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Flash Notes

Examining the Risks of Intervention in the JPY

It's been all about the JPY this week and the last, as Japanese officials convey their opinions on how to battle against their strong currency. USD/JPY punched through the 84.72 fifteen-year-low on August 24, setting a new level at 83.60.

Threatened by the rising JPY and prolonged deflation, Japan's PM Naoto Kan, on Monday, announced a 920-billion-yen stimulus package in tandem with steps by the Bank of Japan (BoJ) to ease monetary policy. Kan said the plan will include steps to boost employment for graduates, investment in green industries and support for smaller businesses and measures to boost consumption. The plan will be ready on September 10, four days before the Democratic Party of Japan's election. On the same day, BoJ Governor Masaaki Shirakawa and his board expanded a bank-loan program by 10-trillion-yen after an emergency meeting. This will be offered in six-month credit, with the term for the other 20-trillion-yen remaining at three months.

One positive thing about the 920-billion-yen stimulus package is that it will be financed from reserve funds, and hence will not require the need for additional JGB issuances. However, judging from the market's reaction, it did not have much of an impact in improving sentiment. USD/JPY has continued to hover around the 84.00-levels. In fact, the disappointment from the lack of convincing initiatives, as well as the decline in US equities (on Monday), saw the Nikkei tumbling down over 3.5% on Tuesday.

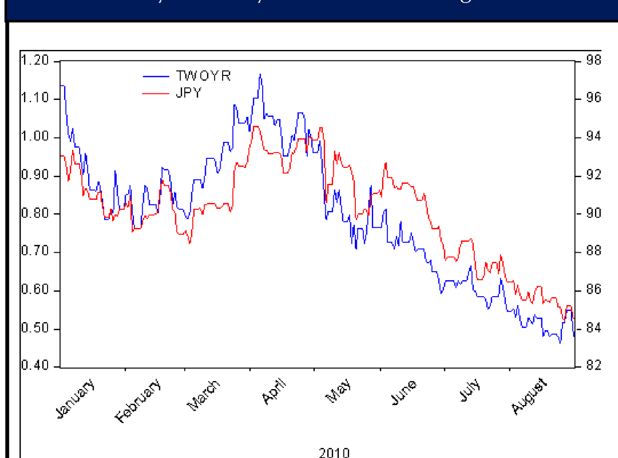
JGB yields were seen to fall with the 10-year yield back below the 1.00% level. The 10-year JGB futures gained nearly half a point. Given where the longer-term yields were last week, they still have significant room to head lower. With USD/JPY back below 84.50, continued pressure on equities will support buying of JGBs. Wednesday's auction of 2.2-trillion-JPY of 10-year notes is expected to provide a clearer gauge of the strength of market demand.

So what's fuelling the JPY's rise?

The JPY has benefited from risk aversion, as market participants continue to seek safety. Notably, prices continue to track very closely with US Treasury yields, keeping the focus on US economic data and indirectly aligning the USD/JPY pair with risk appetite amid ailing confidence over the recovery and the dovish US interest rate outlook.

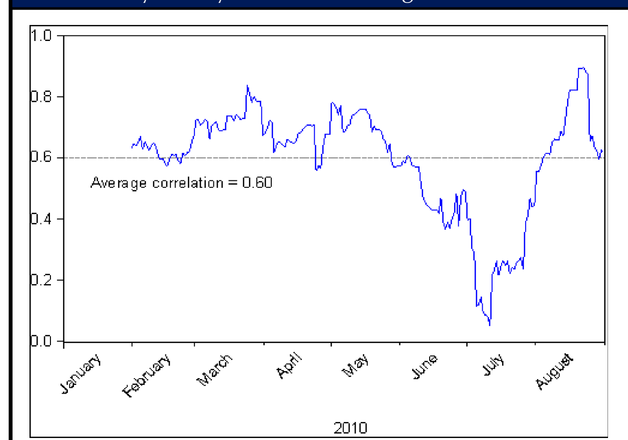
Indeed, the correlation between the trade-weighed JPY and the 2-year US note yield went above 0.8 in the last month on 30-day percent change studies. Considering that carry trades tend to be financed in the perennially low-yield JPY; at times of risk aversion, these positions are unwound along with losses in other assets seen as representing a preference for return over safety, including stocks and commodities, and thus pulling the JPY higher.

