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Daiwa's View

Rethinking supply and demand in yen market

➢ The key is how one anticipates yen selling due to actual demand and speculative investment

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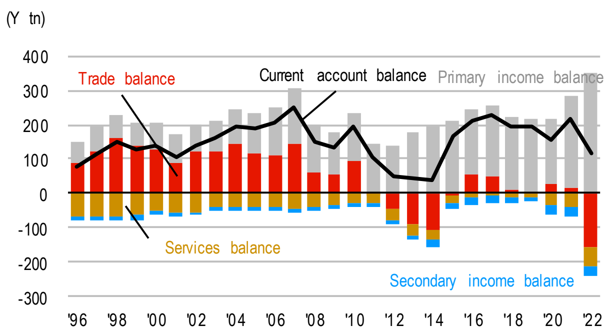
According to the balance of payments statistics that were announced by the Ministry of Finance (MOF) on the 8th, the current account balance in 2022 posted a surplus of Y11.4432tn (Chart 1). A decline in the current account surplus was caused by increased imports, reflecting the rapid depreciation of the yen and rise in commodity prices. The trade balance posted a record deficit of Y15.7808tn. Meanwhile, the primary income balance, which reflects income from past investments, topped Y30tn for the first time, increasing to a record-high Y35.3087tn. As a result, the current account balance exceeded the level booked in 2014, when the surplus shrunk due to a rise in commodity prices.

Although people will likely focus on the large trade deficit, the services balance also booked a deficit of Y5.6073tn, the largest since 2002. This was affected by the fact that the travel balance surplus remained low at Y436.0bn, similar to 2021, due to strict border controls since the start of the COVID-19 pandemic. (The services balance is divided into three general categories—transport, travel, and other services.) That said, border controls have been eased substantially since October 2022. The travel balance surplus has recovered to nearly 70% of the pre-pandemic figure in December 2019 (Y232.7bn), as shown by the surplus of Y159.7bn posted in December 2022 on a single month basis.

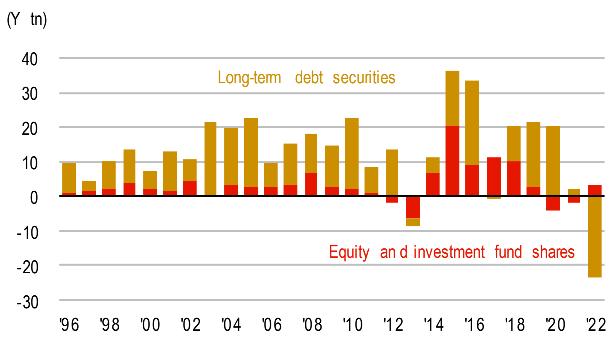
Meanwhile, the other services balance posted a deficit of Y5.1451tn, the largest amount since statistics began. In particular, the deficit in "other operation services" widened, in line with the recent trends, and the deficit widened in "professional management consulting services," in which online advertisement transactions are booked. The deficit in "telecommunications/computer/information services," which include payments for cloud services, also remained somewhat large. We should note to what extent these deficits in the other services balance are covered by the travel balance surplus, which is expected to increase going forward.

Chart 1: Current Account Balance



Source: MOF; compiled by Daiwa Securities.

Chart 2: Outward Portfolio Investment



Source: MOF; compiled by Daiwa Securities.

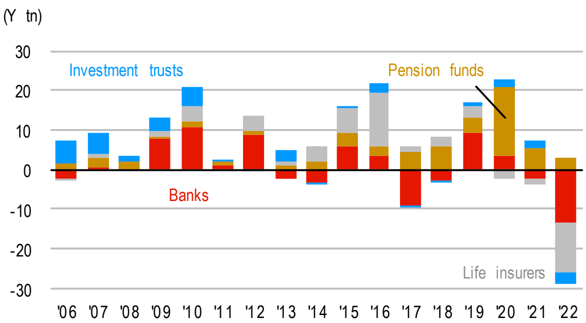
Confirming outward and inward portfolio investments, we found that Japanese investors booked Y2.9658tn in net buying of equity and investment fund shares. Meanwhile, they logged Y23.7872tn in net selling of foreign bond investments (long-term debt securities, chart 2 on previous page). Since 1996, which is how far back current statistics go, annual net selling of long-term debt securities has been posted only twice, in 2013 (Y1.8562tn) and 2017 (Y642.7bn). On a value basis, as well, net selling in 2022 was considerably larger. Needless to say, the cause was the substantial rise in overseas yields as central banks around the globe (such as the Fed) aggressively raised interest rates in order to tame inflation.

Looking at trends in foreign bond investment by investor type, net selling was notable at banks (Y13.3437tn) and life insurers (Y12.8225tn). Investment trusts were also net sellers of foreign bonds (Y2.9673tn, Chart 3). On the other hand, pension funds (trust accounts) booked net buying of Y2.8808tn. As the rise in hedging costs led to negative yields with hedged foreign bonds, banks and life insurers continued to sell substantially.

By nation, net selling in the US was at a record high of Y15.658tn, which drove the total net selling (Chart 4). Net selling in the euro zone also saw a record high at Y4.3372tn, which breaks down to Y1.7883tn in France and Y1.1783tn in Germany. Selling in Italy and Spain was limited because relatively high hedged yields were secured there. Therefore, selling mainly appears to have occurred in core nations. In addition, net selling in Canada saw a record high at Y925.7bn, and that in Australia came in at Y409.1bn. Meanwhile, net buying in the UK came in at Y232.6bn.

