Does Japan need an even weaker yen?

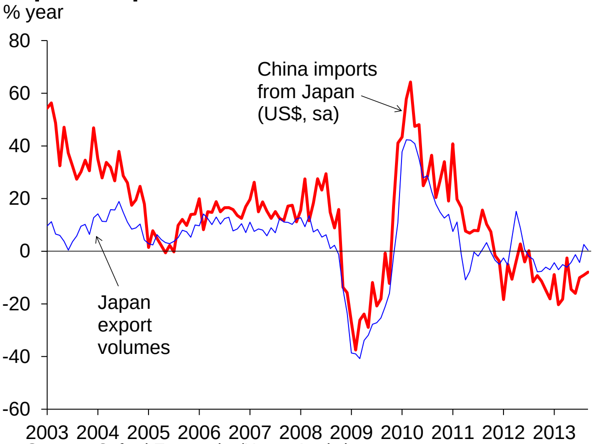
The yen is around 20% weaker on a trade-weighted basis than a year ago. This has helped boost economic activity in recent quarters, but there is a risk that this improvement will not be sustained as the planned rise in the consumption tax bites and if external demand falters. In our view, a weaker yen is probably the strongest channel through which the authorities could boost economic growth, but this might require a further loosening of monetary policy and could run into international resistance – the real yen exchange rate is already at its weakest since the mid-1980s.

Boost from a weak yen may not be sustained…

Since the Japanese authorities moved to aggressively loosen monetary policy from late 2012, the yen has depreciated sharply and is currently 20% weaker on a trade-weighted basis than a year ago. The depreciation has certainly helped boost economic growth in Japan in recent quarters, but there is a risk that this upturn may not be sustained.

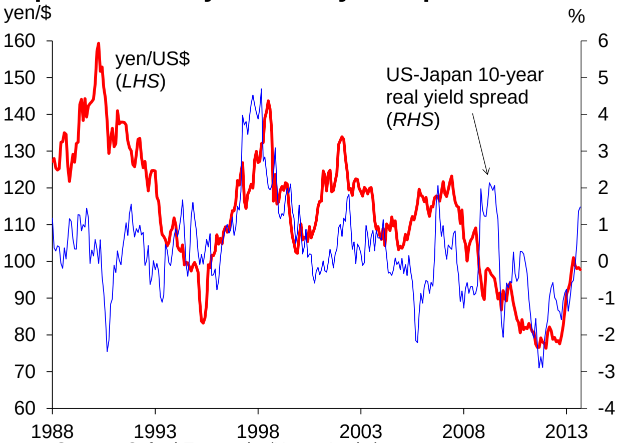
Consumption tax hikes in 2014 and 2015 will hit consumer spending (we estimate they will cut real household income by about 2%) and require an even bigger contribution from the export sector to sustain growth. And there is also a risk that external demand may not grow as fast as hoped, as there are downside risks to US growth from recent fiscal turmoil. Asian demand does not look particularly firm, either. The latest Japanese trade data showed export volumes falling back in September and the dollar value of exports to China (despite recent better indicators there) is still lower than a year ago.

Japan: Export trends



Source : Oxford Economics/Haver Analytics

Japan: Currency and real yield spread



Source : Oxford Economics/Haver Analytics

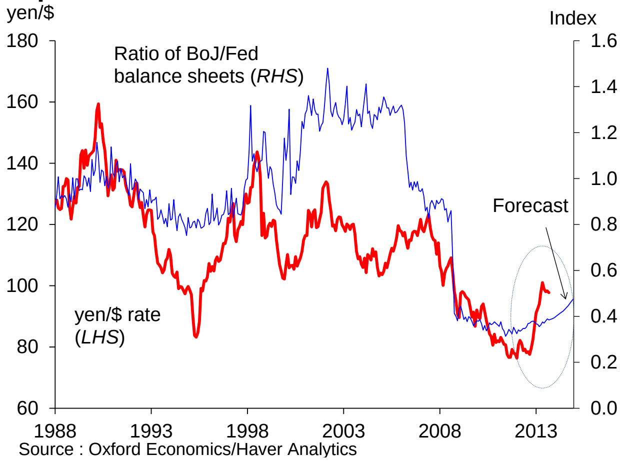
…but policy might have to shift to drive the yen down further…

In our view, the exchange rate in Japan is probably the strongest channel by which the authorities can boost the economy. But achieving a further yen weakening might require an active effort by Japanese policymakers. Our current forecast suggests that the yen will weaken by a further 5% or so against the dollar by mid-2014, based both on a relatively bullish dollar forecast and on the forecast shift of the long-term (ten-year) yield spread between the US and Japan (which has a reasonable long-term relationship with the yen/$ rate).

But there is a risk that this additional yen weakness does not materialise. First, it is arguable that changes in the relative sizes of the balance sheets of the Bank of Japan (BoJ) and the US Fed are as important a driver of the yen/$ rate as interest rate differentials. On this view, the Bank of Japan's aggressive expansion of its balance sheet this year and next has weakened the yen through 'portfolio balance' effects. But regression analysis of the relationship between relative balance sheet sizes and the level of the yen suggests this effect is already fully priced in to the existing yen exchange rate – this should not be too surprising as the BoJ at the start of the year laid out its planned balance sheet expansion for 2013 and 2014 and markets will have absorbed this information.

