Daiwa's View

Yen supply/demand outlook for 2022 ~ Foreign exchange supply/demand consistent with weaker yen

- Our yen supply/demand estimates for 2022 suggest significant selling pressure for first time since 2014, mainly due to trade deficit
- Hard to explain 2021 yen weakness in terms of supply/demand; moves possibly driven by speculation
- After Fed makes progress hiking rates, need to watch for sudden yen appreciation on unwinding of speculative positions once concerns about economic outlook/speculation about preemptive rate cuts strengthen

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Yen supply/demand outlook for 2022 ~ Foreign exchange supply/demand consistent with weaker yen

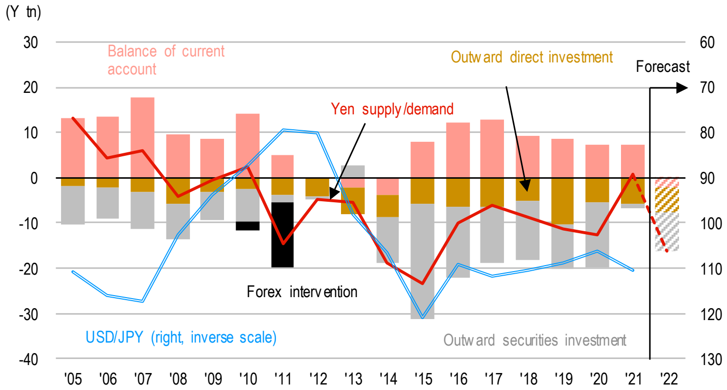
Yen supply/demand consistent with current weaker yen, but watch for sudden yen appreciation on unwinding of speculative positions

Yen depreciation seen in 2021 has continued in 2022 with this trend accelerating from March. This depreciation is attributed to diverging US/Japan monetary policy approaches and concerns about Japan's widening trade deficit brought about by surging resource prices. In this report, we want to update our view of yen supply/demand conditions, including Japan's trade balance, and provide our outlook for this market.

Using Japan's balance of payments statistics and the MOF's foreign exchange intervention operations, Chart 1 provides estimates for yen supply/demand with certain adjustments made to those figures likely to influence exchange rate movements. Here we can see that supply/demand conditions in 2021 resulted in yen net buying to the tune of around Y0.7tn. Supply/demand was tilted in the direction of yen buying following the Y12.5tn selling in 2020. Meanwhile, the actual yen exchange rate moved in the exact opposite direction. This was likely attributed to speculative flows, such as long-short foreign exchange movements due to futures trading, which is not reflected in balance of payments statistics.

The current account surplus is projected to shrink meaningfully in 2022, mainly due to the trade deficit and foreign exchange supply/demand associated with current transactions, which could result in yen net selling to the tune of about Y2.0tn. This will depend on the trading trends involving Japanese corporations and institutional investors that appear in the capital account balance. However, assuming historical average capital outflows, the yen supply/demand would come to yen net selling of about Y16.0tn. The balance of payments statistics are also expected to suggest significant yen selling pressure for the first time since 2014 in terms of the flow of funds.

Chart 1: Yen Supply/Demand (estimates)



Source: MOF, BOJ, Bloomberg; compiled by Daiwa Securities.
Note: As for figures in the balance of payments statistics, reinvestment income is excluded from current account balances (seen as not involving foreign exchange transactions). Bond interest, which is partially reinvested, is likewise not included. Furthermore, amounts for outward direct investment and outward securities investment differ from published amounts because adjustments are made based on assumptions about occurrence of foreign exchange transactions and hedging ratios.

