21 June, 2022

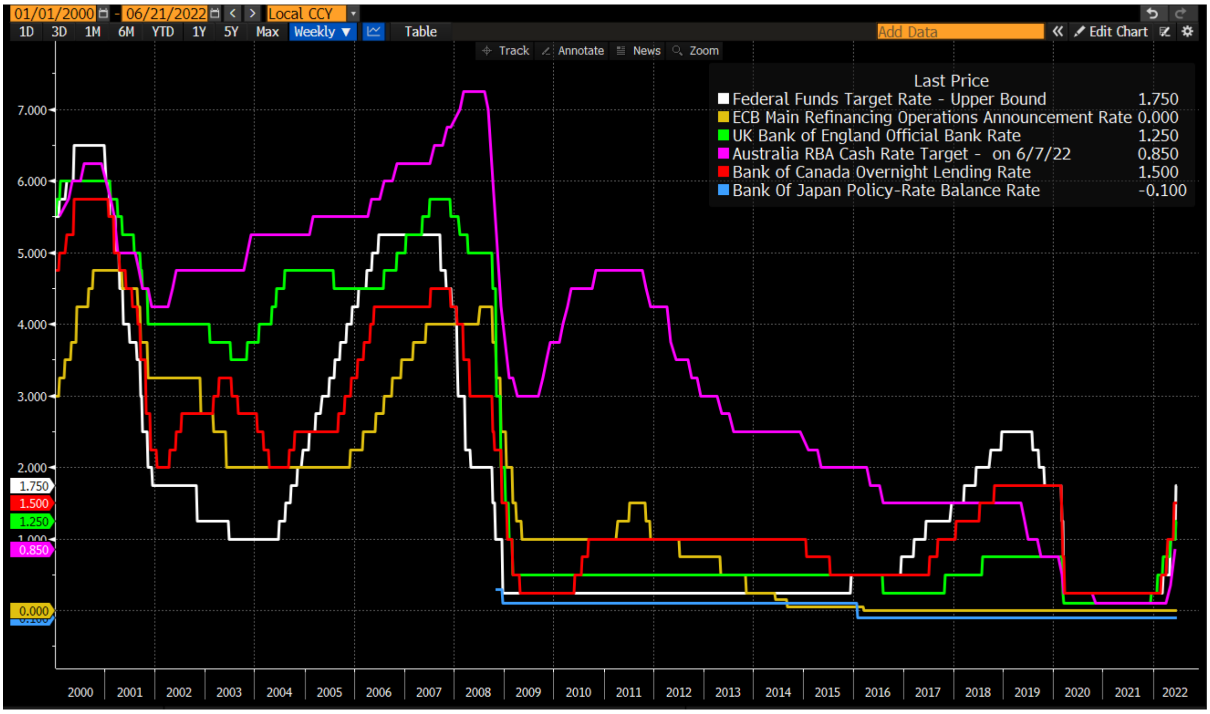
Bank of Japan's Conundrum and Weak Yen's Disappearing Benefits

Financial markets participants continued fixated on inflation, which has soared to multi-decade highs for many nations, and more and more central banks are stepping up rhetoric and actions on monetary policy tightening. High inflation is hurting regular people as it diminishes the purchasing power from their hard-earned salary, and at the same time eroding corporate margins – particularly those that are unable to pass through higher costs to downstream or end customers. Sell side analysts at Wall Street firms are busily revising down estimates for earnings growth for this and next year. At the same time, economists and strategists are raising the prospect of economic slowdown, and some have warned of the likelihood of recession and even stagflation.

Confronting the conundrum of taming inflation and supporting economic growth, central bankers from most developed nations are leaning towards focusing on the former. Many of these nations have experienced periods of rampant inflation during the '70s and '80s, and their policymakers fully comprehend the importance of not letting inflation expectations ingrained into people's mindset. Otherwise, this could germinate and lead to runaway inflation (even hyperinflation) with devastating consequences.

The chart below shows policy rates of six major central banks since early-2000. It can be seen that the US, UK, Australia and Canada have moved swiftly to adjust interest rates higher this year. So far, only European Central Bank (ECB) and Bank of Japan (BOJ) have stayed put. In recent weeks, ECB has made it clear that they are ready to join the fight against inflation by raising rate in their July policy meeting. On the other hand, BOJ is staying firm and reiterated the need to maintain ultra-loose monetary policy.

