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The Yen Conundrum

Seventy years ago next month, Winston Churchill described Soviet foreign policy as a "riddle wrapped in a mystery inside an enigma". That now may be apropos of the Japanese yen.

Japan is a country that appears to be literally in decline. The population has begun shrinking, as has the work force. It has been almost 21 years since the Japanese stock market peaked. The overnight rate has been close to zero for the better part of 15 years. Deflation continues to grip the economy, which is plagued with slow growth. In fact despite the 1.5% expansion reported in the April-June quarter, in nominal terms, that is when unadjusted for prices the Japanese economy contracted by 0.6%. The lost decade has turned into two.

The Japanese government's debt/GDP ratio is more than twice the U.S. level. The central bank buys ¥1.8 trillion (~$20 billion) a month of Japanese government bonds in what are called "rinban" operations. Were the Federal Reserve to do this, the market would be up in arms.

The political situation is poor. Japan has surpassed Italy with the dubious honor of having the most frequent changes of governments among the major industrialized countries in the past two decades. During this time Japan has had 14 prime ministers, and since 2006, the average tenure in the post has been less than one year. The ascension of the Democrat Party of Japan (DPJ) has not changed this. They have had two prime ministers in the past year and the DPJ leadership challenge on September 14th may result in a third.

The first DPJ government was decidedly pro-growth, with tax breaks, payments to households with children, and abolishing public high school tuition fees. When Naoto Kan took over a few months ago, he shifted the focus to Japan's large debt burden, distancing the government from prior spending commitments, and even opened the proverbial "can of worms" by calling for a doubling of the retail sales tax.

Reasonable people may differ on which economic model best explains or predicts currency movement, but nearly all would agree that Japan's macro political and economic conditions are not typically associated with an appreciating currency. Yet the Japanese yen continues to be the strongest currency among the majors.

Since the crisis began in mid-2007, the Japanese yen has appreciated by 46% against the U.S. dollar, more than 50% against the euro and nearly 70% against sterling. On a trade weighted basis, it has risen by roughly 53%, a quarter of which has been recorded since March.

Why?

It might sound banal but the yen, like other floating currencies, appreciates when there are more buyers than sellers. To begin trying to understand the source of yen strength, one might be better served by stepping away from the macro-economy and follow the money.

The first step is to reject the standard periodization that begins with the description of the yen's appreciation from the onset of the financial crisis. Instead, one needs to appreciate that the yen, on a trade-weighted basis, trended lower from 2000 through mid-2007, depreciating nearly a third. When the crisis began, the yen was close to its nine year low.

The weakness of the yen, at least in part, helped finance the excess leveraging that ultimately, turned a housing market bubble into an existential crisis for many businesses and households. The deleveraging which continues to grind on is expressed here in terms of the unwinding of massive yen carry trades, which pushed the yen to multi-year lows.

There is also a less virtuous dimension to the yen's appreciation. The financial sectors in the U.S. and Europe are not fully operational. The patient may be off the critical list, but remains in intensive care. Most policy makers in the industrialized countries judge it premature to stop life-support.

In recent weeks, the Federal Reserve took measures to resist a passive shrinkage of its balance sheet via the maturities (and pre-payments) of its mortgage securities. The ECB extended its special liquidity facilities that were set to expire. The Bank of Japan extended one of its short-term lending facilities.

The yen's strength somewhat reflects the breaking down of the international circuit of capital. The way the balance-of-payments system is supposed to work is that countries with current account surpluses should run capital account deficits. It appears that Japan is running both a current account surplus and a capital account surplus. In the market's vernacular, the yen's strength is a result of Japan being unable or unwilling to re-cycle its current account surplus by exporting an offsetting amount of capital.

It is Not about China

Recent Japanese data showed that in July China bought about ¥590 billion (~$7 billion) of Japanese debt obligations (largely bills, less of the longer-dated bonds). This is the general pattern that has persisted since the start of the year. Japanese officials have made note of this, but ultimately this is a benign situation which only distracts from the real issues.

China flows are generally modest in the context of other forces at work. Consider the primary parts of Japan's current and capital account.

Above the line, in what balance-of-payments analysis are regarded as autonomous, includes Japan's trade surplus, the income it has earned on it past investment (dividends and interest payments), as well as royalties and licensing fees and foreign purchases of Japanese assets. This is not a comprehensive list, but it captures the main items.

Below the line is where balance-of-payments analysis puts items that equilibrate. The problem Japan is having, which is driving the yen higher, is that the items below the line are not sufficiently offsetting those above the line.

The major item below the line is Japan's purchases of foreign assets, primarily debt instruments. One of the most troublesome aspects of the yen's appreciation is that is has been taking place at the same time that Japan has been stepping up its export of portfolio capital. Weekly Ministry of Finance data shows that over the past quarter Japanese investors have purchased about ¥17.5 trillion (~$208 billion) of foreign bonds and stocks.

It is ironic that as the Chinese were buying the bills that seemed to be an issue of concern for at least some Japanese policy makers, Japan was buying six times more U.S. Treasuries (¥3.62 trillion in July, just shy of the October 2001 monthly record high of ¥3.72 trillion). In effect Japan borrowed from China at practically nothing (3, 6 and 12-month bills yield about 11 bp annualized) and lent to the U.S..

Measure Twice and Cut Once

In any event, the prodigious portfolio outflow from Japan is at its strongest pace since the time series began almost 10 years ago. To better appreciate the magnitude that is involved, consider that the last time Japanese officials intervened in the foreign exchange market was a large scale operation in Q4 '03 and Q1 '04 when the BOJ sold roughly ¥20.5 trillion and ¥14.8 trillion yen, respectively.

The record shows that those yen sales did not manage to drive the yen lower against the dollar. The private sector has purchased foreign assets of roughly the same magnitude and it too has been unable to prevent the appreciation of the yen on both a trade-weighted basis and on the bilateral exchange rate with the U.S. dollar.

A back of the envelope calculation of the major items on the above the line is in the magnitude of ¥4-5 trillion yen a month. Japan's portfolio outflows more than offset this. This is the real conundrum. There are several channels of capital movement that have not been discussed here, leaving aside the time series are not all aligned and other methodological issues.

A more thorough analysis would have to include speculative capital, like margin trading in Japan, or futures trading at the IMM, where in the most recent week, speculators were long the equivalent of about ¥612 billion (just a bit more than the amount of Japanese debt obligations China bought in July). There is also extensive and harder to track over-the-counter activity. Some industry estimates suggest retail foreign exchange business could be as much as 40% of the turn-over in Tokyo.

Conclusion

This discussion does not pretend to solve the conundrum of the yen's strength. It objective was more modest: It identifies the direction of the answer, which lies in the circulation of capital, not macro-economic performance and political consideration. The unwinding of the previous yen carry trade is playing out and although the private sector is purchasing a large amount of foreign assets, roughly the same amount was tried previously (by the BOJ) and, it too, did not work. The stemming of the yen's appreciation will require greater export of capital from Japan.

Short-term speculative capital flows and other flows not picked up in this sketch are difficult to ascertain, leaving it difficult to generate an estimate of the magnitude of capital that needs to be exported from Japan. However, if the will was there, the Japanese government could step in to address the market's failure to sufficiently export Japan's surplus capital.

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