20 September 2022

FX Research

Bank of Japan's Gordian knot

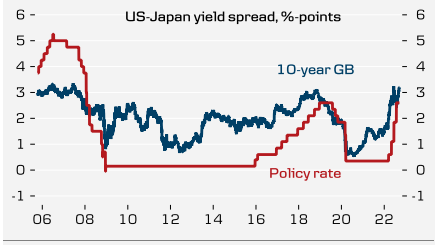
- **BoJ looks stuck between a rock and a hard place. It defends its YCC amid muted inflation, but face pressure from Ministry of Finance to curb JPY freefall.**
- **The spread between US and Japanese interest rates continues to widen which both keeps upwards pressure on USD/JPY and on 10Y JGB yields.**
- **We expect BoJ to stay put at Thursday's meeting – any near-term changes to FX intervention and/or the YCC will have to be forced upon BoJ from the outside.**

Bank of Japan (BoJ) did a "rate check" last week after USD/JPY rose close to 145. It marked a second step before it starts to buy JPY in FX intervention after verbal intervention in the market over the recent months. Meanwhile BoJ defends its yield curve control (YCC) with a 0.25% rate cap – on Tuesday, it bought JPY836.1bn worth of 10-year bonds, the largest amount since June 2020. The spread between US and Japan interest rates will reach the highest level since the financial crisis when Federal Reserve in all likelihood raises its policy rate by at least another 75bp this week. BoJ may have to step up its effort to defend its YCC and avoid another JPY freefall – two conflicting targets in our view. It buys JPY (and sells FX) with the one hand and sells JPY (and buys bonds) with the other. If the Ministry of Finance (MoF) directs the BoJ to make FX intervention buying of JPY, we expect BoJ will be forced to do large-scale intervention. Japan holds USD1.2tn of FX reserves – about similar to foreign investors' holdings of JGBs.

While external factors, i.e. monetary policy in the US, is pressuring BoJ, inflation is still muted in Japan, although on the rise. That is why the BoJ clings to YCC and why we expect BoJ to stay put on the policy meeting Thursday. Changes on FX intervention and/or YCC will have to be forced upon BoJ from the outside. BoJ's preferred inflation measure has climbed above the inflation target to 2.8%. CPI inflation, excluding energy and food, was only 0.7%, but it is on the rise. That gives BoJ some hope core inflation can rise, even in Japan. Inflation has not rubbed off on wages yet, the output gap is still negative and there is still slack in the labour market, which means there could still be some way to go. An unfunded fiscal relief package was announced by the government to shield consumers from rising prices could further add to inflation. So could high energy prices as Japan imports over 90% of its energy consumption. The global energy crisis increased the trade deficit to JPY2.4tn in August – another pain point for JPY.

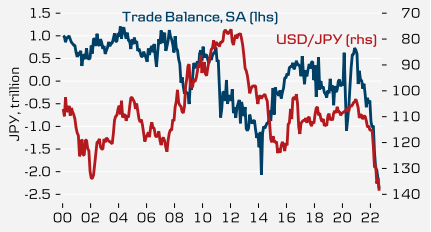
If MoF decides to start FX intervention, it opens Pandora's box in financial markets. The market will speculate in BoJ abandoning its YCC as it cannot both have low yields and a stronger currency. The impact on USD/JPY is difficult to foresee. FX intervention may cap USD/JPY, but for how long? Should BoJ scrap its YCC, it paves the way for a big drop in USD/JPY. But as we note above, energy prices also have a big impact on USD/JPY. Speculative investors look as undecided as we are. IMM positioning is neutral to slightly short in JPY. The only thing we are quite certain of is that monetary policy regime changes, such as what could await in Japan, are rarely pretty.

Yield gaps widen



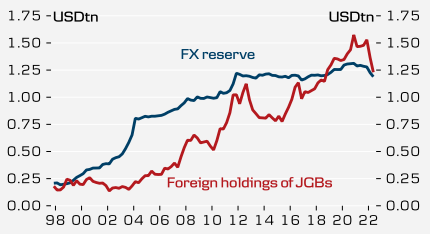
Source: Japanese Ministry of Finance, Macrobond
Financial Note: Past performance is not a reliable indicator of current or future results

Largest trade deficit on record weighs heavy on JPY



Source: Japanese Ministry of Finance, Macrobond
Financial Note: Past performance is not a reliable indicator of current or future results

FX reserve corresponds to foreign investors' holdings of JGBs



Source: Japanese Ministry of Finance, Macrobond
Financial

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