Daiwa Securities

Daiwa's View

High crude oil price contributing to yen, euro depreciation

- Watch for higher crude oil price, further currency depreciation over short term

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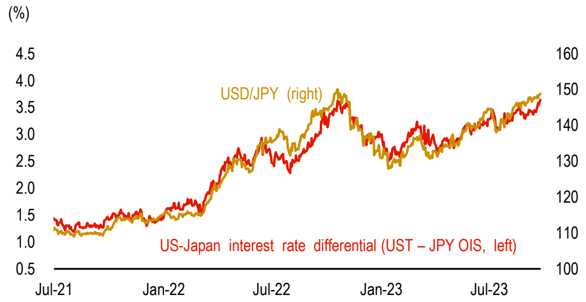
For roughly the past two years, the USD/JPY exchange rate has generally moved in line with the US-Japan interest rate differential (Chart 1). Last week, the FOMC and the BOJ Monetary Policy Board held meetings. The Fed was more hawkish than expected, while the BOJ provided no new information on policy revisions. With the difference in monetary policy stances between Japan and the US again becoming more pronounced, the yen is likely to depreciate toward USD/JPY150 if the US-Japan interest rate differential widens.

A significant portion of the USD/JPY price movement since last year has been attributed to this interest rate differential. However, Japan's widening trade deficit is another reason for the yen's depreciation. As Japan's balance of trade is heavily influenced by crude oil and other energy price trends, its trade deficit is likely to swell as crude oil prices rise. Crude oil prices have been moving upward since around July and this factor is also exerting downward pressure on the yen versus the US dollar. Chart 2 shows the relationship between crude oil prices and USD/JPY fluctuations that cannot be explained in terms of just the interest rate differentials. Here, we can confirm that downward pressure on the yen versus the US dollar since July has been due to more than just the interest rate differential.

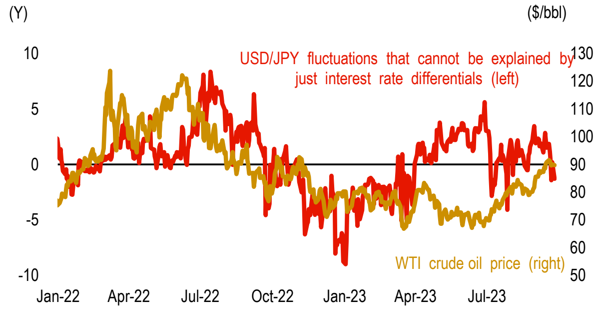
The currently high crude oil prices are being driven by not only the continued Saudi and Russian crude oil production cuts, but also by the growing belief that demand is stronger than expected and that the supply/demand balance is expected to tighten. However, prices for commodities in general, such as copper and iron ore, remain stagnant and there is little sign of the global economy strengthening (Chart 3). Current crude oil demand is partly boosted by post-coronavirus pent up demand. As such, there are some doubts about the sustainability of high crude oil prices over the medium to long term.

Chart 1: USD/JPY Rate, US-Japan Interest Rate Differential



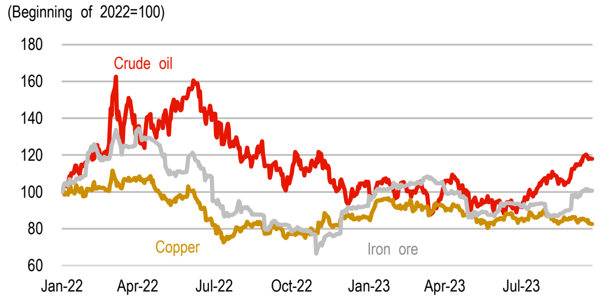
Source: Bloomberg; compiled by Daiwa Securities.

Chart 2: Crude Oil Price, USD/JPY Trends not Fully Explained by Interest Rate Gap



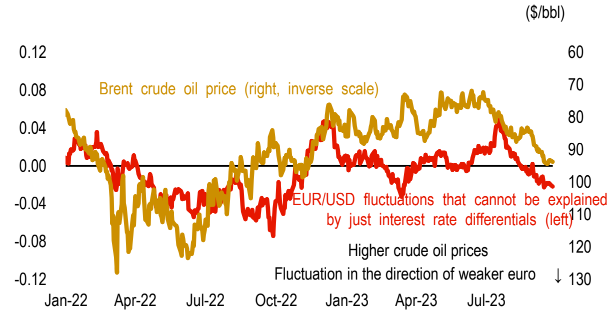
Source: Bloomberg; compiled by Daiwa Securities.
Note: USD/JPY fluctuations that cannot be explained by just interest rate differentials are the residuals between the estimated and actual values based on the 10-year US-Japan interest rate differential.

Chart 3: Commodity Prices



Source: Bloomberg; compiled by Daiwa Securities.

Chart 4: Crude Oil Price, EUR/USD Trends not Fully Explained by Interest Rate Gap



Source: Bloomberg; compiled by Daiwa Securities.
Note: EUR/USD fluctuations that cannot be explained by just interest rate differentials are the residuals between the estimated and actual values based on the 2-year US-Germany interest rate differential.

That said, the International Energy Agency (IEA) has forecast a significant crude oil supply shortage in the Oct-Dec quarter due to production cuts among oil-producing countries and other factors. Some on the market have even suggested that prices will target $100/bbl by the end of this year. Over the short term, caution regarding higher crude oil prices seems warranted and the yen could further weaken versus the US dollar even if the US-Japan interest rate differential does not widen. Even if there is a rise of only a few yen above the level implied by the current US-Japan interest rate differential, due to higher crude oil prices, there could be a renewal of last year's yen weakness with the yen depreciating beyond USD/JPY150. Such a fluctuation cannot be ignored in the midst of a possible last-minute forex market intervention decision that could come at any moment. Future developments must be closely watched.

The same is true in the eurozone, where high energy prices have led to currency depreciation. Following Russia's invasion of Ukraine, the eurozone has experienced a marked deterioration in its trade balance due to a sharp increase in imports blamed on higher crude oil and gas prices. Against this backdrop, combined with the fact that the Fed started raising interest rates ahead of the ECB, the euro was firmly below parity from last summer through the fall. Since then, the ECB followed the Fed in rapidly raising interest rates and the US-Germany interest rate differential has continued to narrow. As a result, the pair firmed to the EUR/USD1.12 level until around mid-July of this year.

Since then, there has been a divergence in the strength of the US and eurozone economies, and German interest rates have been unable to keep pace with rising US interest rates, putting downward pressure on the euro. However, since September, the widening of the US-Germany interest rate differential has paused, but EUR/USD remains weak. One factor explaining the recent euro sell-off is high crude oil prices. High crude oil prices will further increase concerns of an economic slowdown in the eurozone and exert downward pressure on the euro from a supply/demand perspective through the trade balance deterioration. Chart 4 shows the relationship between the crude oil prices and EUR/USD trends that cannot be fully explained by just interest rate differentials. As with the USD/JPY mentioned earlier, we can confirm that the euro has been under downward pressure due to factors beyond just the widening interest rate differentials. Such movements have been particularly noticeable since September.

The eurozone economy is already on the brink of recession, making it harder for the ECB to prop up the currency via interest rate hikes. As such, the euro will likely weaken further if crude oil prices remain high.

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