Flossbach von Storch
RESEARCH INSTITUTE

MACROECONOMICS 01/08/2024

Is the Japanese Yen on the Track of Recovery?

Or is a Permanent Crash Looming?

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Abstract

The Japanese yen has weakened because the Bank of Japan has not followed the interest rate increases by the Fed and ECB. However, the depreciation of the yen need not be permanent because Japan has large foreign currency-denominated assets that can be repatriated at any time. Unless the resulting yen appreciation triggers a financial crisis, which undermines permanently the internal and external value of the Japanese currency.

Zusammenfassung

Der japanische Yen ist schwach, weil die Bank von Japan den Zinserhöhungen von Fed und EZB nicht gefolgt ist. Die Abwertung des Yen muss aber nicht für immer sein, weil Japan über ein großes fremdwährungsdenominiertes Auslandsvermögen verfügt, das jederzeit repatriiert werden kann. Es sei denn, dass die resultierende Yenaufwertung eine Finanzkrise auslösen würde, was den Innen- und Außenwert der japanischen Währung auf Dauer unterhöhlt.

The Japanese yen is weakening. While it was trading at 77 yen per dollar in January 2012 and 104 yen per dollar in January 2021, it was over 160 yen at the end of June 2024. After a recovery in July, it is currently around 150 yen. The devaluation is so strong that it has changed travel behaviour worldwide. In Japan, people are complaining about an "overtourism crisis" and that a selfie mania blights scenic locations.

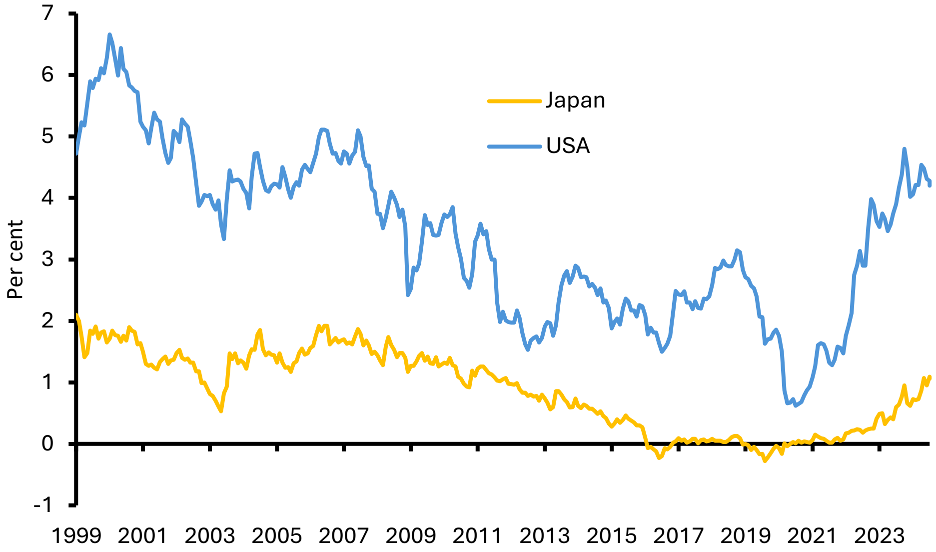
Japan's Ministry of Finance has reacted nervously with foreign exchange market interventions, which are not just about Japan's reputation as a tourist destination. The devaluation has become a political problem because it has driven up the prices of food and energy. Prime Minister Kishida's popularity ratings have collapsed. The Bank of Japan could stop the depreciation pressure by raising interest rates, but remains hesitant. Does this point to a permanent decline of the Japanese currency?

Figure 1: Exchange rate yen per dollar

Source: IMF.

The reason for the current weakness of the yen is obvious. After inflation had risen sharply in most industrialised countries since 2021, the US Federal Reserve and the European Central Bank raised key interest rates with force from 2022. The Fed has reduced the securities holdings on its balance sheet, with the result that interest rates on 10-year government bonds have risen sharply realative to 10-year Japanese government bonds (Figure 2). The growing interest rate differential between Japan and the USA has made it attractive to borrow in yen at low interest rates and to invest in higher-yielding dollar assets despite exchange rate risks. The so-called carry trades - speculators borrow in low-interest currencies and invest in high-interest currencies – have gained momentum, with Mexico and India being major destinations. Many purchases of tech shares are also likely to have been financed with yen.

Figure 2: Japan and USA: Interest rates on 10-year government bonds



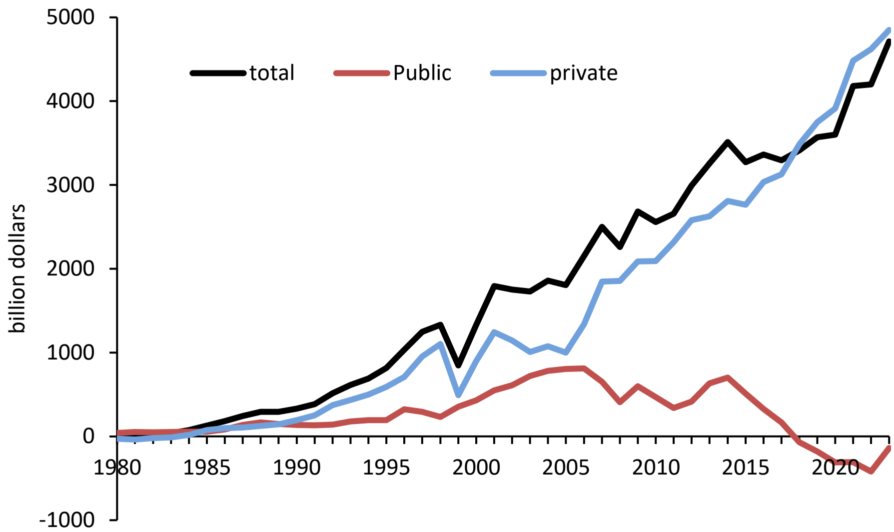
Source: IMF.

