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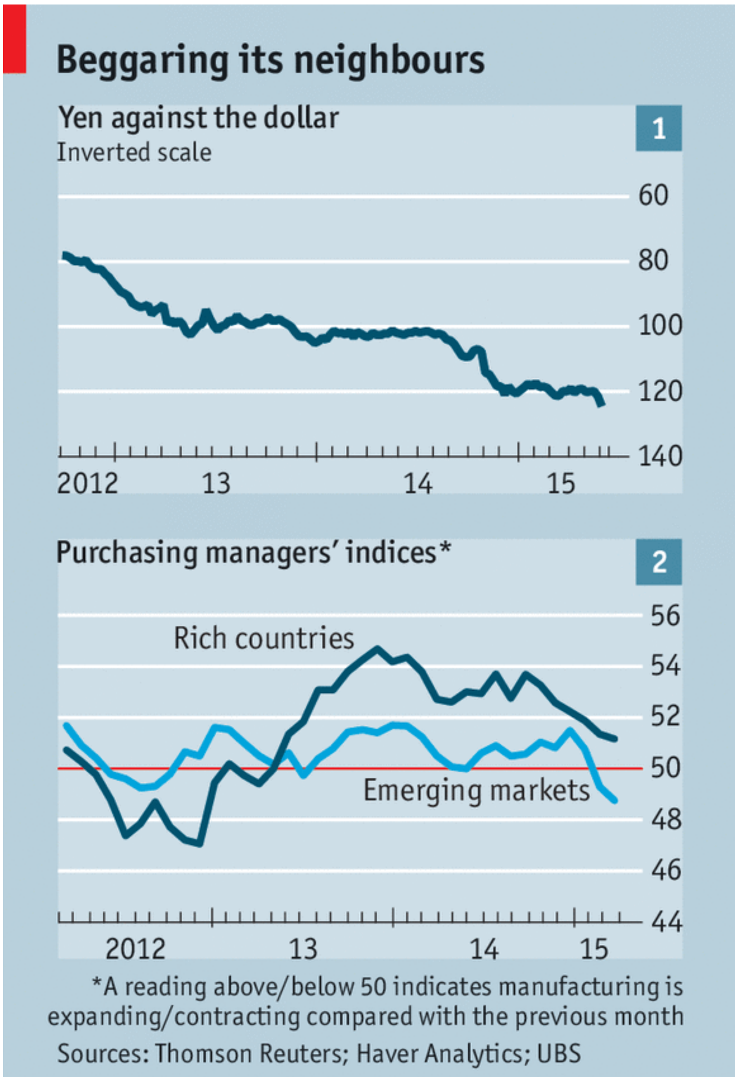
Signs of a slowdown

A weaker yen poses problems elsewhere

THE efficacy of Abenomics, the reform programme of Japan's prime minister, Shinzo Abe, is a matter of vigorous debate. There have been periods of decent economic growth and higher inflation since Mr Abe became prime minister in 2012, but they have not lasted. Japanese GDP is forecast to rise by only 0.8% this year and headline inflation is just 0.6% (the core rate is even lower, at 0.3%).

Where Abenomics has clearly made a difference is in the value of the yen. At the end of 2012 it was trading at ¥87 to the dollar; this week, it fell below ¥125, a decline of more than 30% in 30 months (see chart 1). That is down to the Bank of Japan's massive programme of quantitative easing (QE), which involves creating new yen to buy assets; the Bank is printing ¥80 trillion ($644 billion) a year.



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A weaker yen creates two challenges for the rest of the world. First, it makes Japanese exporters more competitive and thus weakens the position of rival exporting nations. That is happening at an especially inconvenient time. Over the past three months, all the main emerging markets bar China and Hong Kong have seen weaker exports than in the same period of 2014, according to UBS, a Swiss bank. Global exports fell slightly in May, the first decline in nearly two years.

Some of the recent sluggishness in global trade may be down to changes in the Chinese economy. Chinese manufacturers used to import parts from the rest of Asia and then export finished goods to the rest of the world; now China may be making more of the parts itself. The result is a decline in intra-Asian exports.

That explanation, however, is of scant consolation to other Asian exporters. South Korea's exports have fallen 11% in dollar terms (although less by volume); export growth in the Philippines has slowed to an annual rate of 1% from 13% in the last quarter of 2014. The purchasing managers' indices in many emerging markets have fallen below 50, indicating a contraction in manufacturing (see chart 2).

The second challenge posed by the weaker yen is the potential deflationary effect. Cheaper Japanese goods will make it more difficult for competitors to raise prices. Lower commodity prices have led to falling headline inflation rates around the world. Central banks have been cutting interest rates in response. The latest example is India, which reduced rates for the third time this year on June 2nd.

A fall in commodity prices is a benign event for consuming nations, the equivalent of a tax cut that supports demand. Fears of a plunge into deflation in Europe have eased somewhat, with both headline and core inflation now positive. But falling prices for finished goods from Asia could yet have a bigger impact. A broad-based measure of Chinese inflation, the GDP deflator, is now showing falling prices. The prices of goods produced by Chinese factories have been falling for more than three years.

The continued willingness of both the Bank of Japan and the European Central Bank to pursue QE indicates continued concern about weak demand and deflation. In such an environment, central banks are happy to see their currencies weaken. The problem is that this exports deflation to the rest of the world.

For financial markets, however, QE means that central banks are absorbing an awful lot of new government debt. That has helped keep sovereign-bond yields low, despite a recent bout of volatility, which has encouraged investors to buy risky assets and allowed stockmarkets to shrug off weak economic data.

American GDP fell in the first quarter, and early indications for the second quarter are wan: the Atlanta Fed's GDPNow model suggests annualised growth of just 1.1%. Britain also had a weak first quarter and the euro zone, although recovering, is hardly sprinting: its composite purchasing managers' index (covering both services and manufacturing) fell in May.

Throw in the weak emerging-market data and it might seem as if the global economy is slowing significantly. But investors remain convinced this a blip. A survey of global fund managers by Bank of America Merrill Lynch in May found that 70% expected stronger economic growth this year, and only 11% thought it would weaken. If recent trends continue, investors may be in for a nasty shock.