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Chief Economist's Corner: Burgernomics in Practice

Marketing communication

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From Tokyo to Tivoli – What the Price of a Burger Reveals About Exchange Rates and Purchasing Power

Japan has become interesting. There have probably never been more Danes travelling to Japan on holiday than right now. Tivoli has just opened a new Japanese area, Hikari, and even we economists have begun turning our attention to what is happening in the Land of the Rising Sun.

It is not every day that the US and Japan join forces in the currency market to strengthen the yen. But that is exactly what happened in late July, after the Japanese currency had approached its lowest level in nearly four decades. The intervention worked – but only briefly. Within just a few days, much of the gain had already evaporated. This raises the underlying question: is the yen genuinely undervalued, or are there forces simply pulling it weaker and weaker?

This is an analysis where economists traditionally look at the so-called purchasing power parity (PPP) exchange rate – the rate at which an identical basket of goods in Japan and the US would cost exactly the same. This is a rate that the OECD, among others, attempts to calculate on an annual basis, and the latest figures suggest that the yen is significantly undervalued. In fact, the numbers indicate that last year the yen was approximately 35% undervalued against the dollar relative to what purchasing power parity would suggest.

This finding is supported by one of my favourite tools for assessing whether a currency is under- or overvalued: the Big Mac Index, which The Economist has just celebrated the 40th anniversary of. The idea is simple – if a Big Mac is a broadly uniform product around the world, its price should in principle be the same when converted into a common currency. Of course, that is not how reality works. Wages, rents, taxes, raw materials and productivity all vary from country to country, and a burger cannot simply be traded across borders. It really needs to be eaten on the spot!

But as an accessible illustration of purchasing power parity – PPP – the Big Mac Index is quite brilliant. And in this year's edition, the message is very clear: Asian currencies, and the yen in particular, look cheap against

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the dollar. The weakening of the yen has in fact been so dramatic that a Big Mac in Japan is now markedly cheaper than in China, measured in dollars. And according to The Economist, the Big Mac Index suggests an undervaluation of the yen of close to 50% against the dollar – even more than the OECD's estimate. Since Japan runs a large trade surplus with the US and a considerable current account surplus more broadly, all of this points to strong competitiveness – and suggests that a strengthening of the currency should be well within reach.

The reason the yen nevertheless remains weak comes down, above all, to interest rates. Sluggish growth and near-absent inflation have meant that Japan has maintained some of the lowest interest rates in the world for many years, making it attractive to borrow in yen and invest the proceeds in higher-yielding assets elsewhere. This weighs on the yen against other currencies. And even today, as Japan has moved away from the extremely accommodative monetary policy that defined the country for so long, Japanese interest rates remain low compared to those in the US.

Currency intervention alone is therefore not necessarily enough to strengthen the yen. Japan and the US can buy yen for billions of dollars and euros, pushing the rate up, but if the interest rate differential continues to make it attractive to sell yen, the market quickly reverts. That is precisely what we are seeing now. And unless the interest rate gap narrows – for example through further monetary tightening by the Bank of Japan – this dynamic will persist, with ever-cheaper Japanese burgers as a consequence.

For us Danes, it is at least equally interesting to turn our attention to our own currency. According to the latest Economist survey, the Danish krone is in fact noticeably overvalued against the dollar. Burgernomics therefore suggests that the yen is markedly undervalued against the krone – nominally perhaps by as much as 60–70%! So almost however you look at it, Japan stands out as an economically attractive destination for Danish travellers in the current climate. And it would take a great deal of intervention, and most likely Japanese interest rate hikes as well, before that conclusion changes.

It should therefore come as no surprise that Japan will continue to feature prominently on the list of favourite destinations for many Danes and tourists from other countries alike. And for those who cannot afford it, do not fancy it, or simply cannot make it happen – well, a trip to Tivoli can still offer an authentic taste of Eastern delights, even if you probably should not expect to find a Big Mac for a bargain price there!

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