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◆2022 trade deficit could swell to Y6.0tn

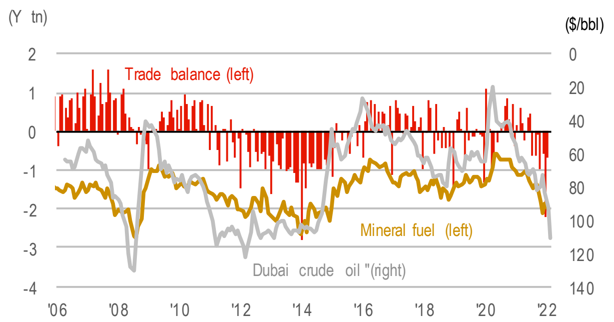
Taking a closer look at yen supply/demand conditions, while there was a trade surplus of Y1.8tn in 2021, many expect a trade deficit in 2022 due to surging crude oil prices. For example, Daiwa Institute of Research forecasts a Y5.8tn trade deficit assuming a crude oil price of $110/bbl (WTI)[1].

The Great East Japan Earthquake of 2011 dramatically changed the configuration of Japan's trade balance. Following this earthquake, Japan's nuclear power plants were all temporarily brought offline and only those plants that satisfy new regulatory standards, which were formulated with even stricter criteria to increase safety, are being restarted (five plants as of Mar 2022). The shutting down of nuclear power plants led to increased utilization of thermal power generation stations as alternatives. This in turn pushed up Japan's imports of crude oil and liquid natural gas (LNG) to fuel these thermal power stations. In recent years, the import volumes of mineral fuels have held steady, but changes in resource prices impacted the value of these imports (Chart 2). When the price of crude oil rose above $100/bbl in 2012-14, the trade deficit (balance of payments basis) was calculated at around Y4.0tn to 10.0tn. Now, in a similar manner, there is an increased likelihood of Japan recording a trade deficit due to surging prices for resources, particularly crude oil.

That said, in the US, the Biden administration, which had been pushing a decarbonization policy, has changed course and is now calling on the energy industry to increase production. Also, Belgium's policy was to close all seven of its nuclear reactors by 2025, but there have been calls to extend the period of time for which these nuclear power plants will continue operating. As Belgium had planned to use Russian LNG as a post-nuclear energy source, its main focus is likely to be on avoiding dependence on Russia, rather than on rising energy prices. However, there is no denying the possibility that Japan will rework its energy policy.

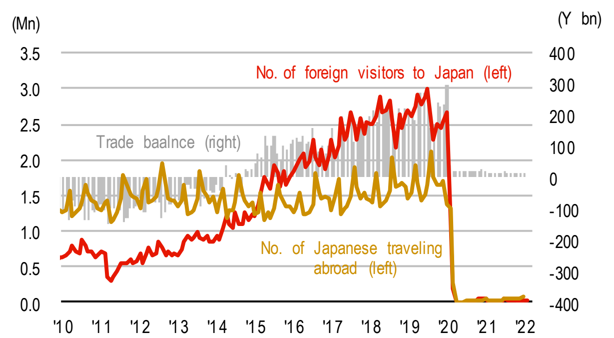
Actually, there have also been prominent media reports on growing calls from the ruling and opposition parties, as well as the business community, to restart Japan's nuclear power plants. Also, a survey conducted by the *Asahi Shimbun* on 19-20 February found that 38% of the respondents favored restarting nuclear power plants (up from 32% in a Feb 2021 survey), while 47% opposed brining these plants back online (53%). This marked the first time that the percentage of those opposing the restarting of nuclear power plants was less than 50% (since June 2013; while the same question has been used, simple comparisons not possible due to a change to survey method from July 2016). Along with a growing sense of crisis over energy security, households are also anxious about rising costs for electricity and daily necessities in general. Debate over energy policy may intensify in Japan as well. In the event of an energy policy shift, we want to keep a close eye on any such developments as changes to the configuration of Japan's trade balance would meaningfully impact yen supply/demand conditions.

Chart 2: Crdue Oil Prices, Trade Balance



Source: MOF, Bloomberg; compiled by Daiwa Securities.

Chart 3: Foreign Visitors to Japan, Japanese Traveling Abroad, Travel Balance



Source: MOF, Japan National Tourism Organization; compiled by Daiwa Securities.

