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Daiwa's View

Weak yen's warning about distortions in policy mix

- Expansionary fiscal policy under supply constraints is simultaneously intensifying pressure for yen depreciation and upside risks to inflation
- As pass-through effect of exchange rates on prices intensifies, scope for monetary policy and currency intervention becomes constrained
- Credibility and predictability of policy management are once again being called into question through exchange rates and interest rates

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Expansionary fiscal policy under supply constraints and concerns that BOJ is behind the curve

The yen briefly weakened into the high Y161 range against the dollar, with the Y162 level, not seen since 1986, now in sight. Speculation about currency intervention by the government and the BOJ has also intensified, but it is not sufficient to explain the current yen weakness simply in terms of the Japan/US interest rate differential or expectations of further US rate hikes. Rather, the recent yen depreciation strongly reflects the market's assessment of Japan's fiscal and monetary policy mix.

At the BOJ's Monetary Policy Meeting (MPM) in June, the policy interest rate was raised from around 0.75% to about 1.0%, a level not seen in 31 years, since 1995. At the same time, however, it was confirmed that policy board member Toichiro Asada opposed the rate hike, indicating that cautious voices regarding additional rate increases remain within the board. This is recognized as the political presence of a cautious stance within board members and raises concerns that the policy response is behind the curve.

What is critical in this phase of yen weakness is that even though the Japanese economy has already exited deflation and is transitioning to an inflationary economy with significant supply constraints, its policy management still shows a reliance on low interest rates and fiscal expansion.

Last week, an outline of the government's growth strategy was unveiled, reportedly envisioning investments totaling Y370tn from both the public and private sectors by 2040. However, the scale of new government spending and the specific details of its funding sources remain unclear, and the market has yet to fully digest this information. Nevertheless, with the output gap already in positive territory, the prospect of additional fiscal expansion implies that factors pushing interest rates down are scarce; instead, upward pressure on rates is likely to persist. In such an environment, stimulus for domestic demand is not absorbed by domestic supply, leading to an increase in imports, which in turn fuels yen depreciation pressure. Consequently, rising interest rates and yen depreciation are prone to occur simultaneously.

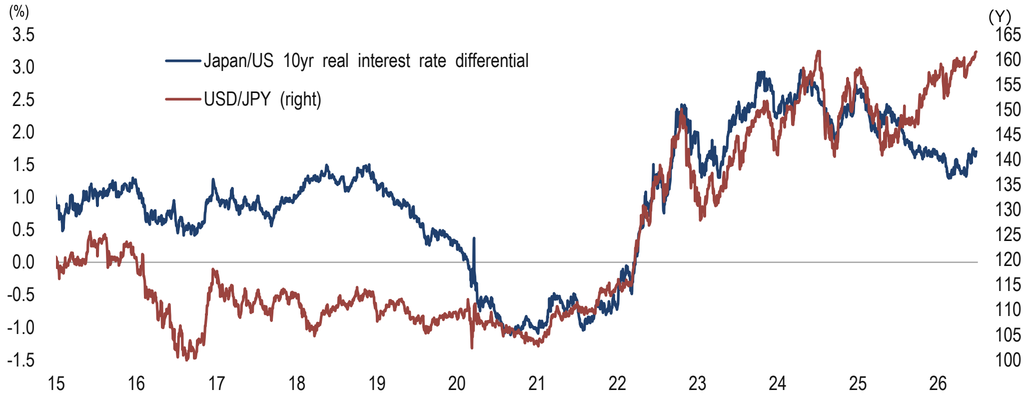
A weak yen pushes up import prices, eroding household real purchasing power through inflation. At the same time, if concerns about fiscal deterioration lead to a rise in long-term interest rates, it will result in a parallel progression of yen weakness and rising rates. This is not the "stronger currency from higher interest rates" scenario envisioned by the administration's economic advisors, but rather a phase where the currency is sold off due to anxieties over the sustainability and consistency of policies.

In fact, even after the BOJ decided to raise rates at its June meeting, upward pressure on interest rates remained in the JGB market. The rise in superlong yields after the policy rate was hiked to 1.0% and the halt to reductions in JGB purchases was announced suggests that the market is conscious of concerns that the policy response is still behind the curve. While the rate hike itself is a step toward normalization, as long as the financial market simultaneously senses the fiscal expansionary stance and considerations for JGB supply/demand conditions, it is difficult to fully price in the BOJ's tightening stance.

