Liquid Insight

Yen's 2024 problem

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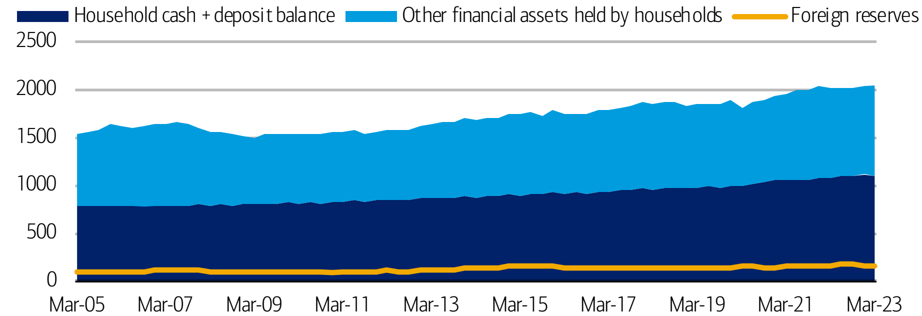
Key takeaways

- If global inflation remains elevated in '24, JPY may face policy trilemma with households rebalancing away from bank deposit
- Capital control is politically infeasible while interest rate stability may be more indispensable, leaving JPY under pressure
- Set of policy reforms to support JPY may be needed but pain may have to come first in such risk scenario.

By Shusuke Yamada

Chart of the day: Japanese households' financial assets and Japan's foreign reserve (¥tn)
Japanese households' cash + deposit balance is 6 times larger than Japan's foreign reserve



Source: BofA Global Research, Haver

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Yen's 2024 problem

In our previous note, we noted the yen weakness could transition into its third phase in 2024 if the Fed does not cut rates through 2024 as Japanese households may start to diversify away from cash and deposit to protect their purchasing power (Liquid Insight: Phase 3 of JPY's structural decline in 2024? 28 June 2023). We look at this issue from a perspective of impossible trinity.

Impossible trinity or policy trilemma states that a country can accomplish only two out of three policy objectives: (1) free capital movement; (2) exchange rate stability (more narrowly, fixed exchange rate); (3) an independent monetary policy. In Japan, a low inflationary environment may have allowed relative stability in the exchange rate and interest rate without a capital control and despite low growth and growing public debt, but this may be changing given rising inflation.

This is not our base case but if the Fed does not cut rates or cut rates much less than priced in 2024, policy trilemma may hit the yen market. In such a scenario, as the hurdle to impose any capital control measures or to compromise on interest rate stability remains high, the government may have to let JPY weaken until pressure forces reform.

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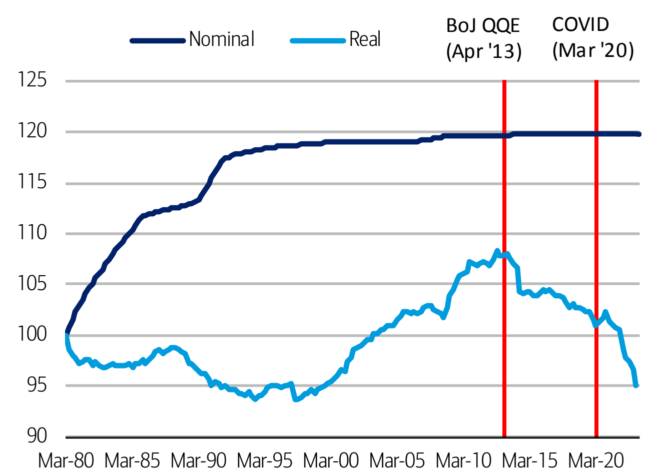
Low inflation has allowed stability in interest rate and exchange rate

Japan has not faced the degree of the yen weakening pressure we have seen since last year and the yen rates market has been stable during much of the past two decades without no tightening in capital control measures and despite low economic growth and growing public debt. This may have been at least partly thanks to the low inflationary environment at home and, to a lesser extent, abroad. Japanese ordinary bank deposits had been able to maintain purchasing power without yield enhancement effort until the recent pandemic (Exhibit 1).

As capital did not have to leave home to search for yields, JPY did not face severe selling pressure. The bank deposit balance has grown much more than the lending balance, creating excess liquidity, a source of demand for and stability of JGBs (Exhibit 2). Of course, the deflationary environment had its own problem, including persistent nominal appreciation pressure on JPY, which led to unprecedented monetary easing by the BoJ over the past decade.

Exhibit 1: Nominal and real total return of Japan's ordinary bank deposit (indexed)

Yen deposit has lost 5.5% in purchasing power over past two years



Source: BofA Global Research, Haver

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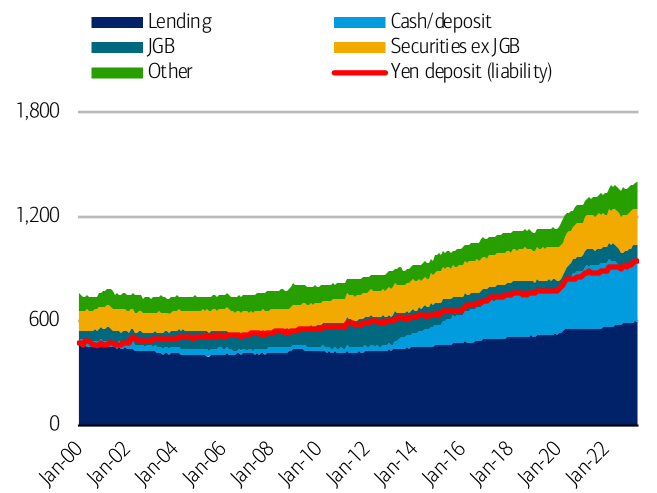
Exhibit 2: Japanese banks' assets and yen deposit liability (¥tn)

