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# Daiwa's View

## YCC and foreign exchange rate (USD/JPY)

- Is YCC causing excessive depreciation of the yen?

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### YCC and foreign exchange rate (USD/JPY)

**Is YCC causing excessive depreciation of the yen?**

Since 6 July, the USD/JPY rate has been fluctuating substantially up and down. One factor behind this is speculation about policy revisions at the BOJ's Monetary Policy Meeting (MPM) to be held on 27-28 July. At last week's press conference following the meeting of G20 Finance Ministers and Central Bank Governors in India, BOJ Governor Kazuo Ueda said that he recognized that there was still a ways to go in order to sustainably and stably achieve the central bank's 2% inflation target, adding "If our assumption is unchanged, our overall narrative on monetary policy remains unchanged."

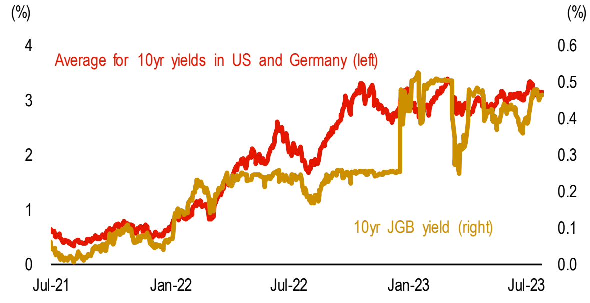
BOJ executives gave a lecture to the press thereafter on 21 July. Bloomberg ran a report with the headline "BOJ sees little need to act on yield control for now, sources say." According to the report, these sources said that costs and benefits of revising YCC could be a subject of discussion during the July meeting, but also said that the view that no major problems have arisen in terms of bond market functioning had not changed. Reuters also ran a report with the headline "Bank of Japan leaning towards keeping yield control steady next week, sources say." As such, despite the fact that expectations for policy revisions at the July meeting rose suddenly at the beginning of July, now more people feel that the BOJ will decide to maintain current monetary policy.

Speculation about policy revisions at the July MPM was triggered by an article about an interview with BOJ Deputy Governor Shinichi Uchida. However, it is thought that another underlying factor was a series of remarks by Japanese officials warning about a weak yen that were made before the article came out. Since late June, Finance Minister Shunichi Suzuki and Vice Finance Minister Masato Kanda had engaged in verbal intervention on practically a daily basis during the time the USD/JPY rate approached Y145, which was regarded as a threshold level ((for details, see our 30 Jun 2023 report *Daiwa's View: Forex market intervention again this year?*)

Looking back on the course of events that led up to the BOJ suddenly revising YCC in December 2022, we see that, first, the yen started depreciating rapidly in March, and then, when the USD/JPY rate exceeded Y140 in September, the government implemented currency intervention in September and October. When it comes to the policy mix for macroeconomic policy, monetary policy and currency policy need to be headed in the same direction. Specifically, the theory is that, if yen-buying intervention is implemented in order to correct depreciation of the yen, monetary policy should also be revised in a tightening direction (tapering of easing) in line with the currency policy. Therefore, the BOJ's revision to YCC was the correct choice in order to increase the effects of currency intervention.

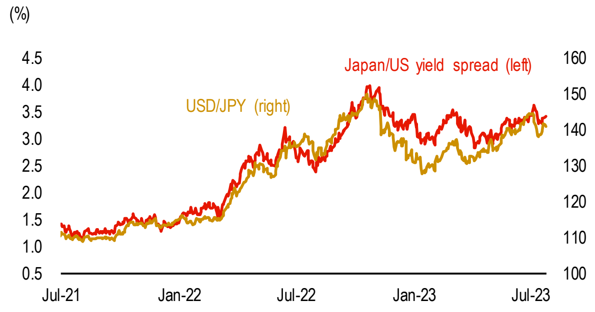
Given this precedent and theoretical background, we think it is natural for there to be increasing expectations in the market of monetary policy revisions by the BOJ if the government is considering currency intervention and taking a stronger stance with regard to restraining yen depreciation.

**Chart 1: Overseas Yields, 10yr JGB Yield**




Source: Bloomberg; compiled by Daiwa Securities.