In this context, the focus of currency intervention is difficult to grasp solely through the debate over levels, such as "at what yen level will they intervene?" While intervention speculation is now heightening in the upper Y161 to near Y162 range, the current yen weakness is a result of a combination of factors: interest rate differentials, fiscal management, inflation expectations, and views on the BOJ's policy reaction. Therefore, while intervention may have the effect of prompting short-term position adjustments, its power to change the underlying trend of yen weakness is likely to be limited as long as the market remains distrustful of the policy mix.

Given that bearish yen positions have accumulated to levels approaching those seen during past carry trade unwinds, there is room for a short-term yen appreciation reversal triggered by intervention or a shift in US interest rate expectations. However, this should not be interpreted as a recovery of confidence in policy management, but rather as an unwinding of excessively one-sided positions.

USD/JPY Rate, Japan/US 10yr Real Interest Rate Differential



Source: Bloomberg; compiled by Daiwa.

Exchange rate is no longer peripheral variable for inflation

The depreciation of the yen has become a more significant issue because the impact of exchange rate fluctuations on prices has become stronger than before. Last week, BOJ Deputy Governor Ryozo Himino stated that the pass-through of rising crude oil prices to consumer prices "will have a certain impact on consumer prices around summer." He also indicated his recognition that the pace of price increases in business-to-business transactions is slightly faster than anticipated in April. Furthermore, regarding the impact of the weak yen on prices, he noted, "One aspect is that exchange rate fluctuations are now having a stronger effect on prices compared to the past," given that companies are becoming more proactive in raising wages and prices.

A similar recognition was expressed in a manner more closely tied to policy decisions during Deputy Governor Shinichi Uchida's press conference after the June meeting. Uchida explained that while the exchange rate itself is not a target of monetary policy, it is discussed at every meeting as a crucial factor affecting the economy and prices. He then shared his view that (1) because corporate wage- and price-setting behavior has become more active, exchange rate fluctuations affect prices more than in the past, and (2) the possibility of forex fluctuations affecting inflation expectations and the underlying inflation rate has also increased compared with before.

This point holds important implications for considering the current yen weakness. In the past, a weak yen was often highlighted for its positive aspects, such as supporting the economy by improving the profitability of export companies and boosting stock prices. Now, however, companies find it easier to pass on rising costs to prices, and the degree to which wages and prices are interlinked is also increasing. The weak yen is no longer just a temporary upward pressure via import prices; it is beginning to have a transmission channel to the underlying inflation rate through corporate pricing behavior and household inflation expectations. Deputy Governor Uchida stated that a mechanism where wages and prices rise while referencing each other is becoming established amid labor shortages, indicating that the pass-through effect of the weak yen could be more persistent than before.

Incidentally, the minutes of the April MPM included the view that, "while there were some arguments that interest rate hikes should be implemented to prevent a depreciation of the yen, monetary policy does not target foreign exchange rates and, under a floating exchange rate system, the determination of exchange rates should be left to the market as much as possible." This view not only rejects monetary policy management aimed at correcting the exchange rate level but also implicitly suggests that public intervention in the exchange rate itself should be approached with caution. This suggests a negative (and ironic) view toward responses including currency intervention.

Policy consistency is called into question more than intervention

The exchange rates and long-term interest rates are prices that directly reflect the market's evaluation of economic policy management. In his article "Japan's yen depreciation and policy interest rates from a macroeconomic perspective (our translation)" in *Chuo Koron* (Jul 2026 issue), Professor Masaya Sakuragawa of Keio University points out that a currency's strength and long-term interest rates are indicators that reflect a nation's "soft power," such as the predictability and credibility of its policy management.

Soft power is not supported merely by economic or asset size, but by elements such as the legitimacy of institutions, trust from other countries, and operational competence. If this is undermined, it tends to manifest as currency weakness and/or rising interest rates.