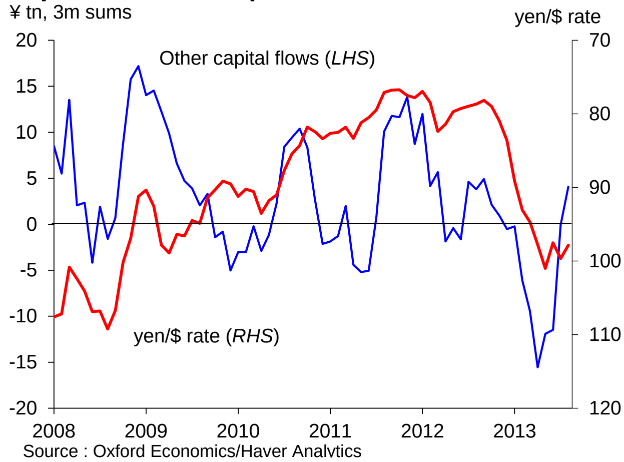
Secondly, there are also some signs that the capital outflows that have driven the yen weaker over the last year are shifting. The yen has correlated well over the last year with capital flows excluding bond and equity flows. In the six months to April, this measure of 'other' capital flows (which includes errors and omissions) recorded a negative balance of ¥15 trillion, but in the three months to August these flows showed a modest positive balance. The yen has more or less held its value over recent months, but if this pattern of capital flows continues, there is a risk that it might actually start to strengthen.

Japan: Yen and central bank balance sheets



Source : Oxford Economics/Haver Analytics

Japan: Yen and capital flows



Source : Oxford Economics/Haver Analytics

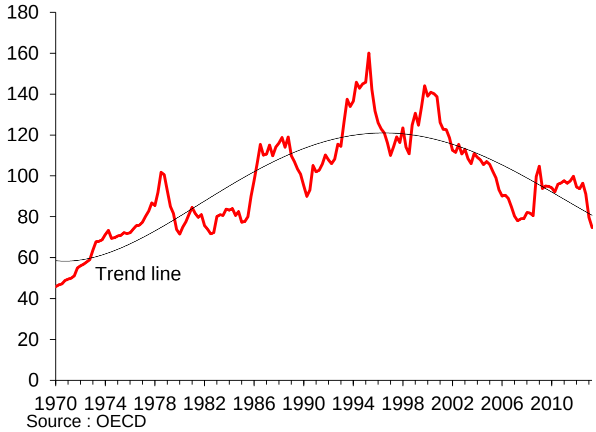
…risking international resistance?

This analysis suggests that further yen weakness is not a given, and that some rebound from its current levels is even a risk. As a result, if the authorities wanted to get a weaker yen, in our view this would require a further loosening of monetary policy – probably a substantial one that would not only expand the BoJ balance sheet further but also push inflation expectations up so that the real long-term yield spread also moved further against the yen. Alternatively, direct intervention in the foreign exchange market would be another option.

Should Japanese growth start to falter over the coming quarters, this would be the best policy option. However, there is a potentially major barrier in the form of resistance from Japan's trading partners. Strikingly, the OECD measure of Japan's real effective exchange rate suggests the yen is at its weakest level since the mid-1980s – just before the Plaza Accord which saw international efforts to weaken the dollar against the yen and other major currencies.

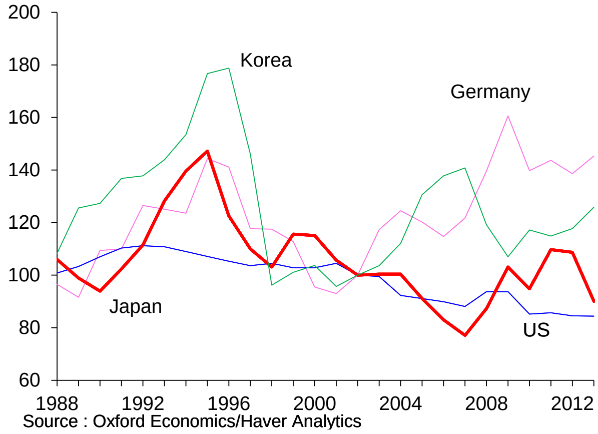
Japan's trading partners could also point to the fact that the recent yen depreciation has meant significant competitiveness gains for Japan at their expense; based on manufacturing unit labour costs (in US dollars), Japan has gained an estimated 17% against the US, 22% against Germany and 24% against Korea. Japan has still not regained the competitive position it had against the US and Korea in 2007, but looks very competitive against Germany.

Japan: Real effective exchange rate
Index, 2005=100 (based on unit labour costs)



Source : OECD

Manufacturing unit labour costs
Index, 2002=100 (US$ terms)



Source : Oxford Economics/Haver Analytics

Against this background, Japan might hesitate to act to weaken the yen further; but the temptation would be strong, as a 15% depreciation from current levels would (other things equal) more or less restore Japan's competitive position against the US to the 2007 level – and a super-weak yen would be the best insurance against the possible negative growth shocks on the horizon.

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