TrendMacrolytics

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MARKET CALLS

BoJ Watch: The Falling Yen

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The Japanese yen touched three year lows overnight below 128/$ on continued speculation that authorities there are prepared to encourage a sustained yen weakening to subdue the chronic deflation that has thrown the Japanese economy into its fourth recession of the past decade. Today's move was touched off when the **Finance Ministry's** senior official on foreign exchange issues, **Haruhiko Kuroda**, appeared to countenance the yen's recent slide, suggesting that the currency "is still in a correction phase."

By the opening of the New York session, though, the currency was trading only slightly weaker than its Friday close at about 127.5/$, amid indications that after falling by some 4 yen against the dollar over the past two weeks, the near-term bet on further depreciation could face some resistance. That resistance is essentially personified by **Bank of Japan chief Masaru Hayami**, who today took the opportunity again to cast a dubious eye on various options for large-scale liquidity additions, including foreign bond purchases or more aggressive outright buying of Japanese government bonds.

No doubt, left to its own devices, the calcified BoJ bureaucracy would be about the last place you'd expect to welcome ideas for unconventional action to quell the deflationary impulses. Fortunately, though, the Finance Ministry doesn't appear to be backing down from its tone of urgency in calling for an end to business-as-usual. Experience suggests that the BoJ's ability to resist such pressure is likely to be limited. In fact, in their Kabuki-like exchanges, the MoF and BoJ appear to be dancing around an option that would allow the central bank to save face while satisfying the Finance Ministry's objective for concerted anti-deflation action. Since the BoJ technically is barred from acting unilaterally to effect foreign exchange values, the option would have the MoF authorize BoJ purchases of non-yen-denominated bonds as a tool of government forex policy.

Most likely reflecting doubt about the sustainability of the yen's recent depreciation, 10-year JGB yields have actually fallen over the last several sessions, and now stand at 1.325%. Given Japan's monetary history over more than a decade, such a market response certainly is not irrational, and helps underscore the extent to which the Japanese authorities must counter deeply embedded skepticism about policymakers' ability to overcome the culture of deflation. But the view here remains that a critical consensus has emerged among the Japanese power elite that radical action is required to correct the past decade of nearly incomprehensible monetary policy error. As abnormally low long-term Japanese yields can be seen as a manifestation of that error, we expect to see a sharp sell-off in JGBs accompanying a credible anti-deflation policy shift, with impressive gains available to those holding short positions. We are closely monitoring the Tokyo policy scene and will continue to provide alerts on any developments relevant to that opportunity.TM

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