DECODING

The yen at its lowest level for half a century: what consequences?

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In recent days, the yen has returned to its lowest level against the US dollar for 20 years. This is largely explained by the divergence in monetary policy between the Bank of Japan and the other major central banks. This obviously has important consequences for the Japanese economy, but as we will see, there is no real consensus among the authorities on the reaction to adopt.

What are the causes of the yen depreciation?

The reason for the recent yen depreciation is quite clear: the very wide divergence in monetary policy between the Bank of Japan (BoJ) and almost all of the other central banks in the world. While even the ECB seems to be heading towards key rate hikes (which has caused a very sharp increase in European long term interest rates), the BoJ has for the moment shown its determination to defend its policy of controlling the yield curve (YCC, *Yield Curve Control*), in which it wants to keep the 10-year rate close to 0%. It must be said that inflation remains low in Japan (1.2% year-on-year in March) compared to what can be seen in the euro zone and the United States (respectively 7.4 and 8.5% in March), and above all still well below the 2% target.

See Appendices – Graph 1

A second explanation can be evoked for the yen depreciation: the sharp deterioration in the terms of trade. In theory, currencies whose export prices falls relative to the import prices (we are obviously thinking of energy prices in the case of Japan) tend to depreciate.

If the yen has weakened against the US dollar, it must be emphasized that the real value of the yen has fallen even more: indeed, inflation in Japan has been lower than anywhere else these twenty last years. Thus, the real effective exchange rate of Japan reached its lowest level for 50 years !

See Appendices – Graph 2

What consequences for the Japanese economy?

Like other countries in the world, Japan has to deal with rising commodity prices (energy, food, etc.). But unlike what we observe in the United States, and to a lesser extent in Europe, there is no inflation linked to an acceleration in demand in Japan. In a context of demand that remains sluggish, the acceleration in production costs faced by companies can only be partially passed on to final prices, due to a lack of pricing power from Japanese companies.

The weakening of the yen increases the price of raw materials and basic commodities imported by the Japanese population. Households, which are particularly sensitive to the prices of these goods, are thus anticipating an acceleration in inflation. According to the Consumer Confidence Survey conducted by the Cabinet Office (EPA survey), 92.7% of households surveyed expect prices to rise in 12 months, the highest level since the inception of this survey (in April 2004), and 54.7% even anticipate a price increase of more than 5%.

Companies are anticipating a rise in producer prices of 2.1% at 12 months according to the latest Tankan survey, but of 2.7% at 3 years, and 3.2% at 5 years. Their consumer price expectations are also trending upwards at +1.8% at 1 year, then +1.6% at 3 years and 5 years. However, these expectations remain lower than those observed in 2014, the date of the creation

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of this survey, and well below the BoJ inflation target, i.e. 2%.

This rise in inflation expectations is penalizing the recovery dynamic, which is still weak in Japan. It should be noted that household consumption has barely recovered to pre-pandemic levels and Japanese industry is suffering from input shortages. Sensitivity to the depreciation of the yen is therefore particularly high.

What reaction from the authorities?

One of the big surprises was the divergence of official speeches in the face of the fall of the yen. For its part, the BoJ has maintained its traditional position. Its objective being to get out of deflation definitively, it considers that a weaker yen stimulates both inflation and growth and that the overall impact is therefore positive for the country. Remember that the BoJ is not in charge of managing the exchange rate, which is managed by the Ministry of Finance. For the BoJ, inflation excluding fresh food seems more and more likely to reach around 2%, but according to it this increase would only be temporary and would therefore not make it necessary to modify its yield curve control policy (YCC). The BoJ even speaks of "bad inflation", given that inflation is mainly driven by the sharp rise in commodity prices (especially crude oil prices) and for them, the impact of the depreciation of the yen is ultimately quite weak. The share of raw material imports relative to the country's total imports has indeed dropped significantly.

The BoJ establishes this view on the results of the Cabinet Office's econometric model (Cabinet Office's Short-Run Macroeconometric Model of the Japanese Economy - 2018), which indicates that a 10% drop in the value of the yen leads to an increase in Japanese GDP of 0.46% after 12 months. However, these results must be nuanced because this model is based on old data (1980s and 1990s) and the Japanese economy has changed a lot since then. Companies have strongly developed production abroad and intra-group trade is much less sensitive to exchange rate fluctuations. The impact of the fall in the yen on foreign trade must therefore be put into perspective. The decline in the share of exports invoiced in yen reinforces this finding.