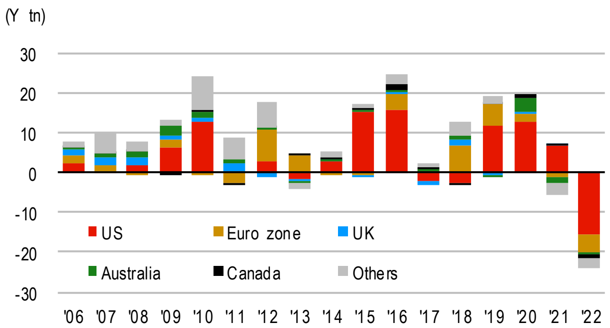
Foreign bond investment in 2022 posted an unprecedented amount of net selling. That said, looking at this by investor type shows that it was mainly conducted by banks and life insurers, as mentioned above. Investment in foreign bonds by banks (mainly major banks) is mainly managed via procurement of foreign currencies. It appears that selling of hedged US Treasuries accounted for a large portion of the total selling of foreign bonds by life insurers. Accordingly, the impact on the forex market seems to have been limited.

Chart 3: Outward Portfolio Investment (by investor type)



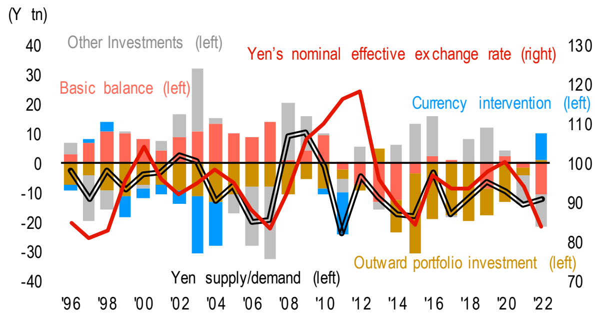
Source: MOF; compiled by Daiwa Securities.

Chart 4: Outward Portfolio Investment (by nation)



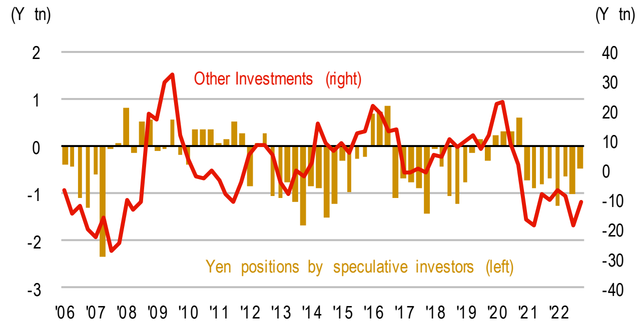
Source: MOF; compiled by Daiwa Securities.

Chart 5: Supply/demand of Yen (estimates)



Source: MOF, BOJ; compiled by Daiwa Securities.
Note: Four-quarter moving totals used for balance of payments data. Basic balance = Current account balance + Direct investment. Current account balance, direct investment, and outward portfolio investment are adjusted by using certain assumptions about hedging ratios and whether or not currency transactions occurred.

Chart 6: Other Investments, Yen Positions by Speculative Investors



Source: BOJ, CFTC; compiled by Daiwa Securities.

Chart 5 shows estimated supply and demand for the yen, which is calculated by (1) using Japan's balance of payments and the actual operations of the BOJ's currency intervention and (2) adding certain adjustments for figures that could have an impact on the forex market. According to this chart, outward portfolio investment shifted to yen buying on a net basis due to the impact of the selling of foreign bonds. However, as mentioned above, most selling of foreign bonds by banks and life insurers had no impact on forex supply and demand. Therefore, it is highly likely that the flow of yen buying related to outward portfolio investment was slight.

In 2022, the current account balance worsened due to the surge in energy prices. Therefore, supply and demand in the basic balance (current account balance + direct investment) leaned significantly towards the direction of yen selling. Although the current account balance maintains a reasonably large surplus, part of the interest and dividends booked on the primary income balance are thought to be reinvested on a foreign currency basis, with no currency transactions taking place for income from reinvestment. Therefore, we think that the actual flow related to the current account balance led to yen selling on a net basis. The basic balance is thought to indicate forex transactions due to actual demand. Looking at the total figure for the entire year, we can sum up by saying that most of the flow of yen selling caused by actual demand was absorbed by currency intervention conducted in September and October.

Other flows are reflected in other investment. This can be regarded as a proxy variable of speculative transactions (such as the carry trade), as clearly shown by the strong correlation with currency futures positions at the IMM (Chart 6). As Chart 5 shows, the total of forex supply and demand seems to point to a slight decline in yen selling pressure compared to 2021. However, one factor here is probably the fact that it is not possible to fully supplement speculative flows, such as long/short currency positions via futures transactions, which are not reflected in the balance of payments statistics.

Excluding currency intervention, 2022 posted yen selling due to actual demand and speculative investment. As outward portfolio investment is expected to be slow as a whole in 2023, as well, an important point when making forecasts will be how one anticipates the flows of actual demand and speculative investment. In this respect, actual demand is likely to improve, given the peaking out of the price of commodities (incl. energy) and the resumption of inbound tourism (refer to our 30 Nov 2022 report: *Things to watch for in 2023 (2): Shifts in two major drivers of yen depreciation*). While the behavior of speculative investors has been based on the interest rate differential between Japan and the US, supply and demand is expected to lean towards the direction of yen appreciation led by US rates, which have a lot of room to fall.

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