is in the midst of a major structural shift, one that will reduce its annual GDP (gross domestic product) growth from the average 10.5 per cent achieved during 2000-2010 to an expected 5 per cent or less over the next decade.

This massive gear-shift is a natural and almost mechanical result of changing demographics (the population is ageing fast), a reduction in investment growth (needed, both because the share of investment in the total GDP remains abnormally high, and because there are obvious indications of excess capacity in many industries), and the rapid catch-up of the previous decades, which makes further progress more difficult to achieve, at least at the same pace.

Such a structural trend alone implies that the peak of the next cyclical upswing that Chinese authorities are currently trying to engineer cannot be a GDP growth rate substantially higher than the previous trough (that is, +6.6 per cent in Q1 2009). This makes cyclical management much more complex, especially when corporates – and to a large extent local governments – are weighed down by high debt leverage (China has the highest ratio of credit to GDP among all large emerging markets).

In such circumstances, the policy of progressive financial liberalisation is almost sure to create large fluctuations in asset prices. Indeed, the prevalence of margin trading on China's stock markets triggered an "obvious" bubble: The 112 per cent increase in the Shanghai Composite index between November 2014 and the peak on June 8, 2015 could not be justified on any fundamental basis, neither from the macro side (economic slowdown, corporate difficulties, excess capacities) nor from the valuation side, as evidenced by the parallel jump in price-to-book ratios. A brutal correction was therefore unavoidable.

Despite the recent collapse, China's equity markets are still above their levels at the end of 2014 (+21 per cent year to date on Aug 11 for the Shanghai Composite Index). The supportive measures by Chinese authorities over the past weeks – including the cut in interest rates and reserve requirements and direct technical and institutional support to the equity markets – have so far succeeded in creating a rough market stabilisation, notwithstanding some persistent valuation issues when taking into account the cyclical and profit outlook.

But financial volatility is adding another layer of difficulty and complexity for the authorities. It may well erode consumer confidence at a time when the slowdown in capital spending intensifies, and so-called wealth effects could turn negative.

Powerful quantitative tools developed by TAC Economics for assessing China's overall macro risk have been capturing these trends and signalling a visible deterioration over the past few quarters. Our latest update moves the average Economic & Financial Risk rating above 40 into the C-category (on a scale from A to D, D meaning high risk).

MACRO RISK

This results mainly from the simultaneous deterioration in the cyclical outlook for domestic demand and loss in currency competitiveness vis-a-vis key competitors, against a background of weak international demand and excessive domestic credit leverage. The latter cannot be cured over the short run except through a banking crisis, which the authorities will obviously want to avoid and certainly have the means to do so; simultaneously, it highlights the constraints on using monetary policy and credit expansion to stimulate spending.

The authorities must thus choose between allowing the downward trend in activity to intensify on the one hand, and regaining external competitiveness to (re)boost exports on the other. This is why a more competitive currency has become a compelling tool in China's cyclical management.

Indeed, when computing an index of currency competitiveness based on inflation and exchange rates in countries that are the direct competitors of China on world markets, we see an overvaluation for the Chinese yuan that started in 2013 and has amplified since 2014 (see chart). This is very clearly the result of large depreciations for most of emerging market currencies since May 2013 and in anticipation of the forthcoming US monetary tightening: For instance, a Turkish group competing with China's largest exporters of "white goods" for household equipment has benefited from a massive 25 per cent exchange rate depreciation, even after incorporating the differences in inflation between Turkey and China in just two years.

China still has the resilience and the ability to deal with such cyclical management complexity, but the set of constraints facing the Chinese economic leadership suggests that the most likely policy will take the form of modest currency depreciation.

Some may believe that the objectives in terms of currency internationalisation and status (including incorporation into the International Monetary Fund's official basket of currency reserves – the Special Drawing Rights) would substantially constrain any currency depreciation. But this view ignores the fact that all reserve currencies fluctuate against each other; nobody suggested that the Japanese yen or the euro could not be reserve currencies when they depreciated by more than 20 per cent against the US dollar over the past two years. There is, however, a cap on a "maximum tolerable" depreciation.

US RATE HIKE

When the US Federal Reserve finally hikes its short-term interest rates, many emerging markets currencies could be affected again and this may be the next trigger for a further depreciation of the yuan. There is no risk of a large or uncontrolled devaluation. The magnitude of the future depreciation will be a compromise, taking into account the large overvaluation registered today (still above 20 per cent, according to our tools), the implications of Beijing's strategy of internationalising the yuan, the overall tensions in emerging market currencies, and the results of other supportive policies.

Our analysis suggests that such a compromise would result in another 5 to 10 per cent depreciation against the US dollar between now and the end of 2016, engineered through small and incremental steps coinciding with further modest financial liberalisation moves.