Chart 1: 2-year UST yields and trade-weighted JPY



Source: Bloomberg, UOB Economic-Treasury Research

Chart 2: 30-day 'rolling' correlation between % change in 2-yr UST yields and % change in USD/JPY



Source: Bloomberg, UOB Economic-Treasury Research

Besides, further fuelling the JPY's safe-haven appeal this week are consensus forecasts that the upcoming headline non-farm payrolls in the US will drop another 100K from the previous decline of 131K in July; with the unemployment rate expected to climb to 9.6% in August from the previous 9.5%. At the same time, Fed Chairman Ben Bernanke said that the FOMC is prepared to provide more accommodation if needed, and went onto add that he expects slow growth in consumer spending. These comments now leave the door open for further quantitative easing measures, after the Fed recent decision to reinvest MBS proceeds into US treasuries.

Will the Japanese authorities intervene?

With the strength in the Japanese currency now weighing on its exports (which have led Japan's recovery from last year's global recession), newswires will be kept busy for now with market participants anticipating of an intervention by the BoJ, which acts on behest of the Ministry of Finance (MoF).

At a press conference on Tuesday, Finance Minister Yoshihiko Noda reiterated the government is ready to take "bold" action on the currency if necessary, and his deputy said any intervention to sell JPY in the market should leave the extra liquidity in the system. Also at the press conference was Economy Minister Satoshi Arai, who said it is "too early" to determine how markets will evaluate the policy steps.

Yet, despite all the verbal jawboning, Japanese officials have not actually come up with drastic measures to curb the JPY's rise. And it seems for now that markets may grow numb to future threats until policymakers actually pull the trigger, leaving us with the question on whether there will be any concrete action.

One possible reason for reluctance could be the costs of intervention. According to reports, the MoF has latent losses of around 9-10-trillion-JPY, which accounts for about 2% of GDP, on the holdings of foreign currency denominated assets it has accumulated through intervention in the past, which have been followed by subsequent JPY appreciation. The challenge, though, is that if it does not intervene, then the MoF's balance sheet could worsen. What this means is that the BoJ has limited options and may leave JPY-selling activities by the MoF unsterilized. Notably, Japan has not intervened to sell the JPY in the FX market since 2004, when the JPY was around 109 against the USD. The BoJ sold 14.8-trillion-yen in the first three months of 2004, after record sales of 20.4-trillion-yen in 2003.

Another likely reason is that the Japanese economy seems to be in an FX intervention trap yet again after their liquidity trap. And this does not look too good for Japan. The ensuing strong JPY amid the global economic slowdown will undoubtedly weigh on exporter and corporate activity. This will lead to a widening output gap which will probably worsen the ongoing deflation. The worry now is that this rise in deflation together with worsening deflationary expectation will raise real interest rates and coupled with the zero rate boundary of the monetary policy, will in turn lead to further strengthening in the JPY. This negative feedback loop will be self feeding and looks to persist until the US recovers with a rise in US interest rates. Yet another reason why the Japanese government and the BoJ are reluctant is that they realize that under these conditions, intervention would have only a limited impact especially if the US and Europe are not on board.

What should we expect from here?

Nevertheless, some members in the DPJ are reportedly arguing for a change in the BoJ's law, to force the central bank into action. On the other hand, there is also speculation that policymakers may choose to step up its quantitative easing program as they did towards the end of 2009. In any case, we think that the chance of this occurrence is very minimal for now. Having said that, with signs that further steps remain open, risks of intervention by the BoJ should not be overlooked.

But clearly for now, we expect the JPY theme to dominate in FX land especially by the fact that markets are paying more attention to Japanese officials who have indicated that they are closely watching the JPY movements. Besides, volatility at the current levels should stay ahead of the BoJ rate decision on September 6; and perhaps only then we may see broader trends in price action. For now, we expect USD/JPY to trade at current levels of 84.00 unless risks of intervention dissipate.

And one cannot ignore, too, the ongoing political battle in Japan. Kan is locked in a battle to retain his job after the ruling DPJ's former No. 2 official, Ichiro Ozawa, declared his candidacy to lead the party in the September 14 contest. Kan has pledged to cap bond sales in an effort to sustain confidence in the world's biggest public debt, a commitment Ozawa has not made. The election for DPJ president will be conducted by the party's parliamentary lawmakers, local assembly members and regional officials, with the votes of the first group worth more than twice that of the next two combined.

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