BoJ Governor Haruhiko Kuroda nevertheless amended his positive judgment on the yen depreciation in mid-April by mentioning that the "quite sharp" depreciation could affect companies' investment plans. The fact remains that the BoJ has indicated that it will do everything necessary to control Japanese long-term rates, which is largely responsible for the depreciation of the yen.

On the government side, the comments are much less positive on the economic consequences of yen depreciation. In an article published in *Nikkei* on April 16, the finance minister Shunichi Suzuki said that the current yen weakness is rather detrimental to the Japanese economy since it is not accompanied by wage increases and the pass-through of rising business costs on final prices. This declaration was followed by those of several personalities from the business community and union representatives, who underlined the difficulties of companies in the face of the yen weakening. The Japanese government is currently working on a public support package to counter the increase in energy prices for households and businesses. But the continued yen depreciation unwinds some of the positive impact of such measures. It is therefore easy to understand the position of the finance minister.

For the government, an obvious way to stop the yen depreciation would be to intervene directly on the foreign exchange market by selling US dollars. After all, Japan holds more than $1,200 bn in foreign exchange reserves (by the way, a significant sale of US Treasury securities would exacerbate the rise in US long rates, etc.). This would not be new, but this tool has not really been in vogue in developed countries since the mid-1990s. Moreover, academic literature shows that coordinated interventions are more effective than unilateral interventions and for it to be effective, an intervention to appreciate the yen should be undertaken in good agreement with the other developed countries and in particular with the United States. At a time when the fight against inflation is the number one priority of US authorities, it is not certain that depreciating the US dollar and thus increasing the price of imported goods is viewed favorably. In March 2011, the ECB and the finance ministries of Japan, Canada, the UK and the US announced a coordinated sale of yens: at the time, the yen had appreciated strongly following the earthquake that caused the Fukushima disaster due to the repatriation of funds held abroad. The yen had depreciated well for 3 to 4 weeks but had started to appreciate again thereafter. There is therefore no guarantee that an intervention would lead to a lasting yen appreciation if the causes of the weakness of the latter do not disappear…

See Appendices – Graph 3

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Ultimately, the publicly displayed divergence of views between the BoJ and the government is surprising, in a country where these two actors work hand in hand more than anywhere else in the developed world. The room for maneuver of the Japanese authorities therefore appears to be very limited. But the decline of the yen could however make the Chinese authorities react since the CNY/JPY parity is back on the highest levels observed since 1994: China is probably uncomfortable with the weakness of the other major regional currency. For the Japanese authorities, one way to interrupt the fall of the yen would be to let Japanese long-term interest rates follow the general rise in global rates but this would not be without cost because it would mean for the government increased budgetary discipline in a country with a debt to GDP ratio of 230%! From an investor's perspective, the yen would have considerable room for appreciation in a scenario where inflationary pressures ease and monetary policy tightening by the world's other major central banks stops.