[1] Daiwa Institute of Research report: *Japan's Economic Outlook No. 212 Update* by Mitsumaru Kumagai, et al. (9 Mar 2022, Japanese version only)

◆Resumption of people flows to meaningfully impact yen

Another meaningful contribution to Japan's shrinking current account surplus following the novel coronavirus outbreak was the deterioration in the services balance, especially the travel balance. It goes without saying that this was caused by the restricted movement of people globally and the sharp decline in foreign visitors to Japan brought about by the pandemic (Chart 3).

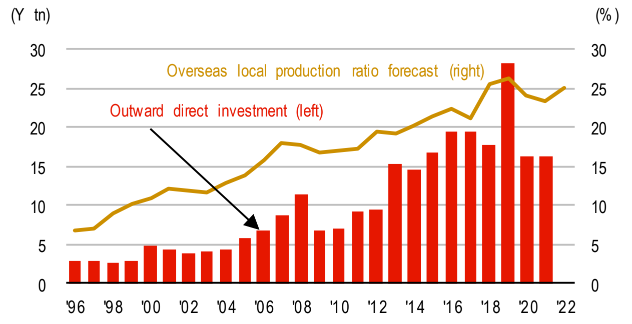
Before the pandemic, the number of foreign visitors to Japan was increasing each year, which led to the travel balance deficit narrowing and turning into a surplus. In 2015, the number of foreign visitors to Japan exceeded the number of Japanese traveling abroad, due in part to Japan's staged introduction of easier visa requirements from 2013 and expansion of the duty-free system in 2014. In July 2019, the number of foreign visitors to Japan was 2.99mn, the highest number for any month on record. However, the number of foreign visitors fell sharply from February 2020 to almost zero. There was a similar sharp decline in the number of Japanese traveling abroad. As such, the travel balance has been roughly even.

Currently people flows remain largely halted globally, Japan's travel balance has been largely zero in 2022, and the service balance deficit seems to be largely on par with that for last year. However, once the back-and-forth movement of people resumes, we can probably expect a reasonably large impact for the yen exchange rate. The travel-related yen buying demand lost due to the pandemic is around Y3.0tn. A complete recovery of that lost amount would be large enough to make up half of the above-mentioned trade deficit for 2022. This, combined with the yen depreciation trend, could bring more tourists to Japan. Although we cannot predict when the coronavirus will be contained, an unexpectedly quick containment of the outbreak would probably have a large impact as no one would be expecting such a development.

◆Hard to expect strong rise in outward investment

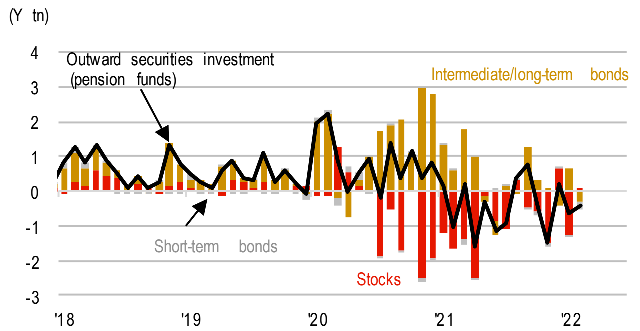
After peaking at Y28.2tn in 2019, outward direct investment declined to Y16.3tn in 2020, due in part to pandemic impacts, and was flat in 2021 (Chart 4). From a somewhat longer perspective, Japanese companies have been active in outward direct investment since 2013. Japanese firms seem to be looking more to overseas markets than to domestic ones. They also appear to be investing overseas due in part to changes in the global environment, such as protectionism and environmental regulations. According to the Cabinet Office's *Annual Survey of Corporate Behavior*, such investments are expected to recover y/y in 2022. However, business confidence is deteriorating rapidly and investment may be postponed due to Russia's invasion of Ukraine and the Fed's switch to aggressive monetary tightening.