**Chart 2: Japan/US Yield Spread (UST, JGB), USD/JPY Rate**



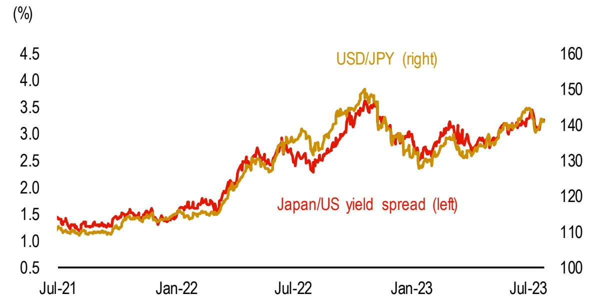

Source: Bloomberg; compiled by Daiwa Securities.

There are many who believe that YCC is causing excessive yen depreciation. For example, a 22 July *Yomiuri Shimbun* article titled "10-year JGB yield cap debate . . . BOJ to continue large-scale easing at next meeting" reported that, "While keeping the 10-year JGB yield low, the BOJ will consider revising its policy to avoid the side effect of distorted market interest rates, which could cause the yen to weaken excessively in the foreign exchange market or hamper funding via the corporate bond market." In general, the mechanism assumed to cause yen depreciation is defined as YCC artificially suppressing JGB yields while overseas yields rise, thereby widening the gap between Japan and overseas yields, which in turn spurs on yen depreciation (Chart 1).

Since last year, the yen has in fact weakened along with the widening gap between Japan and overseas yields. As such, the above explanation seems intuitively correct (Chart 2). However, looking at the US/Japan yield differential and USD/JPY trends, there is a stronger linkage to yield differentials when calculations are made using JPY OIS, rather than the yield differential between US Treasuries and JGBs (Chart 3). The linkage between the yield differential and JPY OIS, which is not directly impacted by YCC, is stronger than the linkage between the yield differential and JGBs. This suggests that the image of yen depreciation since last year caused by YCC artificially widening yield differentials may not be correct (Chart 4).

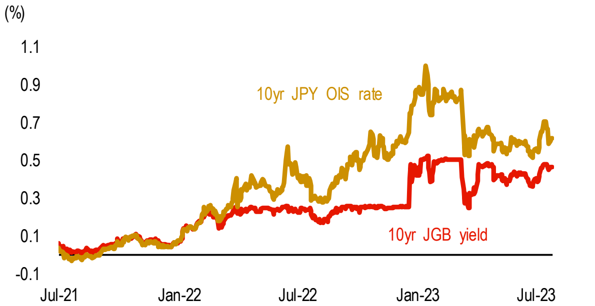
The relationship between the US Treasury/JGB yield differential and the USD/JPY has collapsed, as shown in Chart 2. This collapse mainly occurred from December 2022 when the BOJ revised YCC and the JPY OIS rate was soaring. At that time, the 10-year JPY OIS rate had risen to 0.85% on average due to expectations the BOJ would normalize its monetary policy, while the JGB 10-year yield was stuck at the 0.50% upper limit under YCC and the yen swap spread was widening. It is our understanding that the collapse of the USD/JPY linkage with the US Treasury/JGB yield differential was due to yen appreciation against the backdrop of a narrowing of US/Japan yield differential following a rise in the 10-year JPY OIS rate (not the 10-year JGB yield).

**Chart 3: Japan/US Yield Spread (UST, JPY OIS), USD/JPY Rate**




Source: Bloomberg; compiled by Daiwa Securities.

