Daiwa Securities

Daiwa's View

Forex market intervention again this year?

➢ Macro environment different from last year

Fixed Income Research Section
FICC Research Dept.

Chief FX Strategist
Kenta Tadaide
(81) 3 5555-8466
kenta.tadaide@daiwa.co.jp

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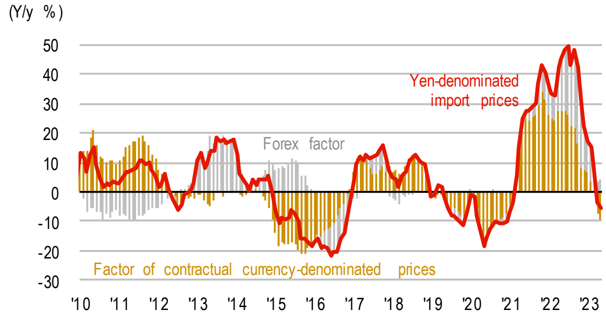
On 29 June, the yen depreciated to USD/JPY144.90, its weakest level for 2023. With the pair pushing ever closer to the key USD/JPY145 milestone, there has been an increase in comments from Japanese officials about the exchange rate. Indeed, verbal intervention is now taking place on a daily basis. When asked on 28 June about the yen exchange rate at the ECB Annual Forum on Central Banking in Sintra, Portugal, BOJ Governor Kazuo Ueda said, "We will monitor the situation very carefully." However, in regards to forex market intervention, Ueda noted that such an action falls under MOF's authority.

As Ueda noted, forex market intervention in Japan is carried out under the authority of the MOF. Accordingly, the most important comments about potential forex market intervention are those from Finance Minister Shunichi Suzuki and Vice Finance Minister Masato Kanda. From around late June, both men have been commenting on foreign exchange rates more and more often. This change came about on 20 June when Suzuki said, "We are continuously monitoring developments in foreign exchange markets," and pledged that "appropriate steps regarding currency policy would be taken if needed." On 26 June, Kanda described the current yen depreciation as "rapid and one-sided." Then on 27 June, Suzuki ramped up his warnings, noting "sharp and one-sided moves" and vowing to "closely watch currency market moves with a strong sense of urgency." Suzuki reiterated his recognition that MOF would respond appropriately if currency moves became excessive.

Interest in forex market intervention is growing in response to the recent yen depreciation. However, even though the level of verbal intervention has increased somewhat, we believe that there is still some distance to go before the MOF can actually intervene on the forex market. This is because officials avoid using fairly strong language such as "decisive action" and the BOJ has not conducted any rate checks. It is well known that forex market intervention in the form of buying the local currency is dependent on the amount of foreign exchange reserves. Japan's foreign exchange reserves totaled about Y182tn (roughly $1.3tn) at the end of May and, given that last year's intervention amounted to Y9.2tn, Japan has sufficient foreign exchange reserves for a similar level of intervention. Still, we would expect more caution when considering intervention that involves the selling of foreign exchange reserves compared to that involving the selling of a country's own currency (in this case the yen), for which there is theoretically an unlimited supply.

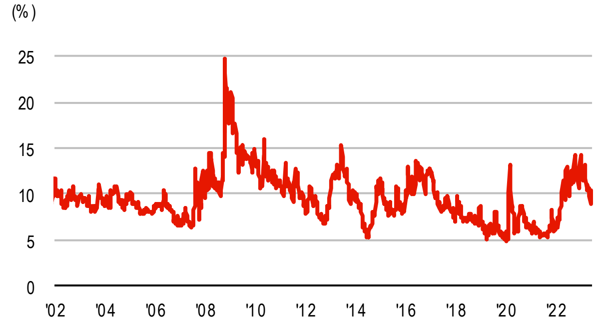
The USD/JPY is now close to the level seen at the time of the autumn 2022 forex market intervention, but the macro environment is quite different. Import prices rose rapidly last year, a situation in which the yen's depreciation, in addition to high resource prices, contributed significantly to pushing up prices (Chart 1). However, import prices are now declining y/y, which means that the upward pressure on import prices due to the exchange rate is gone for the most part. Crude oil and other energy prices have been declining since June of last year and prices are now down by more 30% y/y.

Chart 1: Breakdown of Yen-denominated Import Prices



Source: BOJ; compiled by Daiwa Securities.

Chart 2: Three-month USD/JPY Implied Volatility



Source: Bloomberg; compiled by Daiwa Securities.

The pace of yen depreciation has slowed significantly y/y. Of course, if the yen weakens significantly going forward, import prices could rise. Still, with monetary tightening by various countries believed to be entering the final stages, the yen is unlikely to weaken to that extent. Indeed, we believe that in order for exchange rates to generate inflationary pressure on par with that seen last year, the yen would need to weaken to nearly USD/JPY180. In terms of the macro environment, there appears to be little need to intervene in the forex market. On the other hand, with support for the administration of Prime Minister Fumio Kishida declining, there is no denying the possibility that he will become more worried about yen depreciation, which pushes up prices.

MOF explained its reason for last year's forex market intervention by saying, "Repeated excessive fluctuations due to speculation can never be overlooked." Even the recent verbal intervention has touched on the speed of yen depreciation described as, "rapid and one-sided" moves, but currently there has been a declining trend for USD/JPY volatility (Chart 2). Volatility may only be the official reason (not true intention) for forex market intervention. However, the current situation is such that it may be hard to use "volatility" as an explanation for intervening on the forex market.

Even though the market is now undeniably aware of such levels as USD/JPY145 and USD/JPY150, due to last year's forex market intervention, the increase in verbal intervention may actually intensify speculative moves that test the seriousness of that intervention. Actually, the current trend involves yen weakening to an extent greater than the US/Japan interest rate differential expansion. If this trend were to accelerate, it could lead to a decision to intervene.

The difference in stance between the major central banks, which are tightening monetary policy, and the BOJ, which continues to ease monetary policy, is seen as the main reason for the yen sell-off. Still, we should be wary of developments such as the BOJ's Monetary Policy Board meetings starting with the 27-28 July meeting. This is because any decisions to put policy revisions on hold at each meeting could trigger speculative yen selling and heighten forex market intervention warnings. Also, it has been pointed out that one background factor that helped push yen depreciation into the USD/JPY140-150 range last year was the knocking out of currency options held by domestic importers, combined with increased US dollar buying. If importers, who have lagged behind in buying this year as well, move to buy dollars (not speculation, but . . .), supply and demand conditions could accelerate the yen's depreciation.

We believe that the current yen exchange rate situation is such that the government will not feel compelled to intervene in the foreign exchange market. If the yen sell-off accelerates with the yen depreciating beyond the USD/JPY151.95 mark set last year with no subsequent key milestone to target, the possibility of forex market intervention would increase considerably. In any event, nervousness about forex market intervention is likely to continue for the time being.

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