Forex Focus: Now Watch Currency Tensions Rocket

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A DOW JONES NEWSWIRES COLUMN

LONDON (Dow Jones)--Global currency tensions involving the U.S., Japan and China will get much worse in the months to come as all three try to stay competitive.

Growth in the three major economies is proving disappointing with domestic demand faltering and reliance on exports growing. Just look at the Fed's latest downgrade for U.S. growth Tuesday, prompting it to extend its liquidity measures for the market.

Japan has long been the main basket case of the three, with repeated fiscal stimuli failing to kick start consumer demand. Even hopes for a solid rebound in the country's machinery orders earlier Wednesday were disappointed.

In recent months, as the dollar tumbled towards Y85 and the yen has become less competitive, currency tensions have worsened.

So far, there has been little sign of Tokyo doing anything about the yen's rise, apart from increased verbal intervention about the damagingh effects of further yen strength on the economy.

Despite expectations to the contrary, the Bank of Japan let its latest policy meeting this week pass without resorting to any further monetary easing, which might have helped to pull the yen back down.

The other option--direct market intervention--is still on the table but is unlikely to be used just yet.

First, the Bank of Japan would have to conduct any such exercise on its own as there is little reason for any other central bank to help.

Secondly, market intervention, pushing the dollar higher, would hardly go down well in Washington as the U.S. tries to avoid its own slide back into recession.

The Bank of Japan also has a third problem, China.

Greater demand for Japanese assets, at the expense of U.S. Treasurys, further increases the likelihood that the dollar will soon fall under key support at Y85 and head toward Y80.

See how the dollar has fallen against the yen:

http://www.dowjoneswebservices.com/chart/view/4402

China is now more of a global problem in other ways too.

Trade data for July show exports were stronger than expected while imports failed to meet expectations--suggesting that while global demand is still doing well, Chinese demand is slowing faster than anticipated.

This will destroy hope that Beijing will be confident enough to allow the Chinese currency, the yuan, to advance any faster than it has over the last few weeks since the Peoples' Bank of China released the currency from its fixed dollar peg.

As Mark Williams, senior Chinese economist at Capital Economics in London said: "Something will have to change if China is to avoid a period of sub-8% growth, which we believe remains politically-unpalatable."

As the U.S. faces its own deflation fears, Washington will hardly be keen to see the dollar staging any serious recovery at this stage.

In fact, pressure on China to stop manipulating its currency will increase once again just as disapproval of any attempt by Japan to drive the yen lower through market intervention are likely to grow.

The latest data suggest that there will be little pressure on Beijing to change the status quo. The country's retail sales growth has slowed and consumer price inflation hasn't risen as strongly as expected. In other words, there is even less reason to have a stronger yuan.

Early Wednesday in Europe, the dollar was displaying considerable resilience in the wake of the Fed's decision to use the proceeds from maturing mortgage-backed securities to buy U.S. Treasurys and so prevent any decline in market liquidity.

As investors sought the comfort of safe havens, the euro was pushed down to $1.3048 by 0.645 GMT from $1.3187 late Tuesday in New York, according to EBS.

The single currency also tumbled to Y111.42 from Y112.58 while the dollar traded little chnaged at Y85.36 from Y85.35.

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