The Bank of Japan followed suit in spring 2024 by raising the key interest rate from -0.1 per cent to recently 0.25 per cent and letting increase the interest rate on 10-year Japanese government bonds to around 1 per cent. However, this has not significantly narrowed the interest rate differential with the United States. In contrast to other major central banks, the Bank of Japan is continuing to expand its holdings of government bonds despite the recent reduction in volume. There are many possible reasons for this: The interest liabilities of the highly indebted Japanese government would explode, and the Bank of Japan would suffer heavy losses.

Nevertheless, the yen could also appreciate again. Since the early 1980s, Japan has accumulated net foreign assets totalling around USD 5,000 billion based on continued net capital exports (Figure 3). These assets are denominated in foreign currency (probably predominantly dollars) and are largely held privately. The Bank of Japan has significantly promoted the capital outflows from Japan by keeping interest rates in Japan on average 2.8 percentage points below the interest rate level in the United States since the early 1980s (Figure 2).

According to the open interest rate parity, a permanently lower interest rate level in Japan than in the US signals appreciation expectations of the yen against the dollar. The yen would indeed appreciate if many Japanese investors were to withdraw their capital from abroad and exchange it for yen. In the past, a major earthquake in the Kanto capital region was discussed as a possible trigger because a lot of capital would be needed for reconstruction.

Figure 3: Net foreign assets of Japan



Source: IMF.

If, for any reason, the appreciation expectations become persistent, this could trigger a run into the yen - as was the case after the Plaza Agreement in September 1985. Inter alia, Japanese life insurance companies and pension funds have large investments in dollars, which are only partially hedged against exchange rate risks. As the balance sheets and payout obligations are in yen, a strong yen appreciation could quickly erode a life insurance company's equity. If the appreciation expectations become permanent, financial market players would have to liquidate their dollar investments and exchange them for yen sooner rather than later to minimise such losses. As was the case after the Plaza Agreement between September 1985 and 1987, an uncontrolled, self-reinforcing yen appreciation could hit the Japanese economy hard.

If interest rates in the USA remain high, a dilemma looms. The interest rate hikes in the USA have severely depressed the prices of low-yielding securities. These losses are not realised if the securities are held to maturity. However, if the yen appreciates sharply during this period because the Bank of Japan raises interest rates, painful exchange rate-related valuation losses are incurred. Japanese life insurance companies, banks and pension funds would be faced with the choice of either liquidating US government bonds at a loss or accepting the appreciation losses until maturity.

Japan's Norinchukin Bank recently provided a foretaste of such a scenario. It has decided to liquidate US and European government bonds totalling 63 billion dollars, resulting in an expected loss of around 10 billion dollars in the current financial year. The current weakness of the yen will enable it to offset some of these losses. However, if other institutions repatriate foreign assets, the yen would appreciate, and the interest-related valuation losses could be compounded by appreciation losses on the remaining foreign investments. The later the decision to liquidate foreign assets is made, the greater the losses.

So it seems that not only the politically influential export industry, but also many financial institutions, including large pension funds, fear a strong yen like the holy water puts devils to flight. It is true that the devaluation hurts consumers. However, the government could see a weak yen as the only way to prevent a financial crisis and to safeguard exports as an important pillar of the economy. This could explain the Bank of Japan's dithering over interest rate hikes.

The fact that the Bank of Japan is largely unable to act could also point to a permanent devaluation of the yen. As soon as interest rates in the US fall again, the Bank of Japan would have to ease its monetary policy quickly to prevent the yen from appreciating too strongly. Yet a permanently depreciating yen would only be compatible with open interest rate parity, if long-term interest rates in Japan rise above long-term interest rates in the US. This would be the case if inflation in Japan continued to rise and with it the inflation premium on interest rates, while inflation in the US continued to fall.

To date, the government has kept inflation low thanks to extensive government bond purchases by the Bank of Japan through subsidies for food, energy, local transport and education. However, given the already extremely high national debt, this strategy could increasingly reach its limits. Together with the efforts of the trade unions to compensate for the loss of purchasing power that has persisted for more than two decades through high wage demands, inflation in Japan could continue to rise.

If expectations of a falling internal and external value of the yen persist, as has been the case for some time, Japanese investors could lose the appetite to exchange their foreign assets back into yen in the long term. The upward pressure resulting from repatriation expectations would disappear. Finally, the dwindling external and internal value of Nippon's currency would be adjusted to the long-since dwindling economic strength.

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