Policy rates among major central banks



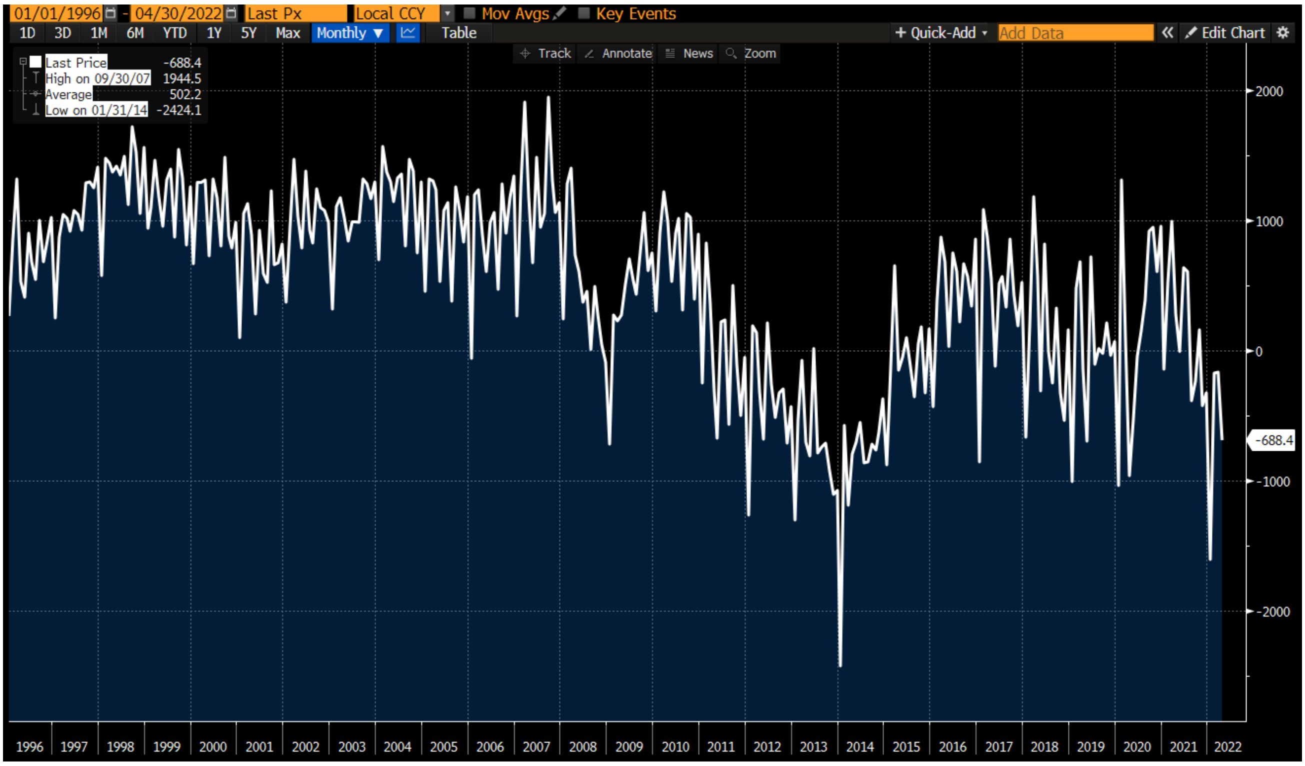
Source: Bloomberg

The divergency in Japan's monetary policy has prompted an exodus away from the Japanese yen. On a year-to-date basis, the yen has fallen in excess of 15% against the US dollar, making it the weakest among the world's major currencies. At the current level, the yen is at the lowest since the summer of 1998 (i.e., 24 years ago).

In the past, when Japan was an exporting powerhouse, a weak yen was highly beneficial to companies as it made their products more attractively priced to foreign buyers. But over the decades, more and more of Japan's established companies have set up manufacturing facilities in oversea locations and hence products being sold in other nations are made locally instead of being shipped from Japan. For those companies producing overseas, a weaker yen does not make their products more competitively priced and therefore has little impact to top-line sales. And because fewer products are made in Japan to export to other markets, this has very limited contribution to GDP growth. In other words, the benefits a weaker yen to Japan has diminished over time.

Looking at Japan's trade balance data, one can see that the nation is no longer a trade surplus champion. Since about 10 years ago, Japan has from time to time recorded net trade deficit, meaning that it had been importing more value of goods and services than it had exported.

Japan Balance of Payments Trade Balance (in billions of yen)



