Daiwa's View

USD/JPY outlook after BOJ policy revision

- Yen appreciation overshoot on expectations for further policy revisions

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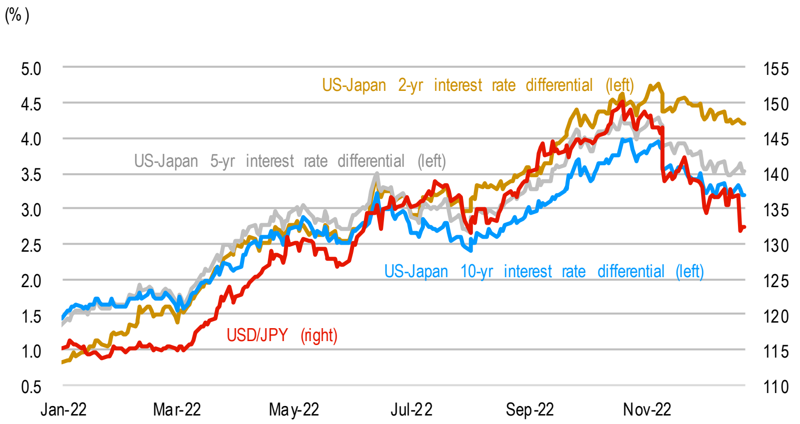
During its 19-20 December Monetary Policy Board meeting, the BOJ made the surprise decision to double the size of its 10-year JGB yield permissible trading range from 0% ±0.25% to 0% ±0.5%[1][2]. This announcement was followed by higher JGB yields, particularly the 10-year JGB yield, and yen appreciation against most major currencies. Indeed, the USD/JPY rate was hovering around the Y137.20 level just before the BOJ announcement, but fell to the Y130 level during overseas trading hours after the announcement.

Since 2021, the USD/JPY has generally moved in tandem with the US-Japan interest rate differential and it is natural the yen to appreciate against the dollar whenever JGB yields rise. The USD/JPY had been rising steadily until early November with a very strong correlation with the US-Japan 2-year interest rate differential (Chart 1). Since then, the peaking of US inflation and the weakening of the FRB's hawkish stance caused US medium/long-term interest rates to decline, which in turn resulted in yen appreciation against the dollar.

The JGB yield gains due to the expansion of the BOJ's 10-year JGB yield permissible trading range have been around 25bp at the most and there is the impression that the Japanese currency should only appreciate about two to three yen versus the US dollar based on the US-Japan interest rate differential perspective. Also, interest rate differentials are likely to further narrow as European and US yields rise along with the rising JGB yields. We believe that the sudden yen appreciation on 20 December was excessive (overshoot), driven by moves anticipating a further reduction for monetary easing, in addition to the BOJ's surprise policy revision.

Chart 1: USD/JPY Rate, US-Japan Interest Rate Differential



Source: Bloomberg; compiled by Daiwa Securities.

[1] *Daiwa's View* "BOJ surprise underscores problem in terms of communication with market" by Mari Iwashita (21 Dec 2022)
[2] *Daiwa's View* "Trading band widened again" by Eiichiro Tani (21 Dec 2022)

The objective of this BOJ policy revision is to improve JGB market functioning. As such, it is not positioned by Bank as monetary tightening. In other words, it is only a minor policy revision and not the start of the BOJ's exit strategy. This means that there are still high hurdles to overcome in order for the BOJ to raise short-term and long-term interest rates to the zero mark. JGB yields are not expected to rise further as a result of this monetary policy revision and medium/long-term yen appreciation against the dollar due to the BOJ's monetary policy factors remains only a risk scenario.

That said, as there have been some media reports suggesting that the government and the BOJ will revise their 2013 joint statement (on overcoming deflation and achieving sustainable economic growth), which raises the possibility that the BOJ's price target will also be revised in the future. If the price target is lowered from the current 2%, or if the target took some other form such as a range, that would signal a shift away from Abenomics and QQE, which could add to yen appreciation pressures. Any review of the joint statement or other such moves would likely be based on political decisions. However, for the time being, we believe that this action will provide more time for assessing the political situation, the appointment of a new BOJ governor early next year, and overseas economic trends.

However, if the joint statement is revised, the hurdle for monetary tightening would become lower than before and the loose monetary policy would provide less of a boost to the Japanese economy. Therefore, if financial markets recognize this aspect, there would be a mix of impacts pushing the USD/JPY both up and down.

This surprise BOJ policy revision is likely to increase market speculation regarding further policy tweaks over the near term, especially among foreign investors. Over the short term, yields are likely to rise and the yen is likely to appreciate. However, we expect the influence of Japan-specific factors on the exchange rate to gradually drop off with the focus shifting to traditional market fluctuation factors such as lower US interest rates. Our forecast for a gradual decline in US interest rates remains unchanged. Also, we expect the yen to appreciate further before becoming affixed around the Y120 level next year.

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