OCTOBER 29TH 2010

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SPECIAL FX

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Another Piece of the Yen Puzzle

Investors and policy makers alike are befuddled by the yen. Its strength continues to defy the traditional explanatory models that typically give a privileged position to risk appetite, interest rate differentials, or external positions.

Earlier in October, the BOJ announced that it would purchase JPY5 trillion (~$61 bln) of various assets, including corporate bonds, exchange traded funds, real estate investment trusts and government paper. On October 28, it provided a bit more detail and indicated it would lower the minimum rating of the corporate bonds it may buy to BBB. Relative to output, this would be roughly equivalent to the Federal Reserve buying around $250 bln of securities.

While most expect the Fed's QEII to be larger, the quality of the assets that the BOJ is buying is widely perceived to be lower than what the Fed is expected to buy (Treasuries). Moreover, the BOJ brought forward the meeting that was regularly scheduled for the middle of next month to the end of next week, shortly after the Fed makes its announcement on asset purchases. Although the ostensible reason for the change was to allow the board more time to discuss the details of the asset purchases, clearly it also positions them to respond to the Fed's move, and signals to the market that the BOJ is at the ready.

Consider the recent string of news. One, in a new quantitative easing exercise the BOJ purchased assets with less than a AAA-rating. Two, the near-zero interest rate policy, derived from an unexpected interest rate cut earlier this month, is being used as a tool to ease monetary conditions. And finally, a recent string of disappointing economic data, including September's decline in retail sales (the first in four months), the seasonally adjusted m/m decline in exports (which have fallen every month this year except for January and April) and four consecutive months of contraction in manufacturing output.

And yet the yen still rises.

US Interest Rates

Some attributed the yen's strength to the decline in US interest rates as the US economy weakened and the Fed signaled a new round of asset purchases. The yen, however, has remained strong even though the US 10-year yield *rose* about 35 bp between Oct 7 and Oct 27.

At the same time, our review of Japanese investors foreign bond purchases indicate that during the current fiscal year through August, US bond purchases accounted for a little more than half. Japanese investors have purchased about JPY15.75 trillion ($180 bln) of foreign bonds in the first five months of FY10, of which JPY8.5 trillion was accounted for by US bonds, according to Ministry of Finance data.

These bond purchases compare with a cumulative current account surplus during this period of about JPY6.4 trillion. The yen should decline if Japan were successfully re-cycling its current account surplus by offsetting it with capital exports. Japanese purchases of foreign assets are concentrated in fixed income and these figures clearly illustrate Japan's prodigious export of capital.

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Since the end of August the US S&P 500 is up around 15%. The Dow Jones Stoxx 600 in Europe is up a little more than 8%. Under the risk-on/risk-off matrix the yen would be expected to fall, but it doesn't.

Foreign Exchange Forensics

The enigma of the yen's rise requires foreign exchange forensics. The demand for yen has to be large. But the speculators at the IMM are too small, though they hold roughly JPY587 bln (~$7.3 bln) of net speculative long yen positions in the futures market. And the position has generally been flat since July so it cannot help shed light on the recent strength of the yen

So where is this large demand for yen coming from? Not from foreign purchases of Japanese stocks and bonds. Those are actually quite meager, considering that due to yen appreciation we may still be talking about the world's second largest economy – not to mention the largest stock and bond markets in the world.

According to the weekly MOF figures, foreign investors have bought about JPY1.4 trillion (~$17.2 bln) of Japanese stocks and bonds (30 weeks) during the fiscal year. In the same period in FY09, foreign investors were net sellers of nearly JPY1.6 trillion of Japanese stocks and bonds.

However, the MOF also provides weekly reports on bill purchases, which are often glossed over by economists focusing on stock and bond purchases. While this simplification may make sense most of the time, now it is an exception. Foreign investors have bought about JPY7.6 trillion (~$89 bln) in Japanese bills through late October. During the same period in FY09, foreign investors sold almost JPY700 bln (~$8.6 bln) worth of Japanese bills.

Now we are getting closer.

Excess Reserves

Foreigner investors prefer Japanese bills because the Japanese stock market has generally under-performed, and bond yields are too low to contribute much to a portfolio while at the same time exposing investors to market risk. The real play, after all, is the yen, and the bill thereby gives the most direct exposure for many institutional investors who may be prohibited from taking on naked currency exposure.

Meanwhile, foreign banks are implementing a version of this strategy in much larger magnitude. Non-Japanese banks-appear to be using the swap market to secure yen funds at less than 10 bp, which is what the Bank of Japan pays on excess reserves and is about the same rate as a 3-month bill.

At the end of September, for example, foreign banks had JPY45.7 trillion (~$562 bln) of excess reserves sitting with the BOJ, even though their required reserves are only JPY260 mln. If we want to understand the yen's appreciation in recent months, for one, we need to look at how much foreign banks have increased their excess reserves in Japan. At the end of May, foreign banks held JPY20 trillion (~$246 bln) in excess reserves with the BOJ.

This JPY25.7 trillion (~$316 bln) increase in excess reserves has not been smooth. A little less than half (JPY11 trillion or ~$136 bln) came in the month of September alone. Recall that during the mid-September intervention, the BOJ sold about JPY2 trillion. September also saw a flood of money flow into emerging markets. This is roughly 40% of the money taken in by emerging market equity funds this year, and also took place in September, according to the fund-tracking company EPFR.

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Foreign banks had more excess reserves at the BOJ at the end of September than did the rest of the Japanese banking and financial system. The total amount of excess reserves was a little less than JPY84 trillion (~$1.04 trillion), domestic institutions accounting for about 45.5%.

Policy Response

A greater understanding of what is driving the yen can help policy makers address its causes and allow investors to better manage their yen exposures. Indeed, the yen is rising because Japanese investors are not exporting enough capital to offset Japan's current account surplus nor to offset the hot money that has flowed into the bill market and excess reserves.

Japanese officials could call officers from the large foreign banks and explain to them why they should not be “gaming” the system. Moral suasion is, of course, polite and diplomatic but there is a broader range of actions officials can take. Namely, the BOJ could stop paying interest on excess reserves. In fact, during the BOJ's past quantitative easing efforts, it suspended interest payments on excess reserves. Although this approach may not have much direct impact, since banks do not keep excess reserves at the BOJ as a yield play, it would send a signal that such funds are not desired.

To underscore this message, officials could also impose a penalty for holding excess reserves with the BOJ, much like Sweden’s Riksbank use of the negative deposit rate did recently. In the 1970s Germany and Switzerland, too, imposed a negative rate on foreign deposits to discourage speculation in their currencies. It is therefore not unprecedented and could prove to be more effective (and less antagonistic) than direct intervention in the foreign exchange market.

Japanese policy makers could also take measures to discourage foreign purchases of government bills. To combat short-term capital from affecting their currency, for instance, Taiwanese officials have barred foreign investors from owning certain short-term financial instruments. Officials could stop shy from a ban and instead use a tax disincentive to discourage using the bills as a way to speculate on the currency. While some may object that these are forms of capital control, they are largely benign varieties and arguably preferable to intervention.

The Bank of Japan has revised down its growth forecast and does not envisage price stability (1% CPI) until FY2013, at the earliest. If the dollar falls sharply in reaction to QEII, and the JPY80 level gives way under the strain, the risks increase that the BOJ will feel compelled to do something. Intervention, especially so close to the G20 heads of state meeting, would raise political hackles, and the BOJ buying foreign bonds, as some have suggested, would be thinly veiled intervention. Going, instead, directly after the hot money would be more effective and politically palatable.

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