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The Japanese Yen Outlook for 2018

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At the start of 2017, the USD/JPY was traded at around 118, after the rapid depreciation of the Japanese yen during the previous year. Since then, however, it showed more or less a sideways trade, ending the year with a historically calm movement of yearly trading range of about 11 yen[1] or change of less than 10%[2]. Apart from the traders who enjoy the profits from market fluctuations, the stable development of the yen exchange rates in a relatively narrow range can be seen as a blessing to Japanese economy. Despite adversities such as heightening strains in the North Korean situations, the USD/JPY was mostly traded stably in a small range at around 112 yen[3] throughout the year, without a stormy appreciation of the yen that might have hit the corporate earnings and stock prices, or neither an excessive depreciation that might have lowered the purchasing power of the household. This low-key contribution of a "stable exchange rate of the yen" can be pointed out as one of the factors that supported the generally good performance of the Japan's economy in 2017.

Then, what will become of the year 2018? Although there are still substantially serious potential risks surrounding the financial market, it is highly probable that the USD/JPY will maintain its stable trend at around the similar range as was seen in 2017. However, if asked which is a higher risk, appreciation or depreciation of the yen, it seems to be the appreciation of the yen for the reasons as discussed below.

The biggest reason why the yen remained in a small range was "status quo of monetary policy", that is, there were no surprise or policy change coming out from the Bank of Japan (BOJ). Under the regime of Governor Kuroda who took office in March 2013, the BOJ came up

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[1] The USD/JPY stayed in a range of 118.60-107.32 in 2017 with a precise range of 11.28 at the writing of this.

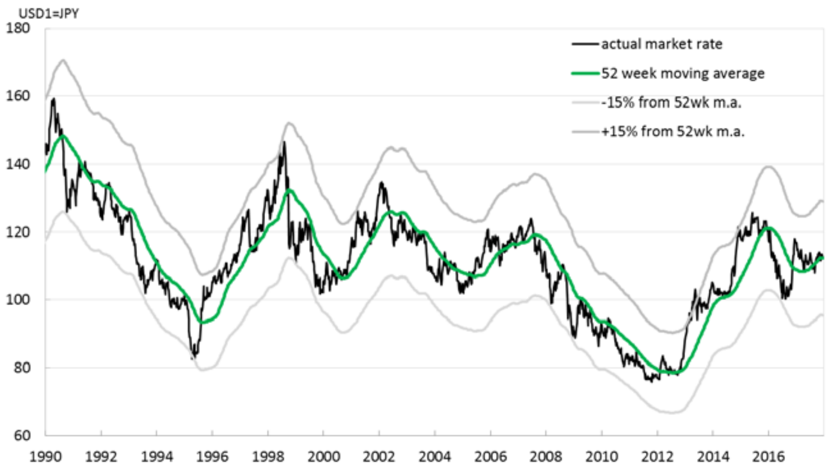
[2] Since 1980, in only three years of 1983, 2006 and 2015 the annual rate of fluctuation fell below 10%.

[3] At the writing of this, annual average rate equaled to 112.10, with a median at 112.96. The equilibrium level estimated from the PPP of the IIMA(average median of PPP based on corporate goods price index and PPP based on consumer price index) was 110.93. Please also see the article written by the author on Nikkei Business on February 14, 2017: "Yen rate will stay around 112.00±5.00 whatever President Trump would say." http://business.nikkeibp.co.jp/atcl/report/15/110879/021400571/

with the “unconventional monetary easing both in quantity and quality”, or so-called QQE in April 2013, which was often described as “shock and awe” policy. In the following October 2014, the bank implemented additional monetary easing by expanding the yearly amount of government bonds purchase to ¥80 trillion. After it had just a minor policy change in 2015, it announced in January 2016 an introduction of negative interest rate policy. In the following September 2016, the bank conducted a “comprehensive assessment” of past policy measures and modified its policy scheme to introduce "QQE with Yield Curve Control", and set a long-term interest rate target at around zero %.

Looking at these policies in a longer perspective, there will be a few who dare to make an objection to the assessment that one of the greatest achievements of these policies was the correction of the yen appreciation. The unconventional monetary easing that the BOJ implemented with twists and turns since 2013 contributed as a big driving force for Japan to move away from the phase of “excessive yen appreciation below 100” that continued for long since the global financial crisis. It was in this way the yen exchange rate had moved in the last five years or less, largely depending on “the monetary policy of the BOJ.” In 2017 there has been no change in BOJ’s monetary policy, which contributed to one of the smallest yearly movements of the yen exchange rate.