Source: Bloomberg

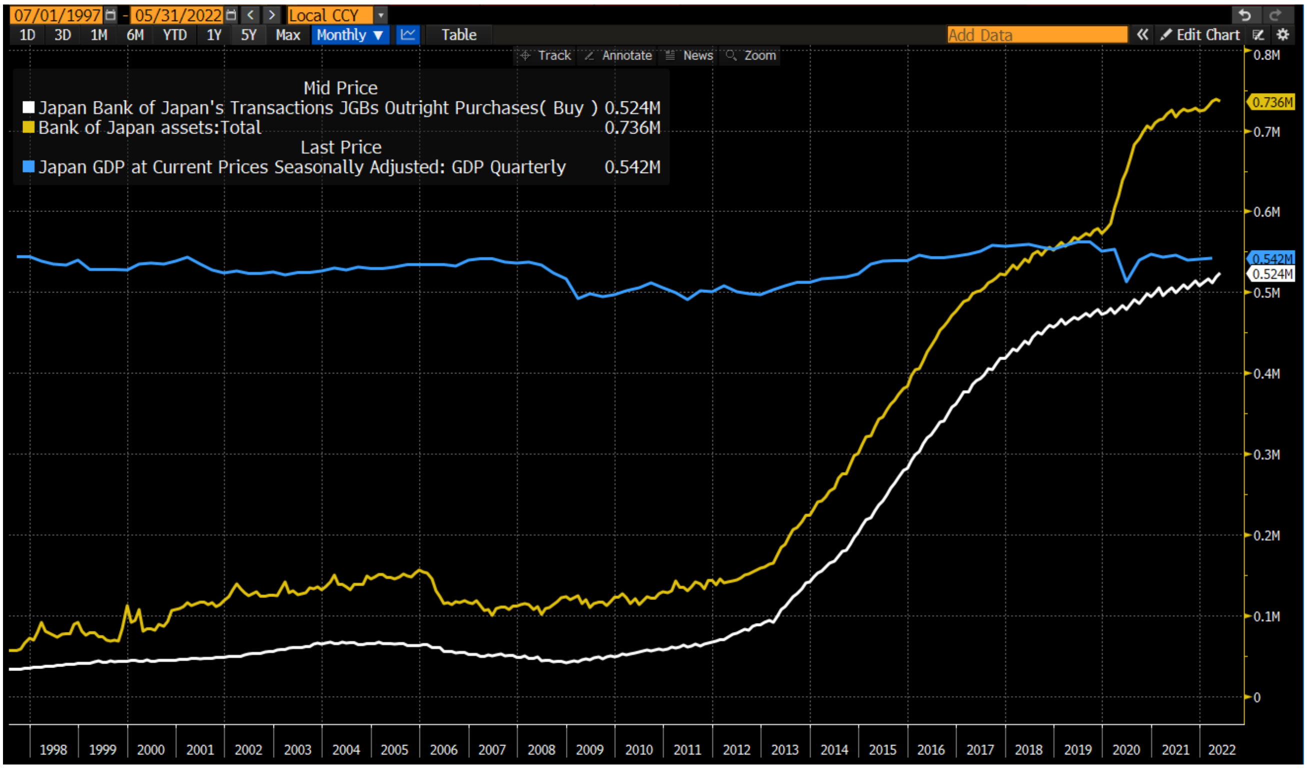
In the chart below from 1990 till now, it can be seen that the white and yellow line tend to move in synch. To be more precise, there were two previous periods when a weak yen failed to support higher stock prices. The first time this happened was during late-90s (roughly from 1996 to 1998) during the Asian Financial Crisis, and the second time was during early-00s (from 2000-2002) after the burst of the Tech Bubble. Apart from the two aforementioned periods, during the past year and a half, the unmooring of a weak yen and strong equities performance is the most pronounced.

Japanese yen exchange rate versus the US dollar *(white line)*, Nikkei 225 Index *(yellow line)*

Source: Bloomberg

Ever since Haruhiko Kuroda became the Governor of Bank of Japan in 2013, he has made ultra-loose monetary policy a mandate and that quantitative easing an unwavering tool to stimulate and promote growth of the nation. From that time onward, BOJ's balance sheet has been growing rapidly and itself become the biggest buyer of Japanese government bonds (JGBs). Starting from 2016, BOJ has added Japanese stocks exchange traded funds (ETFs) to its asset purchase program. But despite trillions and trillions yen worth of pump priming and years of negative JGB yields, Japan's economic growth remains elusive. This can be seen in the below chart with the blue line being Japan's GDP in current prices remaining largely flat since 1997.

BOJ holding of Japanese government bonds *(white line)*, BOJ total assets *(yellow line), Japan GDP at current prices (blue line)*



Source: Bloomberg

Not only is BOJ's ultra-loose monetary policy proved futile in promoting economic growth, it is now confronting two challenges brought on by a weak yen as consequence. As mentioned above, given that Japan is importing more than it export (at least from within its borders), a weaker currency means more expensive imports that will ultimately translate into higher inflation. While higher inflation is something that Mr. Kuroda has been desiring to achieve, he may not be prepared to handle a situation when inflation expectations are ingrained into Japanese people's mindset. And should he finally decided to rein in the ultra-loose monetary policy, he may find it difficult to raise interest rate because of Japan's high debt-to-GDP ratio (near the highest in the world). For higher interest rate means higher repayment for many of Japan's heavily indebted companies and especially the government. At the same time, BOJ would find it near impossible to trim down its bloated balance sheet as it is the largest holder of JGBs and among the biggest investors in Japanese equities (via its stocks ETFs). It is a conundrum that Mr. Kuroda created and ultimately need to confront.

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