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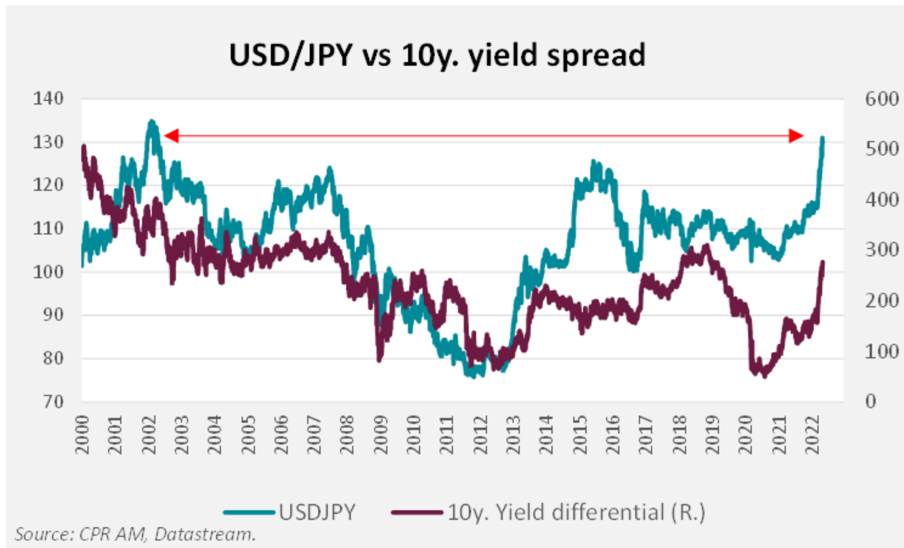
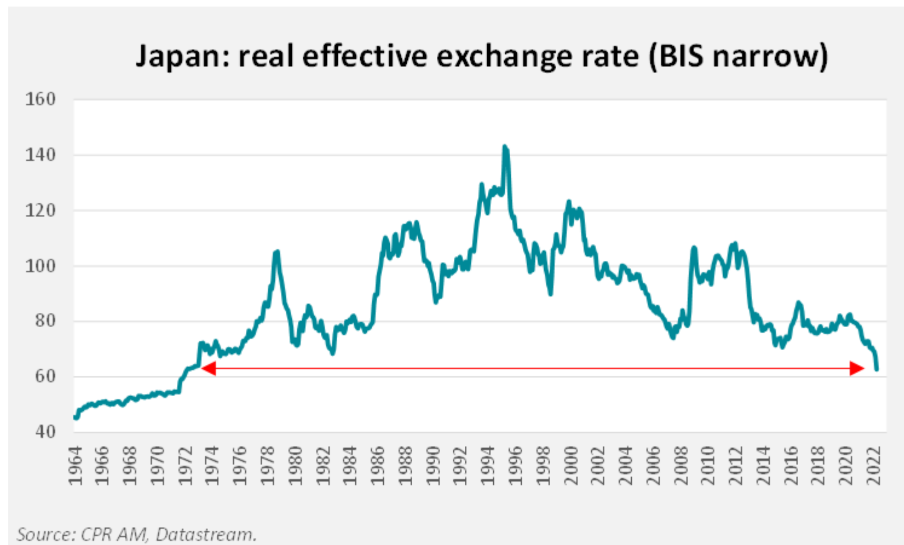
Appendices

Graph 1



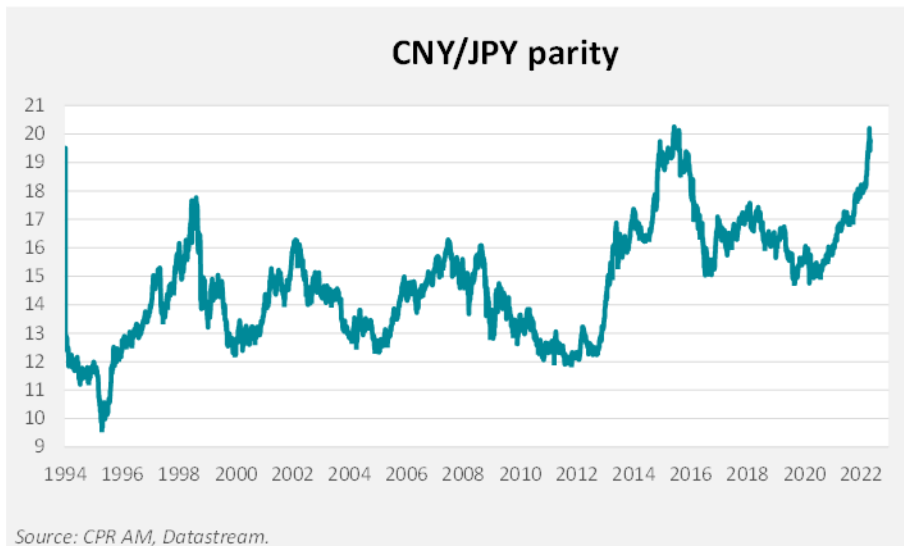
Source: CPR AM, Datastream.

Graph 2



Source: CPR AM, Datastream.

Graph 3



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