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MARKET CALLS

BoJ Watch: A Pause On the Yen's Downhill Road

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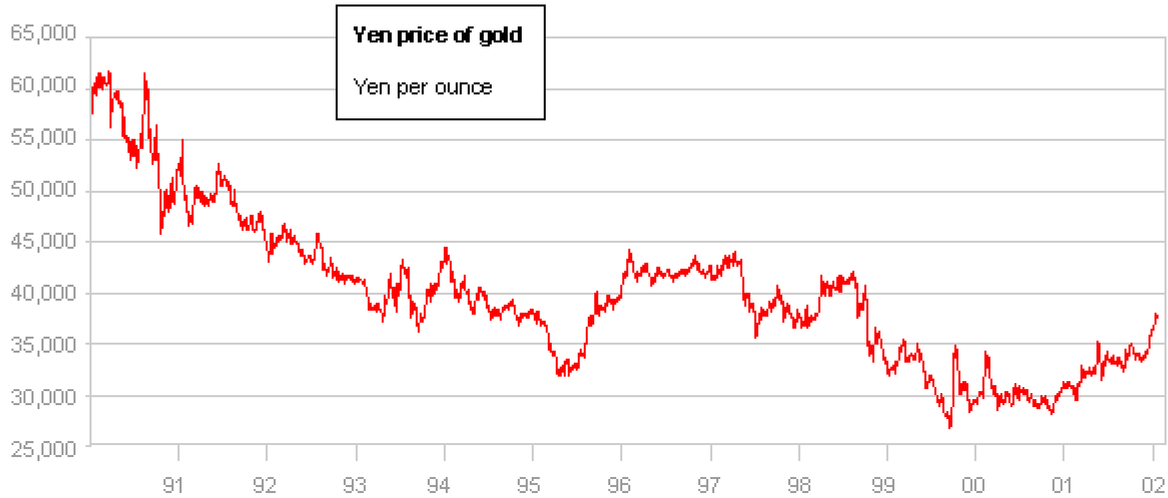
Having fallen steadily against the dollar by some 7% since late November, a confluence of largely political forces is now complicating the one-way bet on a weaker yen, keeping the currency range-bound around 132.5/$ the past two weeks. Against a backdrop of increasing financial fragility in the midst of Japan's worst recession of the post-World War II era, however, resistance to further depreciation is likely to prove short-lived. Odds favoring another leg down in the yen's decline near-term clearly outweigh the chances of a reversal of the recent weakening trend, or sustained stability at these levels, and I'd expect a move toward the 140/$ level to commence soon.

Resumption of the yen's depreciation also should maintain downward pressure on long-term Japanese government bonds. The yield on benchmark 10-year JGBs has risen by 12 basis points since late last month to around 1.45%, the highest level in more than four months. A continued moderate pace of erosion in JGBs seems the most likely course for the period ahead, and a 1.6%-1.75% target for 10-year yields appears plausible over the next several weeks.

After tacitly encouraging the yen's descent over the final weeks of last year, authorities adopted a noticeably more restrained stance when several of Japan's Asian neighbors went public with worries that a continued yen decline would damage their external competitiveness. Such complaints, of course, were meant to be seen as a not-so-veiled threat of competitive devaluation should the yen's slide continue. In no time, all the talk about options for pumping large sums of yen liquidity into the deflation-ravaged Japanese financial system, which had seemed to finally reflect official recognition of the monetary nature of Japan's long-running economic plight, was silenced. Instead, the world was again treated to the insipid pronouncements of Japanese officialdom, as when **vice finance minister Haruhiko Kuroda** announced that "we do not intend to guide the yen lower, nor have we been taking such a policy."

Not to be outdone, the Bank **of Japan's Masaru Hayami** soon upped the ante, averring that it "is important to maintain a strong currency," and suggesting that "no central bank" could support a weakening of its currency. In reverting to form, Hayami's attitude underscores the extraordinary incompetence at the core of Japan's monetary wreckage. The country's top central banker apparently cannot distinguish a "strong" currency that maintains its purchasing power from a unit of account that pulls down the value of everything priced in relation to it, as has been Japan's experience for most of the past decade. Actually, the best gauge of a currency's strength is not relative to other currencies which themselves fluctuate more or less constantly in terms of their real purchasing power. The best gauge is against an internationally traded commodity such as gold which maintains constant real value over time. In those terms, as seen in the accompanying chart, the yen by the end of the last decade was twice as strong in gold terms as it was at the beginning, deflating the entire pricing structure of the Japanese economy along with it. The bankrupting of debtors by the score and the devastation of creditor asset portfolios is the inevitable consequence of such an all-encompassing deflation.



At the same time, the chart also indicates that a measure of relief from the worst of the deflation is now in train, with the yen price of gold now at its highest levels in more than three years, above Y37,000 per ounce. Our best estimate is that restoring a price-stable environment would be inconsistent with a yen gold price below 42,000 per ounce which, assuming a dollar gold price around $280/oz., would imply a yen/dollar rate no stronger than 150. As well, vanquishing expectations of future deflation are at least as critical to reinstituting the processes that would allow expansionary forces to take root. Abnormally low JGB yields, still at least 200 to 250 basis points below what can be considered an internationally competitive real yield, are one manifestation of those lingering expectations.

Nevertheless, the case for further yen weakness remains compelling. For all the reactionary thinking of the BoJ's hidebound bureaucracy, there is at least recognition that the financial system is a ticking time bomb, and that sustained liquidity injections at elevated rates remain necessary to stave off disaster. That figures to be even more the case in the next few months, as removal of the blanket bank-deposit guarantee could lead to runs on smaller and weaker institutions, forcing the BoJ to step up its provision of liquidity to ensure against systemic breakdown. And although they haven been implemented in highly suboptimal fashion, the BoJ's adoption of steadily more generous "quantitative" policy targets have helped provide a non-trivial reflationary impetus, as seen in the recent rise of better-than 10% in the yen price of gold. With the Japanese, this is unlikely ever to be a particularly straightforward process. The betting here remains, though, that the bias toward continued yen depreciation remains in place. TM