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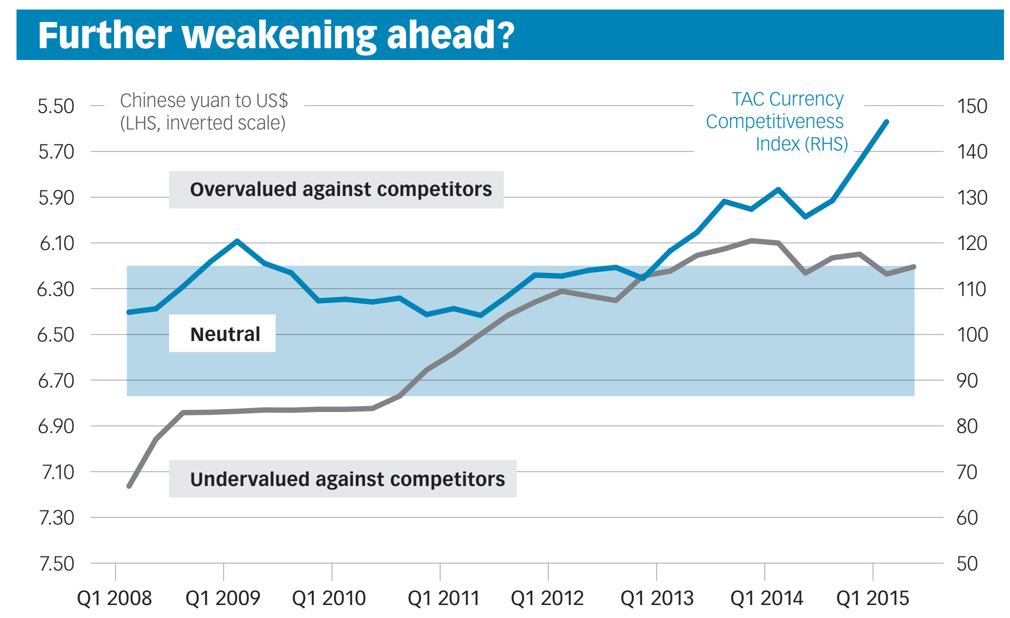
Further weakening ahead?



Source: TAC Economics, Datastream

The writer is chairman of TAC Economics, an economic consulting firm based in Paris. Some of its research is available at its website, taceconomics.com

THE BOTTOM LINE

An optimistic way to look at China's devaluation

By William Pesek

CHINA'S surprise devaluation of its currency over the past two days is sure to stir up fear and loathing among the world's economic populists. (Keep your eyes on Donald Trump's Twitter account.) But the move deserves praise, not condemnation. It might even prove a boon for world growth.

Beijing spent much of the last year propping up the yuan to combat capital outflows, avoid debt defaults and win a place among the International Monetary Fund's (IMF) five reserve currencies. But with growth sputtering and deflation looming, China has now reversed course, cutting its daily reference rate by 1.9 per cent on Tuesday, the most in two decades, and by 1.6 per cent on Wednesday. The Chinese government has effectively admitted that risks are accelerating in the world's second-biggest economy.

Politicians in the United States are sure to call the devaluation a threat to American jobs, and politicians in Japan will bemoan its effects on their deflation fight. But it's important to keep a sense of perspective. China has called this a one-time fix designed to push the yuan towards a more market-determined system, in accordance with the IMF's wishes. Besides, if China were going all-in on a beggar-thy-neighbour policy, its devaluation would have been far more substantial – and even then, there's no guarantee it would have succeeded at propping up the economy.

The yen's 35 per cent plunge since late 2012 is hardly reviving Japan, any more than this year's 10 per cent currency drop is saving Australia. (And let's be honest about the hypocrisy at work: Nobody gave Tokyo or Canberra grief for their dramatic currency drops.) It's also important to acknowledge that Beijing's new policy poses risks for China.

The weaker yuan increases the odds of a surge in defaults on foreign-currency debt, which makes the country highly vulnerable to capital flight. In April, Shenzhen-based Kaisa became the first Chinese developer to renege on such debts. The People's Bank of China is aware a lower yuan could push others to the brink, which is why it probably won't allow the currency to fall too much farther.

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The real question isn't whether Beijing should have devalued the yuan, but what it does with the time this manoeuvre buys. Given how little tolerance President Xi Jinping and Premier Li Keqiang have shown for the shock therapy China needs to wean itself off excessive investment and exports, it would be reasonable to assume the currency move is a tactic to delay reforms and re-inflate the country's stock bubble. If the government unveils new policies to prop up stocks – thus giving the impression the devaluation was essentially a stock-market intervention – then it could reignite the global currency war.

But there's a more optimistic view: Beijing might be buying some stability so it can accelerate the reform process. From that perspective, this week's news that China is preparing to tackle its state-owned-enterprise (SOE) problem looks even more promising.

According to the *South China Morning Post*, China is creating two new kinds of companies to supervise and regulate state-owned behemoths. The scheme is modelled after Singapore's state-owned investment arm Temasek Holdings and, if handled well, it has the potential to alter the foundations of Asia's biggest economy for the better.

These politically-coddled monopolies are at the nexus of all of Beijing's worst excesses – debt, overcapacity, corruption, pollution. Reducing their influence would be a vital first step for cultivating the sort of startup boom that China needs. But it won't be easy. Kickbacks from land grabs, insider trading and old-school rent seeking have minted countless millionaires among Mr Xi's Communist Party comrades. These vested interests will battle Mr Xi's every effort to make SOEs more open, competitive and conventionally profitable.

Taking on this fight would be easier for Mr Xi if China's exports weren't falling (they dropped by 8.3 per cent in July) and deflation didn't loom as a threat. That's where the latest devaluations, and the expected boost to exports, come in. It's plausible that SOE reform motivated the Chinese government's devaluation decision.

If Mr Xi is truly interested in allowing the market to play a leading role in economic decision making, the real test will be whether his government shows the courage to open the country's opaque financial system, tighten corporate governance and allow the media to play a bigger role in weeding out corruption. Rather than bellyaching about the latest currency move, these are the steps China critics should be watching for. Personally, I can't help but feel optimistic that China's yuan-regime change suggests they're coming. BLOOMBERG VIEW