＜Chart 1　Long-term Development of the USD/JPY exchange rates



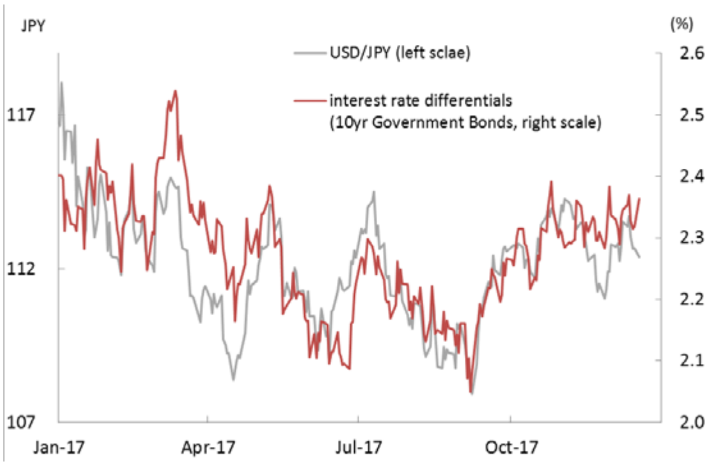
In that sense, there is a great interest in the future policy judgment of the BOJ. Incidentally, there is gradually spreading a view that forecasts that the BOJ will take the first step toward “exit strategy”, although BOJ will never call it that way, and make a policy change “directed toward monetary tightening” for the first time since February 2007. In a backdrop of this view, it is pointed out the communication of the BOJ has changed with regard to its objective of achieving the price stability target. Previously only the aspect of policy guideline of “achieving price stability target of 2% at the earliest possible time” was put forward, but as far as judged from the recent speeches and comments made by Governor Kuroda and/or Deputy Governor Nakaso, it is noteworthy that in an increased number of speeches more consideration has been given to the balance between financial stability and macro-economic performance, as is symbolized by their references to the “reversal rates”[4].

Another background relates to the pick-up of the Japanese economy itself which shows a visible improvement to allow the open discussion of monetary policy shift as well as the BOJ’s judgment on the Japanese economy as indicated by the words of “the real dawn is near at last” (Deputy Governor Nakaso on October 5). Furthermore, there may be a textbook belief at the base of the BOJ thinking that the primary duty of monetary policy lies in minimizing the downturn and upturn of business cycle. Given the fact that many challenges surrounding the Japanese economy relate to structural problems (≒a low potential growth rate), it seems to be quite reasonable that it desires to correct the situation where only the BOJ has to step heavily on the accelerator of monetary easing and it is inclined toward making judgment that the chance has finally come. On the other hand, there is also a well-known hypothesis of “high pressure economy” that the monetary easing continued even at a time of economic expansion would contribute to promote structural reforms and improve potential growth, although it also shows, at the same time, its intention to avoid the byproducts such as bubble-creation and hampering the stability of financial system by keeping super low interest rates for a prolonged period. If the policy change of the BOJ has become clearer, it will endorse the market reaction to lead a higher yen.

In the United States, the Governor of Federal Reserve Board Mr. Jerome Powell is nominated to be the next Chairman and this once-called “Mr. Ordinary” acted in the same way with Chair Yellen in their voting. As for the exit policy of the Fed, “continued safe driving” has been a consensus view. Even taking into account the upward pressure on the economy and inflation by the expected large-scale tax cut, the scheduled interest rate hikes to be made in three or four times in 2018 have been already priced in the market forecast. Furthermore, after the implementation of a series of interest rate hikes the concerns will shift to downside risks such as “when and how the accumulated impact of the rate hikes will be materialized?”, or, “when will the third longest economic expansion be interrupted?” If so, the upward pressure of rate hikes on the dollar rates will be more marginalized than this year. Therefore, the more probable case seems to be in an appreciation of the yen due to narrowing interest rate differentials by a rise in yen interest rates, rather than the accelerated dollar buying promoted by the widening of interest rate differentials that have a strong deciding power on the USD/JPY exchange rates.

[4] In the speech at the University of Zurich on November 13, 2017, Governor Kuroda commented that “Another issue that has recently gained attention with regard to the impact on the functioning of financial intermediation is the "reversal rate". This refers to the possibility that if the central bank lowers interest rates too far, the banking sector's capital constraint tightens through the decline in net interest margins, impairing financial institutions' intermediation function, so that the effects of monetary easing on the economy reverses and becomes contractionary. This idea was theorized by Professor Brunnermeier of Princeton University and others. Markus K. Brunnermeier and Yann Koby (2017), "The Reversal Interest Rate: An Effective Lower Bound on Monetary Policy," mimeo.

<Chart 2　USD/JPY and Interest Rate Differentials>



What discussed above, the outlook for the stronger Japanese yen, is just one of the risk scenarios and the main scenario is, as noted in the beginning, the continuation of a stable development more or less in the same trading range as was seen this year. However, in addition to the possible BOJ policy shift, the factors to drive the stronger yen may include e.g. huge current account surplus of Japan, geopolitical risks such as development in the North Korea situation and protectionist policies of the Trump administration. In view of a relatively eventless financial calendar for 2018 except the BOJ leadership changes of the governor and deputy governors, it seems important to avoid any "conspicuous actions" of the BOJ which could confusingly trigger an unexpected appreciation of the yen. The calm and stable foreign exchange market activity, as we have seen in 2017, could best contribute to the favorable development of the Japanese economy and financial markets.