Daiwa Securities

Daiwa's View

Greater flexibility with YCC will have limited impact on yen appreciation

- A shift towards yen appreciation would require a shift towards easing by overseas central banks

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A shift towards yen appreciation would require a shift towards easing by overseas central banks

At its Monetary Policy Meeting (MPM) on 27-28 July, the BOJ decided to conduct yield curve control (YCC) with greater flexibility. In response to the decision, the yen momentarily strengthened to almost Y138 against the dollar. However, later, it again weakened against the dollar, reaching the Y141 level during US trading hours. The yen had already strengthened to the Y138 level prior to the MPM in response to the *Nikkei* article that had appeared previously. However, when the market closed in New York, the rate had reverted to its previous level before the *Nikkei* article came out. Appreciation pressure on the yen in response to the policy decision appears to have been relatively limited partly because it was confirmed that the BOJ's easing stance was unchanged.

Over the past two years, the biggest factor affecting the USD/JPY level has been the Japan/US rate differential. Therefore, we should note how much JPY rates rise going forward. However, with the BOJ's stance of continuing monetary easing being unchanged, there is still some ways to go before negative interest rates are removed, Furthermore, JGB purchase operations will be continued. Due to the decision by the BOJ, the long-term JGB yield is moving higher than 0.5%. However, fixed-rate purchase operations will be conducted at 1.0%, meaning that a rise in the yield higher than 1.0% will not be allowed. Moreover, as BOJ Governor Kazuo Ueda mentioned in his press conference, the yield basically isn't expected to rise to 1.0% in the first place. In fact, even the 10-year swap rate, which is not directly influenced by the BOJ's YCC, is remaining at the 0.7% level, and, therefore, the 10-year JGB yield, which is currently at the 0.5% level, is unlikely to rise to 1.0% right away.

As we mentioned in our 26 Jul 2023 report *Daiwa's View: YCC and foreign exchange rate (USD/JPY)*, the appropriate medium/long-term level for the JPY rate appears to be the upper range of the 0% level at this point. In this respect, as well, increases in the JPY rate will be limited. To begin with, depreciation pressure on the yen due to artificial moves to suppress JPY rates via the YCC is estimated to be around several yen, and, conversely, appreciation pressure on the yen due to greater flexibility with YCC will probably not be great, either. While the decision by the BOJ also took into consideration the impact of currency market volatility due to YCC, the direct impact on the USD/JPY level will be limited.

It is necessary to take note of the fact that US yields have been tending to rise at a similar pace to JPY rates over the past several days. Recent moves by the BOJ have been garnering particular attention. Therefore, it would seem that the Japanese market is having a greater impact on the UST market. If US yields rise at a similar pace, the degree to which the Japan/US rate differential decreases will be limited. In light of this as well, appreciation pressure on the yen due to a rise in JGB yields is expected be limited. The USD/JPY rate may decline further over the short term, depending on JPY rate trends. Nevertheless, we think that the upper half of the Y136 range, which is the 200-day moving average, is a point of reference.

From the standpoint of stock prices, as well, room for yen appreciation is probably limited. The Nikkei Stock Average reacted to the BOJ's decision by falling. However, it eventually bounced back towards the close of the market, probably because (1) the rise in Japanese stock prices was largely due to re-valuation by overseas investors and (2) the BOJ's easing stance remained unchanged. The firmness of Japanese stocks can be seen as exerting depreciation pressure on the yen.

Although an end to rate hikes in the US and Europe is now on the horizon, with inflation rates still high, a tight monetary stance is expected to be maintained. Under the current circumstances, we don't yet foresee a decline in overseas long-term yields. Meanwhile, the interest rate differential between Japan and overseas will be large, and the market will continue to avoid buying the yen. In order for the USD/JPY rate to shift towards a weaker dollar and stronger yen, we would need to see subsiding inflation in overseas economies and a shift from tightening to easing of monetary policies.

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