GLOBAL MARKETS UPDATE

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CAPITAL ECONOMICS

What can Japan do about a stronger yen?

- The surge in the yen against the US dollar has understandably raised expectations of further action to weaken the Japanese currency. We think the Bank of Japan is unlikely to intervene directly in the markets, in part because the latest moves are not obviously "excessive" or "disorderly". What's more, **we continue to expect the yen to fall back of its own accord as safe-haven flows reverse and monetary policies diverge again**. Nonetheless, the Bank of Japan could accelerate this process by cutting interest further and – probably more effectively – by stepping up its asset purchases again.
- The appreciation in the Japanese currency is due to two main factors. The first is a jump in safe-haven demand, reflected in the close (inverse) correlation between the yen and overseas equity markets. Indeed, on the basis of Chart 1 alone, **a further collapse in the US S&P 500 to 1,600 would be consistent with the yen rising past 100 to the dollar**. The yen's safe-haven status may seem odd given the economy's limited growth potential, high debt levels and permanently low interest rates, but can be explained by its huge net external assets and the scope for repatriation by Japanese investors.
- The second factor is the sharp drop in expectations for interest rates in the US, which have declined by a bigger amount than those in Japan even though the Bank of Japan has now joined the negative interest rate camp. Nonetheless, as Chart 2 shows, **the current spread between US and Japanese short-term bond yields is still consistent with renewed yen weakness in due course**. [The surge in the yen may also have been compounded by short-covering (some of which may have been due to the closing of carry trades funded in yen), but this presumably would not have happened without these first two factors.]
- So what can (or should) Japan do about this? Official concerns about "excessive" or "disorderly" movements in currency markets have prompted speculation that intervention is imminent. But this language is often used and it is not clear that the criteria for action have been met. **Viewed in a longer perspective, the yen is still relatively weak**. The last major intervention by Japan was in 2011 following the tsunami, when the yen was stronger than 80 against the dollar, compared to levels of around 111 today. What's more, other central banks were then happy to join Japan in coordinated action because of the particular vulnerability of the Japanese economy. In the last few days, **the yen has simply been the strongest of the alternatives to the dollar in a broad-based correction in the US currency**. Any unilateral intervention by Japan would therefore surely be seen as a further shot in the so-called "currency wars" and conflict with commitments made to other G7 members. **Nor is it clear that intervention would actually work, given the potential strength of the forces pushing the yen higher**.
- Nonetheless, the Bank of Japan may still want to do something more to cap these pressures. **The obvious next step might be to cut interest rates further, although with rates already so low everywhere else this may not have much impact**. Indeed, the Bank of Japan's decision to join the negative rate club only seemed to sour the global mood. **Stepping up the pace of asset purchases under quantitative and qualitative easing (QQE) may be more effective**; as Chart 2 shows, the big moves downwards in the yen came following the election of the Abe government in anticipation of bolder monetary policies, and again in 2014 when QQE was last expanded. Even if more QQE fails to reverse the upward pressure on the yen, it should at least help to offset the damage to the domestic economy and markets.

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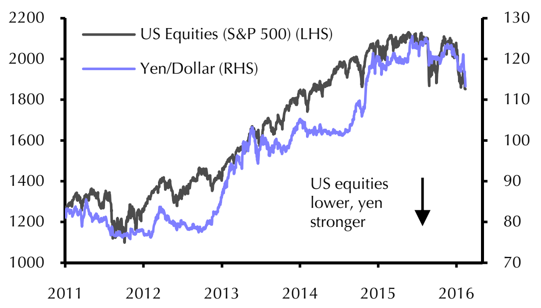
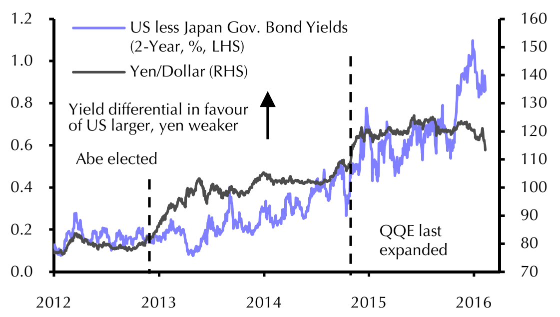
Chart 1: US Equities & Yen/Dollar Exchange Rate



Source – Bloomberg

Chart 2: Yield Differentials & Yen/Dollar Exchange Rate



Sources – Bloomberg, Capital Economics