Daiwa's View

BOJ, exchange rates, and MOF

➢ Will BOJ take action once again because of forex factors?

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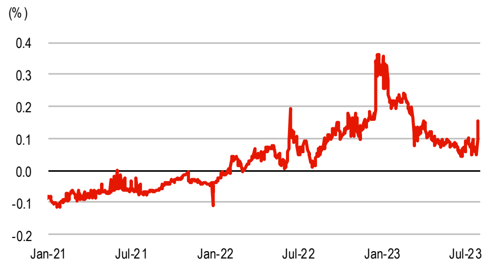
Will BOJ take action once again because of forex factors?

One week has passed since the BOJ decided to conduct yield curve control (YCC) with greater flexibility at its Monetary Policy Meeting (MPM) on 27-28 July. Following the BOJ's decision to exercise greater flexibility with YCC, the yen strengthened momentarily to almost Y138 against the dollar. However, when the market closed in New York on that day, the yen had reverted to its previous level before the *Nikkei* article (which had appeared prior to the Jul MPM) came out. With the trend towards yen depreciation continuing this week, some market participants appear to be increasingly speculating that the BOJ may be forced to remove negative interest rates in order to cope with yen depreciation.

After the July MPM, the JPY OIS 1-year forward 1-month (1Y1M) forward rate rose slightly to a level seen prior to the US bank shock in March. However, unlike what happened when policy revisions were made in December 2022, the market has not factored in the BOJ's quick action towards normalization (Chart 1). According to the Bloomberg survey on 31 July regarding the timing of the BOJ's next policy revisions (which targeted 42 economists), only 7% of respondents anticipated revisions being made within end-2023 (Chart 2). And, 27% of respondents projected they would be made in April 2024, which accounted for the highest percentage of responses that indicated a specific time. Furthermore, 32% of economists anticipated revisions would be made in 2025 or later. With regard to the BOJ's next move, the largest number of respondents felt it would be to remove YCC, with the next largest group anticipating that it would be to raise short-term interest rates. However, all respondents assumed that negative rates would be removed in 2024 or later, and 43% of them projected they would be removed in 2025 or later. As such, many feel that there is a long way to go before negative rates are removed.

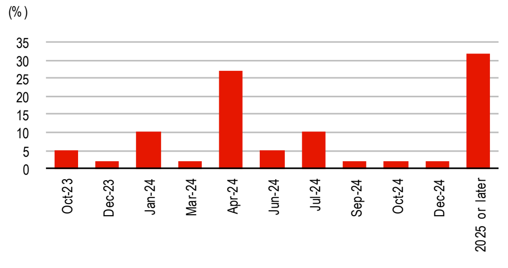
At his press conference after the July MPM, BOJ Governor Kazuo Ueda stated that he did not expect the long-term rate to rise to 1%. At his press conference on 2 August, BOJ Deputy Governor Shinichi Uchida indicated that he felt the framework following the decision to conduct YCC with greater flexibility would be relatively solid. At the July MPM, the BOJ implemented preemptive measures to lessen side effects that could occur in the future. Therefore, further modifications to YCC are not anticipated at this point. However, it is not unreasonable for speculation to increase in the forex market that the BOJ might take further action if the yen were to continue depreciating.

Chart 1: JPY OIS 1Y1M Forward Rate



Source: Bloomberg; compiled by Daiwa Securities.

Chart 2: Expected Timing of BOJ's Next Policy Revisions



Source: Bloomberg; compiled by Daiwa Securities.

While market distortion was one of the reasons officially given by the BOJ for YCC revisions in December 2022, the decisive factor appears to have been the excessive depreciation of the yen that occurred until October. As for the latest decision, BOJ Governor Ueda explicitly stated that the BOJ had given consideration to the forex market, saying that the BOJ intended to rein in volatility in financial markets, including, this time, volatility in the forex market.

It is highly likely that the weak yen was a major influence in the BOJ's decisions to make its last two policy revisions. Of course, the Ministry of Finance (MOF) was also probably involved in the decisions. In fact, media reports after the July MPM pointed out factors behind the relatively fast action by the BOJ—indications that the MOF called on the BOJ to make the policy revisions due to concerns about yen depreciation. We think that the MOF, which is in charge of public debt management and foreign exchange policy, has been dealing with yen depreciation since last year by trying to achieve a mutual balance. In addition to currency intervention in September and October 2022, the MOF appears to have required the BOJ to lessen depreciation pressure on the yen by widening the allowable trading range for the long-term interest rate via a revision to the YCC range. It has been pointed out that an adverse effect of YCC is looser fiscal discipline, but the MOF probably aimed to recover fiscal discipline by responding in this way.

That said, from the standpoint of public debt management, YCC now being conducted with greater flexibility may have raised the cap for the long-term interest rate to its limit under current economic and price conditions. This is because rising JGB yields compress national finance in the form of increased interest payment costs. In his press conference, BOJ Governor Ueda stated that the BOJ had set 1% as the upper limit, just in case. That said, a long-term interest rate of 1% is also an important level in terms of public debt management.

For example, in a trial calculation of the impact on revenues and expenditures in subsequent fiscal years in which the MOF estimates outlooks for revenues and expenditures, the MOF forecasts that the assumed interest rate (which is used to estimate the cost of interest payments) will rise from 1.1% in FY23 to 1.3% in FY24, 1.5% in FY25, and 1.6% in FY26, in a scenario with a nominal economic growth rate of 3% (CPI growth rate of 2%). Meanwhile, in a scenario with a nominal economic growth rate of 1.5% (CPI growth rate of 1%), the MOF forecasts that the assumed interest rate will be unchanged from 1.1% in FY23. In a situation in which it is difficult to forecast achieving the 2% price stability target in a sustainable and stable manner, it may be difficult to raise the upper limit of the long-term interest rate to, for example 1.5%, through further YCC revisions, from the standpoint of fiscal conditions (interest payments).

If we think of policy revisions only in terms of responding to the forex market, removal of negative rates while maintaining the YCC framework could become an option. BOJ Deputy Governor Shinichi Uchida explicitly stated that removal of negative rates would be a measure to prevent rising prices by suppressing demand in terms of the real economy via a hike in the short-term policy interest rate. Given current economic and price conditions, we do not think it would be easy to make such a decision. In addition, as clearly shown by price movements following the decision to conduct YCC with greater flexibility, leeway for a stronger yen would not be large even if YCC were revised further or negative interest rates were removed on the assumption of continued easing. Therefore, if the yen were to weaken at an accelerated pace and exceed Y151.95 against the dollar, which was its highest level in 2022, the MOF would probably implement currency intervention, rather than the BOJ springing into action (for details, see our 30 Jun 2023 report *Daiwa's View: Forex market intervention again this year?*).

Of course, once achieving the price stability target appeared on the horizon due to a rise in inflation expectations, tax revenues would increase amid a rise in the nominal economic growth rate. This might raise the permissible interest rate level in terms of public debt management. In such a situation, further modifications or action by the BOJ towards an "exit" would be justified in terms of economic and price conditions. As mentioned previously, there is no more leeway to fine-tune the extent of easing of monetary policy by responding to exchanges rates. Therefore, it would seem to be difficult for the BOJ to take additional action because of forex factors.

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