Chart 4: Overseas Local Production Ratio Forecast, Outward Direct Investment



Source: MOF, Cabinet Office; compiled by Daiwa Securities.
Note: Overseas production ratio forecast based on a five-year outlook. 2022 refers to 2022 forecast in 2017 survey.

Chart 5: Outward Securities Investment by Pension Funds



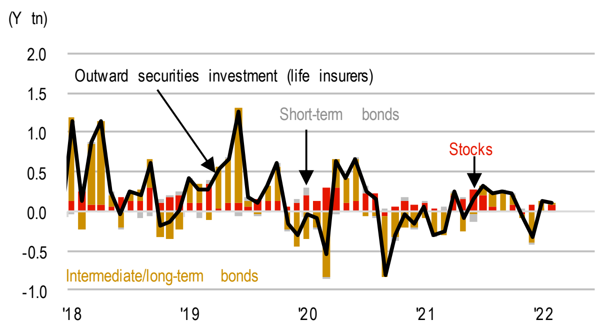
Source: MOF; compiled by Daiwa Securities.
Note: Pension funds refers to banks and trust banks (trust accounts).

Turning to outward securities investment, yen selling by Japanese investors declined significantly in 2021. Pension funds were net buyers of foreign bonds in 2021 to the tune of Y5.3tn, which was meaningfully topped by the Y10.4tn in net selling of foreign equities (Chart 5). Apparently, there was a shift from foreign equities to foreign bonds as investors took advantage of rising equities, particularly US stocks, to rebalance their portfolios. Life insurers and others are also not aggressively investing in foreign bonds (Chart 6). The second half investment plans held by major life insurers seem to suggest reasonably aggressive investing in foreign bonds. However, actually they seem to be holding back from investing in consideration of the market environment. We are still waiting for the FY22 investment plans, but a return to yen bonds is expected as yen-interest rises and foreign exchange hedging costs increase.

◆Foreign exchange supply/demand supporting yen depreciation, but wary of unwinding speculative positions

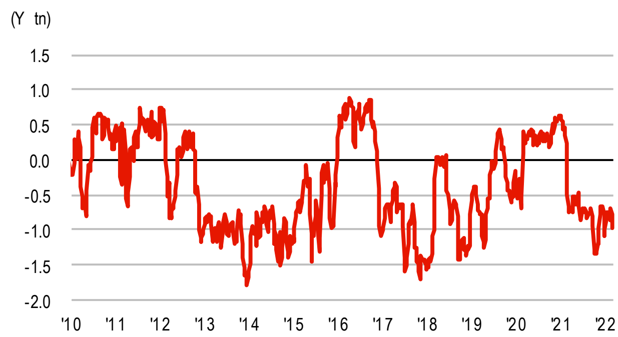
As mentioned at the beginning of this report, foreign exchange supply/demand conditions for 2021 do not suggest a yen sell-off and there is a high probability that speculative moves will be the main driver. Actually, currency futures statistics (from CFTC Commitments of Traders report) show a meaningful accumulation of yen short positions (Chart 7). On the supply/demand side, yen depreciation seems reasonable considering that in 2022 the primary balance (current account balance + direct investment balance), amid the backdrop of a trade deficit, points to a yen sell-off. However, this probably includes a considerable amount of speculative activity. Once the buying back of such positions is triggered, the yen could appreciate rapidly. Currency transactions involving trade and travel include many outright transactions. This is basically a buyout (or sellout) of the yen and foreign currencies, but speculative positions are always subject to counter trading. For example, after the Fed makes progress hiking rates, investors will probably need to be on guard for growing concerns about economic outlooks and increasing speculation about preemptive rate cuts.

Chart 6: Outward Securities Investment by Life Insurers



Source: MOF; compiled by Daiwa Securities.

Chart 7: Yen Positions by Speculative Invesotrs



Source: CFTC, Bloomberg; compiled by Daiwa Securities.

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