The Yen Conundrum
Policy Implications And Who to Blame

Ahead of the BOJ policy meeting the question arises whether there should be a policy reaction to the weak Yen, if yes by whom and importantly how. My view is that BOJ will stick to its current policy framework and let the FX market run out of steam by itself. The main reason being that Japan's current macro-economic situation simply does not call for tighter monetary conditions, and adjusting policy to strengthen the Yen would undermine BOJ's monetary logic of 9 years of Kuroda leadership.

Separately I think it is time to analyze further the global implications of why the currency of a high inflation country rallies, while that of a low inflation country falls. Have the bond vigilantes fallen asleep?

Implication Details:

Political Pressure

I have argued that a falling Yen is the Achilles Heel of Kuroda's policy framework in case of public dissatisfaction and resulting political pressure, and we are just over two months away from Upper House elections expected on July 10th. However, while the political risk to policy remains, we are not there yet. Considering the weakness of the opposition and the secondary importance of the upper house, Kishida is not in any real danger of losing his ability to govern. The importance of the upper house election is more due to the LDP's interest in constitutional amendments, which need a 2/3 majority in both houses. Importantly also, Kishida will politically gain most from being seen handing out cash to mitigate rising energy and food prices, rather than blaming the BOJ with unknown economic effects of any policy change. Finally, it is MOF that is responsible for FX policy, not BOJ. Without MOF claiming an emergency it would unnatural for BOJ to move. Finance Minister Suzuki is just a political appointee, and his views carry little weight in Japan as well as at the G20, where he was also more or less ignored.

Economic rationale

The economic conditions between the US, Eurozone and Japan differ significantly. Everybody globally has a primary inflation problem from rising commodity prices, but while the US and Europe also have a second-round inflation problem, Japan does not. That was one of the main points of Kuroda's speech at Columbia University last week, which I consider to be clear guidance ahead of the BOJ meeting. Europe is facing the dilemma of having to choose between price stability and the recovery, but it would be a tragic policy mistake if BOJ was to scale back their clear focus on growth. Allowing short-term FX considerations to contaminate the bank's messaging would undermine the effectiveness of policy.

Who to blame

There is clearly public discontent with rising energy and food prices, but while Yen weakness is mentioned as a factor, the thrust of the blame still mainly focuses on global commodity prices. It is thus still possible for Kishida to portray cost-push inflation as akin to a "natural disaster", and Japan's traditional policy response in that case is handing out cash via a supplementary budget. That is the route being taken also now. On the other hand, the public is of course very much aware of the Yen weakness, and worried what that implies for the future. This discussion has however just started, and in people's minds the connection to this being BOJ's fault is not yet that strong.

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On the surface it is easy to argue that Fed tightening vs BOJ staying easy creates the natural background for a strengthening USDJPY. In judging whether this price action is sustainable however, we need to also get a clearer picture about what the underlying flows are and how significant the traded volume is. I am sure that MOF and BOJ are busy analyzing this information as a basis for their response.
On as short-term view, higher commodity prices dump larger Yen amounts into the FX market to buy the same amount of commodities, while the lack of foreign tourists allowed into Japan reduces the natural demand for Yen. The rapid FX move also likely knocked out Japanese importers' FX hedges, forcing them to sell yen even at these extreme levels. Finally, trend following leveraged accounts likely also accelerated the move, as seen from high open futures positions.

Considering the logic of institutional and retail investors however, suggests a less convincing story. The main foreign investment from Japan without an FX hedge is GPIF and retail. GPIF must be seeing the yen value of their foreign investments push to the upper end of their bands, suggesting potential for rebalancing back into Japan assets. Retail in Japan are mostly contrarian investors, and while retail capital flight is a risk, I think it would need some clear geo-political catalyst, like war in East-Asia. Institutional investors buying foreign assets unhedged at 128 in FX and with current global valuations, I think is rather unlikely.

High inflation – strong currency?

In this note I will only flag the issue, but I think it will be important to tire-kick our assumptions for why a country with a 8.5% CPI also has a strong currency. Domestic institutionals don't consume their assets under management, so only need to position correctly on the yield curve, but otherwise their benchmarks insulate them from inflation pain. For foreign investors however, rising yields or stocks of profitable companies are only attractive as long as the currency remains stable. Failure by the Fed to manage a soft landing would carry the risk of reversing this win-win cycle.
A related issue is the historic low of the JPY REER. It basically mainly says that a low inflation country would need to see permanent currency appreciation for their REER to remain stable.

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