Daiwa Securities

Daiwa's View

Confidence in yen not lost

- Must carefully assess current account balance trends considering coronavirus impacts
- Factors that make yen a safe haven (current account surplus, Japan's status as world's largest holder of net foreign assets) remain solid

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Confidence in yen not lost

Basis for viewing yen as safe haven (current account surplus, Japan's status as world's largest holder of net foreign assets) unchanged

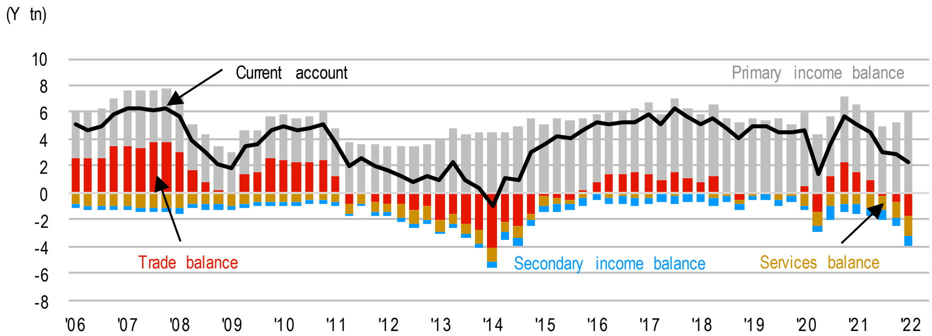
During just the three months since March 2022, the yen suddenly depreciated by Y20 against the dollar to hit its weakest point since October 1998, roughly 24 years ago. Due to this recent deprecation, there is the view that some confidence in the yen has been lost or that its status as a "safe haven" has been shaken.

The yen's status as a safe haven is due to Japan's current account surplus and its position as the world's largest holder of net foreign assets, which were built up through the accumulation of current account surpluses until now. Currently there are concerns about Japan's current account balance moving from a surplus to deficit amid the widening trade deficit, which is a factor that could threaten the yen's status as a safe haven.

Looking at current account balance trends (original series), Japan recorded a current account deficit of Y1.2tn for January 2022, falling into the red for a second straight month. The balance on income surplus was not big enough to offset the balance on goods and services deficit. The main factor now driving this current account deficit is Japan's widening trade deficit. Rising resource prices due to Russia's invasion of Ukraine and other factors have meaningfully impacted Japan's trade balance. Likewise, the balance on services has remained in the red due to a shrinking travel balance surplus with the number of foreign visitors to Japan plummeting due to entry restrictions since the pandemic started.

On a seasonally-adjusted basis, Japan's current account balance has remained in the black. Indeed, Japan posted current account surpluses of Y2.3tn for Jan-Mar 2022 and Y0.5tn for April (Chart 1). However, the trade balance has continued to deteriorate on surging resource prices, posting increasingly larger deficits over three straight quarters since Jul-Sep 2021. Conditions now suggest that the trade balance deficit will continue growing over the next few months, so there is the potential for Japan to post current account deficits for several months.

Chart 1: Current Account (seasonally-adjusted)



Source: MOF; compiled by Daiwa Securities.

Amid growing awareness that Japan's current account balance could move into the red, the debate over the International Balance of Payments Development Stage Theory is gaining momentum. This theory, advocated by Crowther and Kindleberger, explains how the international balance of payments structure changes at each stage of economic development (Chart 2).

Chart 2: International Balance of Payments Development Stage Theory

Stage	I. Immature debtor nation	II. Mature debtor nation	III. Debt repayment nation	IV. Immature creditor nation	V. Mature creditor nation	VI. Credit disposition nation
Trade & services balance	Deficit (–)	Surplus (+)	Surplus (++)	Surplus (+)	Deficit (–)	Deficit (– –)
Primary income balance	Deficit (–)	Deficit (–)	Deficit (–)	Surplus (+)	Surplus (++)	Surplus (+)
Current account	Deficit (–)	Deficit (–)	Surplus (+)	Surplus (++)	Surplus (+)	Deficit (–)
Balance of external assets and liabilities	Net debtor nation (-)	Net debtor nation (-)	Net debtor nation (-)	Net creditor nation (+)	Net creditor nation (++)	Net creditor nation (+)
Outline	Underdeveloped industries result in imports outweighing exports. The balance on goods and services is in the red. A lack of capital means the nation must rely on procurement from abroad, resulting in a balance on income deficit as well.	Export industries have developed and balance on goods and services is in the black. Balance on income remains in the red due to foreign debt interest payments.	Surplus for current account balance as surplus for balance on goods and services outweighs balance on income deficit due to increased exports.	Foreign assets exceed liabilities and balance on income turns into a surplus, resulting in a net creditor nation.	Loss of international competitiveness due to higher costs, resulting in a deficit in balance on goods and services. Current account balance remains in the black due to a large balance on income surplus.	Balance on goods and services deficit outweighs initial balance of payments surplus and current account balance falls into a deficit. Accumulated foreign assets are drawn down.