A policy of coexisting low interest rates and fiscal expansion in an inflationary environment may appear growth-oriented at first glance, but it tends to simultaneously intensify currency depreciation and price increases, thereby eroding policy credibility. The article states that "If the predictability of economic policy management—reflected in the interest rates of long-term government bonds that signify fiscal stability, and the exchange rates that signify the currency's strength—is betrayed, the nation's soft power would be diminished, long-term interest rates would soar, and the yen would be sold" and "If we truly want to restore a 'strong economy,' we must become a country that is credible, legitimate, competent, and exemplary in the eyes of other nations. The weak yen is the market's assessment of this decline in soft power."

In this respect, the BOJ's June rate hike was an important step, but it was not a sufficient message. While raising the policy rate to 1.0%, the BOJ maintained its explanation that the financial environment remained accommodative even after the hike and would support economic activity. Deputy Governor Uchida explained that with the underlying inflation rate approaching 2%, the BOJ would continue to raise the policy rate in response to developments in economic activity and prices as well as financial conditions. However, a source from the MOF expressed the view that "a strong message of fully controlling inflation was not sent, and this rate hike had almost no effect in correcting the yen's weakness" (*Yomiuri Shimbun*).

Furthermore, what the market is focusing on is not so much the intention to implement additional rate hikes itself, but rather the feasibility of actually doing so. The fact that board member Asada opposed the rate hike and that a member seen as cautious about further rate hikes will replace the retiring member Junko Nakagawa leads many to be conscious of the possibility that support for normalization within the policy board may weaken. Such a situation is also easily linked to the perception that policy management is heavily influenced by the political environment.

In particular, the perception that the administration still places emphasis on the benefits of low interest rates and yen depreciation is important for the market. Prime Minister Sanae Takaichi stated during the September 2024 LDP presidential election, “I think it's stupid to raise interest rates now.” Although such direct language has subsided since she assumed the post of Prime Minister, some government officials have indicated that "the Prime Minister will not show understanding for rate hikes" (*Asahi Shimbun*).

As long as the market perception persists that the Japanese prime minister holds a "deep-seated, unwavering conviction" about the benefits of a weak yen and low interest rates, the view will likely remain that the BOJ's normalization efforts are susceptible to political constraints, even in situations where the need for additional rate hikes increases. The continuation of this perception itself is a factor that preserves a market environment where yen weakness and rising interest rates can easily proceed in tandem.

On the other hand, US involvement cannot be ignored. There is a view that pressure exists to support Japan's monetary policy normalization out of caution that rising Japanese long-term interest rates or a weak yen could have spillover effects on US markets. For this reason, the future focus will shift to whether the government and the BOJ will respond to the weak yen with currency intervention or by moving to enhance the consistency of monetary and fiscal policy. Currency intervention may trigger an unwinding of short yen positions in the short term, but as long as low interest rates, expansionary fiscal policy, supply constraints, and upside risks to inflation coexist, yen depreciation pressure is likely to intensify again.

Stabilizing the yen requires not a response to the exchange rate level itself, but a restoration of trust in policy management. Specifically, the BOJ is required to make it clear that it will not fall behind the curve in addressing upside risks to inflation and to secure the room to proceed with additional rate hikes as necessary.

At the same time, the government is called upon not to pursue policies that further stimulate demand under supply constraints, but rather to bolster the economy's supply-side capacity by creating an environment where the private sector can engage in economic activities more freely and by implementing measures to address the low birthrate, which would enhance the predictability of future demand. In particular, if government-led resource allocation intensifies in the fields targeted by the growth strategy, there is a risk that it could distort market functions and preserve vested interests.

If the government takes the lead in investment because private companies are not investing sufficiently due to risk considerations, it is based on the premise that government judgment surpasses market choices, and its effectiveness requires careful examination. What is needed is not for the government to lead investment (spend money), but policies that draw out private-sector investment through reviews of regulations and barriers to entry.

In conclusion, the current yen weakness is not merely a problem of a strong dollar or the Japan/US interest rate differential. It is a situation where the forex market is issuing a warning about Japan's policy management as a result of a combination of low interest rates, expansionary fiscal policy, supply constraints, the progress of price pass-through, and concerns that the BOJ is behind the curve. Currency intervention may serve as a short-term line of defense, but to sustainably curb the yen's depreciation, the BOJ's normalization stance and the government's fiscal management must be revised to be consistent with an inflationary economy. The weak yen is not a mere byproduct of policies; it is emerging as the market’s assessment of the consistency of policy management.

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