**Chart 4: 10yr JGB Yield, 10yr JPY OIS Rate**

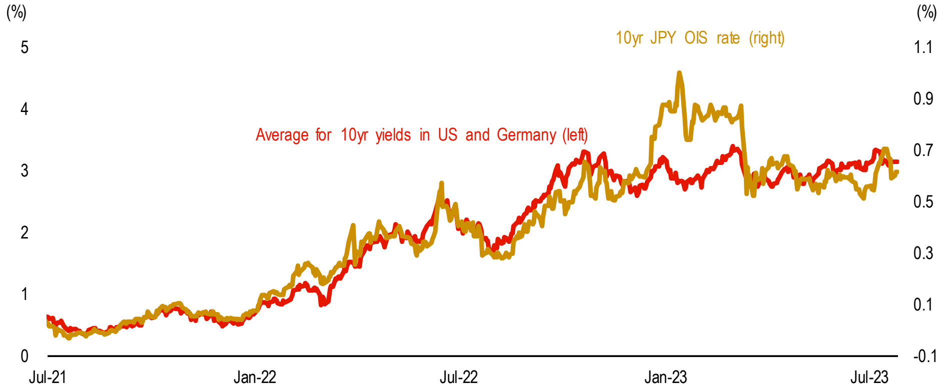



Source: Bloomberg; compiled by Daiwa Securities.

The linkage between the US Treasury/JGB yield differential and the USD/JPY has broken down in the direction of a stronger yen. This alone cannot be used to argue that YCC is not causing excessive yen depreciation. However, it is true that when the yen both depreciates and appreciates, the USD/JPY closely follows the JPY OIS rate, which is not directly impacted by the YCC.

As shown in Chart 5, the JPY OIS rate is closely linked to overseas yields and has stable beta (see our 25 Jul 2023 report *Daiwa's View: There is no decisive factor to revise YCC in terms of the current market balance*). JGB yields have risen since last December, regardless of the US Treasury yield moves. However, this is probably because the market has factored in expectations for an early normalization of monetary policy, such as eliminating YCC or removing negative interest rates, following the unexpected policy revisions at the December 2022 BOJ meeting. Still, expectations for early normalization have faded due to the US banking sector shock in March and the launch of a new BOJ regime led by Kazuo Ueda in April. It is our understanding that linkage with overseas yields has been reestablished.

**Chart 5: Overseas Yields, 10yr JPY OIS Rate**




*Source: Bloomberg; compiled by Daiwa Securities.*

A new issue that emerges here is the question of whether the yen will actually appreciate if the BOJ revises YCC. As we have seen, when there is yen appreciation due to JGB yield factors, the USD/JPY is strongly influenced by the JPY OIS rate. Accordingly, if the BOJ decides to revise YCC (expand/eliminate permissible 10-year JGB trading range), in order to impact the exchange rate, that decision would need to be viewed as a shift toward a tightening of the monetary easing measures. Also, the JPY OIS rate would need to rise as the market's assumed timing for eliminating negative interest rates is brought forward. However, as for removing negative interest rates, BOJ Deputy Governor Shinichi Uchida stated in an interview that, "Ending negative rates essentially amounts to a 0.1-point hike. When looking at economic and price indicators and the future outlook, there's still a long way to go before we can make that decision." Earnest policy normalization is still far off. Given that monetary easing close to the BOJ's status quo is likely to continue for the time being, there will be little room for yen appreciation even if the BOJ revises YCC to counter side effects.

As the 10-year JPY OIS rate is also indirectly affected by YCC, the possibility that it is being held at somewhat low levels cannot be denied. However, based on IMF estimates, Japan's natural rate of interest is likely in negative territory (around -0.2 to -0.5%) with the breakeven inflation rate (BEI) at around 1.1%. The natural rate of interest tends to have large estimation errors and BEI is also not a perfect data set. Still, considered along with these levels, we are not left with the impression that the 10-year JPY OIS rate is far below its appropriate medium/long-term level.

As mentioned above, based on the JPY OIS rate and USD/JPY relationship, it appears that YCC is not causing excessive yen depreciation. However, JGB yield fluctuations are too small compared to US Treasury yield fluctuations, making it ultimately difficult to discern the actual impact. Conversely, yen depreciation is largely the result of the diverging stances taken by the Fed, which is pursuing historic monetary tightening, and the BOJ, which continues to pursue an accommodative monetary policy. Accordingly, if we assume continued monetary easing, eliminating yield controls (revising/scrapping YCC) would not likely arrest yen depreciation, in our view. In order for the yen to appreciate under Japan's monetary policy, the BOJ would need to normalize policy as an exit strategy and JGB yields would need to rise.

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