Source: Ministry of Economy, Trade and Industry materials, others; compiled by Daiwa Securities.

When confirming the conditions for Japan, there is a prominent view that from around 2011 Japan began to transition from the previous "Stage IV. Immature creditor nation" to the "Stage V. Mature creditor nation" stage with a balance on goods and services deficit. Then in 2021, after the coronavirus shock, Japan had a balance on goods and services deficit, a large primary income balance surplus, a current account surplus, and was the world's largest holder of net foreign assets (explained in later section). As such, there is the growing argument that Japan has advanced by one stage of development, having satisfied all of the characteristics of "Stage V. Mature creditor nation."

Furthermore, under the current conditions in which the trade deficit continues expanding on high resource prices, there is the view that Japan could advance to "Stage VI. Credit disposition nation" provided the trade deficit continues expanding and produces a current account deficit. However, the recent current account balance trends should be carefully assessed. Certainly, if the trend of high resource prices continues, the trade deficit could widen further, resulting in a current account deficit for individual months or for several months. However, many do not anticipate a current account deficit for Japan on a full-year basis.

For example, the current balance of services has deteriorated as a result of the pandemic, which artificially suppressed international flows of people. As such, this balance is seen as not fully reflecting the true economic fundamentals. Global inbound demand continues to grow as a long-term trend against the backdrop of rising incomes in Asian countries. Furthermore, when taking into account the recent depreciation of the yen and other factors, such latent demand in Japan appears to have grown meaningfully. Once international flows of people normalize, the government's pre-pandemic goal of 60 million visitors to Japan in 2030 may be achieved. In that case, the outlook for a balance on services surplus would brighten.

Also, structural changes since the Great East Japan Earthquake have meaningfully impacted even the trade balance, for which a trade deficit has continued to grow. There was a series of nuclear power plant shutdowns in Japan in the wake of the Fukushima nuclear power plant accident and most of the nation's nuclear power facilities still remain off line, with a few exceptions. The ratio of thermal power (= nuclear power alternative) in Japan's energy mix has increased. The accompanying increase in fuel imports has resulted in a structure whereby when energy prices rise, the value of imports into Japan swells significantly, causing the trade balance to fall into the red.

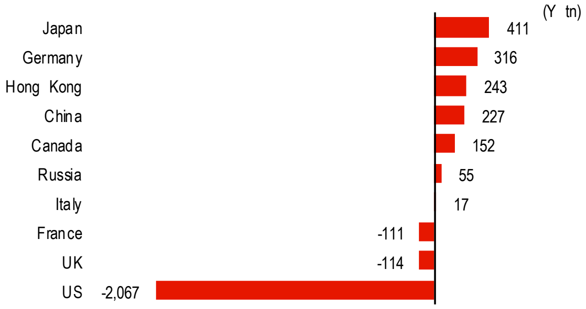
Recently there has been more talk about restarting nuclear power plants. Progress on that front would likely contribute to a better trade balance. However, as the current widening trade deficit is largely influenced by price factors, ultimately a significant improvement in the trade balance will require lower energy prices. If we assume current energy prices are being pushed up by Russia's invasion of Ukraine, the trade balance should improve once this temporary factor drops off. Yen appreciation after the Lehman shock and Great East Japan earthquake encouraged Japanese firms to offshore some of their production. This created a trend of producing and selling more goods overseas, resulting in a decrease in exports directly from Japan. Accordingly, even if nuclear power plants are restarted and fuel imports decline, Japan will probably not return to the trade surplus levels seen before 2010. Still, there is probably room to meaningfully shrink the current trade deficit.

Over the medium to long-term, there is a high probability for Japan to become a country with persistent current account deficits, or in other words a "credit disposition nation." However, there is the strong likelihood that the current account balance is now heavily skewed by special factors, so we think even greater care than usual is needed when assessing current account balance trends.

From the perspective of net foreign assets, the Ministry of Finance on 27 May released the International Investment Position of Japan (as of end-2021). Japan's net foreign asset balance (overseas assets held by Japan's government, companies, and individuals minus liabilities owed to foreign investors, others) grew Y56.1tn vs end-2020 to roughly Y411.2tn, marking a record high for the first time in two years (Chart 3). The main swing factor was forex market moves, specifically the inflated value of assets denominated in foreign currencies (up Y62.2tn) due to the recent yen depreciation. Other adjustments, which reflect changes in stock and bond prices, were down Y16.8tn. Even though growth was only Y10.8tn due to trading flow factors, Japan still maintained its status as the "world's largest holder of net foreign assets" for the 31st straight year.

