

MARKET CALLS

BoJ Watch: The Yen Paradox

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The rally of the Japanese yen appears to have run its course -- after rising more than seven yen against the U.S. dollar in little over a week before falling back by more than a full yen today. To be sure, the reversal of the bulk of the currency's depreciation over the past three months is a jolting reminder that a bet on Japan's overcoming a decade of deflation is no risk-free proposition. Given the penchant of Japanese authorities to send signals about their intentions that are at best inconsistent, and at times conflicting, a fair degree of volatility can be expected. Still, the policy direction now in place, under which the **Bank of Japan** is committed to inject new yen liquidity at a rapid pace, will likely overwhelm the short-run forces driving the currency higher (see "[BoJ Watch: Climbing on Board.](#)" March 1). We'd expect to see the yen/dollar rate break back through 130/\$ in short order, *en route* to a medium-term target around 140/\$.

The currency's surge can be seen reflecting an apparent contradiction in that it was spurred in large measure by the BoJ announcement last week adopting a significantly more aggressive liquidity stance, acquiescing to the **Koizumi** government's anti-deflation program. The explanation for the paradox of a reflationary policy initially producing deflationary results is primarily one of timing. By reducing systemic risks and holding out the best promise in years that the deflationary pall will finally be lifted from the Japanese economy, the immediate impact of the BoJ announcement was to lift growth expectations and thus demand for the currency. The enormous shift in sentiment regarding the Japanese economic outlook can be seen in the 21% gain in the Nikkei equity index since February 20, the day before word first leaked out that the BoJ was likely to accede to the government's call for action.

But the BoJ, although it has signed on to permanently inject liquidity amounting to Y1 trillion per month, will do so on its own predetermined schedule. This timetable is likely to be influenced little -- if at all -- by anything as ephemeral (from the BoJ bureaucracy's perspective) as the market's reckoning of what yen supply/demand conditions may be at any particular time. In fact, while **Finance Ministry** officials were clearly alarmed by the yen's ascent and hinted broadly about the possibility of intervention, **BoJ Governor Masaru Hayami** projected an aura of calm detachment. Today he stated that the rebound in the currency was "no big deal," and indeed that it was welcome "up to a certain extent." Then again, this is a central bank that was only too happy to let it be known last week that while it was going along with the government's request for additional liquidity, it was confident that Japan's deflation was not a monetary phenomenon.

That sort of mind-boggling incompetence would be difficult to overlook if not for the fact that the central bank, in accepting the government's recommendations for anti-deflation strategy, has been effectively neutered in its exercise of discretion. In due course, it will fulfill its government bond purchase commitments, which likely will add yen liquidity sufficient to more than satisfy the increased money demand being signaled by the market. That also seems to be the bet reflected in the 10-year JGB, which would likely have rallied appreciably if the yen's recent movement were signaling another slide into deepening deflation expectations. Instead, the benchmark JGB has remained in its present trading range at a yield just below 1.5% throughout the week. **TM**