

## HSBC fears horrible end to Japan's QE blitz as Abe wins landslide

The warning came as Mr Abe won a sweeping victory in Japan's snap elections over the weekend, consolidating his power in the Diet and giving him a further mandate for deep reforms.



The ruling Liberal Democratic Party is seeking a mandate to pursue some of the most radical changes in Japan's modern history Photo: AP

By Ambrose Evans-Pritchard

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HSBC has warned that Japan's barely-disguised attempt to drive down the yen is becoming dangerous and may spin out of control, leading to an exchange rate crisis next year and a worldwide currency storm.

"It is entirely possible that the Yen decline becomes disorderly and swift," said the bank, in one of the starkest criticisms so far of Japan's radical stimulus policies.

David Bloom and Paul Mackel, HSBC's currency strategists, voiced growing concern that premier Shinzo Abe is backing away from fiscal retrenchment and may pressure the Bank of Japan (BoJ) to fund policies aimed at boosting household spending.

"The temptation to drift towards increasingly generous fiscal programmes could grow. We do not expect a 'helicopter drop' of income into

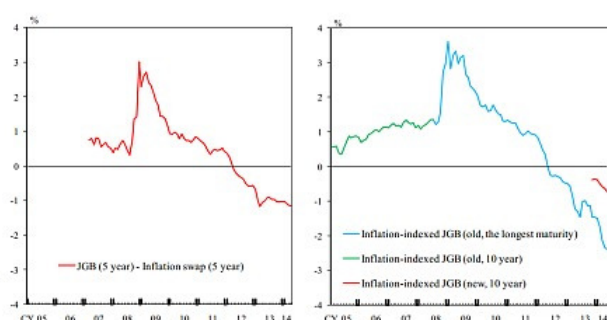
every household, but the yen would react very badly to any sign that the government is heading down a route of overt monetisation," they wrote in a report entitled "The Year of Living Dangerously".

The warning came as Mr Abe won a sweeping victory in Japan's snap elections over the weekend, consolidating his power in the Diet and giving him a further mandate for deep reforms. "I promise to make Japan a country that can shine again at the centre of the world," said Mr Abe.



Japan's recovery has faltered. Mr Abe's Thatcherite shake-up, or Third Arrow, has yet to get off the ground, though he is now in a much stronger position to break monopolies and confront vested interests. The economy slumped back into recession in the middle of this year after a rise in the sales tax from 5pc to 8pc, a move that was clearly premature.

### 5. Decline in Real Interest Rates



The Abenomics experiment still depends largely on the BoJ's asset purchases, running at 1.4pc of GDP each month, the most extreme monetary blitz ever attempted in a modern economy. Economists are deeply divided over whether this alone can overwhelm the fiscal shock, and lift the economy out a 20-year stagnation trap.

HSBC said Mr Abe may succeed in driving up wages, setting off a "wage-inflation spiral". This may not necessarily lead to a bond rout since the Bank of Japan is effectively holding down bond yields. However, the exchange rate might take the strain instead.

The worry is that this could set off a beggar-thy-neighbour devaluation process across Asia, eventually sucking in China. "The tentacle of the currency war would spread," said the report.

HSBC said China is determined to avoid joining this debasement game as it tries to wean its own economy off export-led growth, but there may be limits. The Chinese economy is slowing and is already in deep producer price deflation. Japanese exporters have been switching to a new strategy over the last six months, cutting export prices to gain market share as the yen falls, rather than pocketing the windfall as extra profit.

"There are grounds to argue that China would join the currency war and devalue the yuan if currency moves elsewhere became disorderly," it said. The warnings have raised eyebrows since HSBC has close policy ties with the Chinese authorities.

The report sketched an unsettling scenario in which capital flight from Japan flows to the US, setting off an "explosive" rise in the dollar. This may combine with "reignited European break-up fears" as political risk spreads, most immediately in Greece.

Such a combination would put immense strain on those emerging markets that have borrowed heavily in dollars. The Bank for International Settlements says cross-border loans to developing economies have soared from \$3 trillion to \$9 trillion in a decade, creating systemic risk.

HSBC warns that the potential trifecta of a yen crash, a euro slide, and an emerging market crisis could lead to a dollar spike that the US authorities "would be powerless to prevent". This would "destroy the world" as we know it. The report stressed that this is not a forecast but a tail-risk that cannot be ignored.

Takeshi Fujimaki, a Japanese banker and former adviser to George Soros, has also issued a string of warnings. "Once investors see through the BOJ's camouflage, the yen will spiral out of control to Y200 (to the dollar) and beyond," he said.

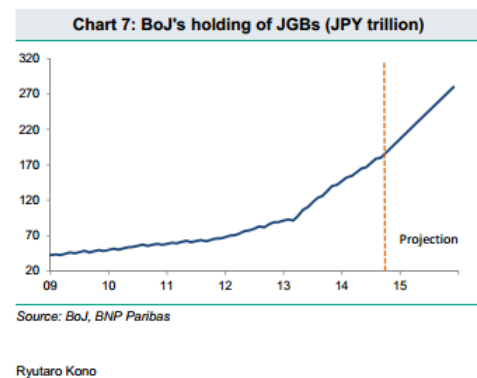
The BoJ has already driven down the yen by 50pc against the dollar to \$119 over the last two years, and by the same amount against the yuan.

While this was welcomed by Japanese firms at first, it risks going too far. Protests are rising from those who rely on imports.

The central bank's governor, Haruhiko Kuroda, stepped up the pace of QE in October in a bid to push up inflation and reignite the damp wood of the Japanese economy. The move was fiercely resisted by four of the BoJ's nine voting members.

The unstated purpose is to raise nominal GDP growth from past rates of zero to nearer 4pc or 5pc. This is deemed the safe required to stabilize the ratio of public debt to GDP – now 245pc – and avert a debt-compound trap.

The BoJ is currently soaking up the entire bond issuance of the government, forcing down the real interest rate to deeply negative levels. It has accumulated \$2.14 trillion of state debt so far, equal to 47pc of GDP. This is rising fast, fuelling suspicions that Mr Kuroda's true objective is to whittle away the debt burden by printing money.



The HSBC view is unusually gloomy. Mr Kuroda said the bank will "approach" its 2pc inflation target in 2015 and there are signs that business investment is picking up.

The Daiwa Institute says real wages are poised to rise as the tax shock fades. "Signs of a virtuous cycle are definitely emerging," it said. The yen may stabilize once the economy has adapted to a new nominal GDP trajectory.

Ryutaro Kono from BNP Paribas said Abenomics ran aground in late 2013 but may now have been rescued by the slump in oil prices. Japan imports almost all its fuel. The effect is worth a tax cut of 1pc of GDP. "Its a godsend for Abe," he said.

Yet Japan is clearly at a critical moment. Moody's downgraded the country's debt one notch to A1 earlier this month with an explicit warning: Japan cannot stabilize its debt ratio unless all elements come together at once.

These are fiscal and pension reforms, higher taxes, higher productivity growth, an end to deflation, and nominal GDP growth above 3.5pc. If any one of these falls short, Mr Abe's great gamble may fail.

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