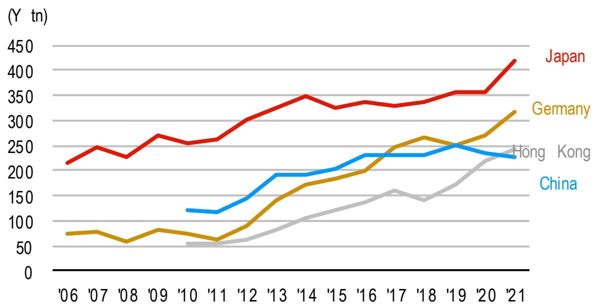
Looking at the major countries (regions), the largest holders of net foreign assets after Japan as of end-2021 were Germany (equivalent to Y315.7tn), Hong Kong (Y242.7tn), and China (Y226.5tn). Meanwhile, the US is the world's largest net debtor nation with a net external debt balance equivalent to Y2,067tn. The gap between net foreign assets held by Japan and No. 2 Germany had been narrowing from the time of the European debt crisis into 2018, but widened somewhat after the coronavirus outbreak. The gap between these two countries widened to roughly Y100tn as of end-2021 (Chart 4).

Chart 3: Net External Assets in Major Nations (regions, as of end-2021)



Source: MOF; compiled by Daiwa Securities.

Chart 4: Trends of Net External Assets in Major Nations (regions)



Source: IMF, Bloomberg; compiled by Daiwa Securities.

Although the net foreign asset gap with Germany has not narrowed in recent years, Germany could eventually take the top spot away from Japan. This is because, as it is often said, Germany has accumulated external net assets as the world's largest current account surplus country, backed by the euro, which is undervalued relative to its fundamentals. Even in that case, Japan would still maintain the status of being the world's No. 2 holder of net foreign assets. Such a development is not expected to have much impact in terms of confidence in the yen.

A more important point is probably whether the current account balance is a surplus or deficit at that time. When a country has a current account deficit, as discussed in the Balance of Payments Development Stage Theory, it becomes a credit disposition nation with its external net assets decreasing in stages. It seems as if the impact of being overtaken by Germany while maintaining a current account surplus would be quite different from that of falling to the No. 2 spot amid conditions in which Japan books current account deficits.

It has been indicated that one point of contention related to safe havens is that the so-called "risk-averse yen buying" is no longer seen in a market environment where investors are becoming increasingly risk averse. This may be due to the fact that low interest rates have become the norm in many countries in recent years, and the yen carry trade has been weak due to the existence of currencies with lower interest rates than the yen, such as the euro.

On the forex market, carry trades are often used to procure low-interest-rate currencies and invest that money in high-interest-rate currencies, but the yen, with its long-standing low interest rate, has consistently been the currency procured. Investors tend to conduct carry trades when they are more risk oriented and tend to unwind these trades when they become risk adverse. Therefore, the yen is sold when risk appetite increases and bought back when risk aversion increases, and this is the mechanism by which "risk-averse yen buying" occurs.

Some earlier studies have suggested that the yen is not being bought so much as a safe haven, but it is simply being bought back after previous selling. For example, Hossfeld and MacDonald (2015)[1] argued that the yen rises when markets become increasingly risk averse, mainly because of the unwinding of carry trades, and so the yen should be viewed as a procurement currency for the carry trade, not as a safe haven. Defining a safe haven as a currency that has a negative correlation with the return of a global equity index when financial market tensions are high, this report suggests that the Swiss franc is the only safe haven among G10 currencies and that the US dollar is also a possible safe haven, although not as clear-cut as the Swiss franc.

As we have seen, it is conceivable that the recent depreciation of the yen is not due to a loss of confidence in the Japanese currency, but rather due to the monetary policy gap between the US and Japan. Current account balance trends must be carefully assessed in light of the coronavirus impacts, but the factors that have made the yen a safe haven (current account surpluses, Japan's status as world's largest holder of net foreign assets) are still solidly in place. However, the studies that consider the impact of carry trades in defining safe havens are compelling. A closer examination of whether the yen is truly a safe haven is an issue for the future.

[1] Oliver Hossfeld and Ronald MacDonald. "Carry funding and safe haven currencies: a threshold regression approach," Bundesbank Discussion Paper No 34/2014.

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