Paul Krugman - New York Times Blog

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A Yen For Yen

The FT has an article noting the strength of the yen against the euro, which it attributes to the yen's "enduring status as a haven against the global financial turmoil." Well, yes — Japan is seen as safe, despite its high level of debt, just like all the other advanced countries that have retained their own currencies.

But there's a special feature of Japan that is important in understanding the high yen: the interaction between deflation and the zero lower bound.

Japan, of course, has deeply embedded deflation, while both the euro area and the US still have modest positive expected inflation. Expectations of deflation tend to push interest rates down. But short rates can't go below zero. And the Japanese long rate has to stay some ways above zero, because it in effect contains an option value: short rates can go up, but they can't go down.

So Japan has expected inflation that is around 2 points less than in other safe haven countries, but it has long interest rates that are only about 1 percentage point lower; Japan is a high real rate country. And this pushes up the value of the yen.

Just to be clear, this is a bad thing from Japan's point of view; the country really needs more exports, and the high yen prevents that.

Another reason why you really, really don't want to get into a deflation trap.