Rising deposit-lending gap has created excess liquidity



Source: BofA Global Research, INDB

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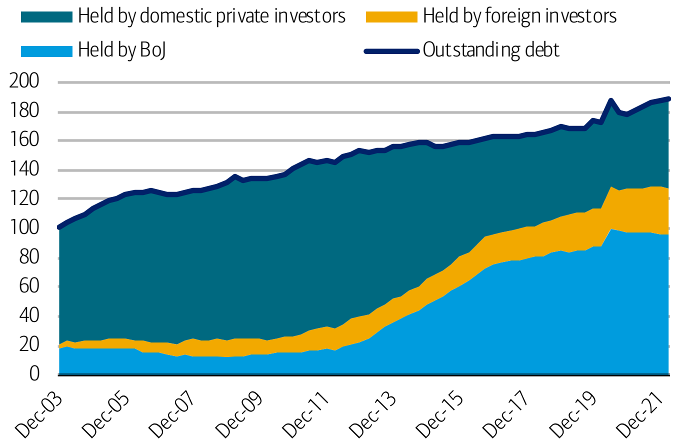
But rising inflation has started to break the stability

This framework may change as our economists see a case for a sustained high inflation in Japan (see: Global Economic Weekly: Japanese inflation: The sun also rises 12 May 2023). With a rapid rise in inflation rate, an ordinary deposit's purchasing power has fallen by 5.5% over the past two years (Exhibit 1). Also, if inflation becomes sustainably high, it would eventually urge the BoJ to normalize policy. The JGB market will have to find demand from the private sector if the BoJ may scale back bond-buying and over the long-term, reduce the size of its balance sheet.

We think banks and lifers will buy JGBs once the BoJ tweaks or removes YCC this year – our economists expect the BoJ to tweak YCC in October (see: BoJ Watch: Cautious BoJ to bide more time to tweak YCC 10 July 2023). But whether the demand is sustainable over the long-term will depend on (1) Japan's current account; (2) the visibility of the yen rates outlook; (3) stability of bank deposits. If global inflation remains high, Japan's current account surplus may be lower with a presumably elevated oil price, the yen rates outlook would become less visible as the BoJ may need to implement proper policy tightening, and depositors may start to diversity assets to protect their purchasing power.

Exhibit 3: JGB holdings by investor type (% of GDP)
Private sector should increase JGB holdings for BoJ to normalize policy



Source: BofA Global Research, Haver

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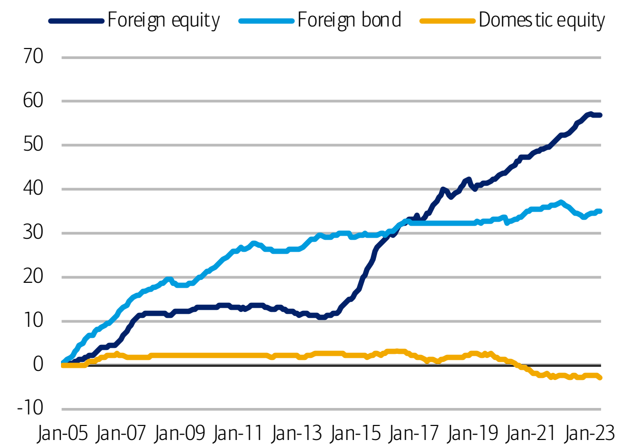
Exhibit 4: Cumulative net investment by Japanese investment trusts (¥tn)
Japanese investment trusts have been adding foreign equities while have sold Japanese equities over the past decade



Source: BofA Global Research, Haver

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2024 problem

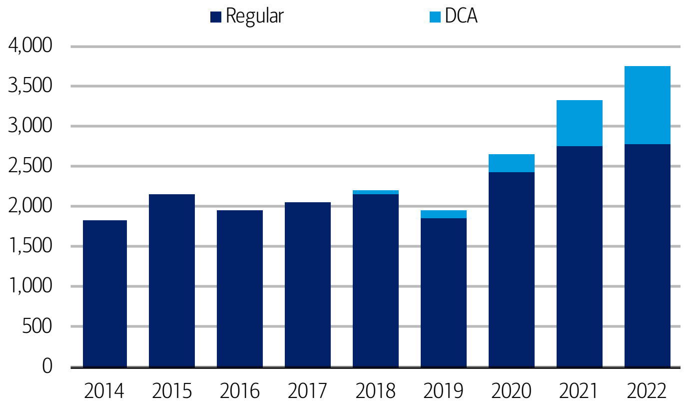
2024 could be a pivotal year for JPY. The expanded NISA (Nippon Individual Savings Account), a tax-exempt investment account for individuals, will become effective in January 2024 (see: FX Watch: Japan's push for retail investments – risk or opportunity for JPY? 16 December 2022). Given the scope of the expansion, we think the new NISA will broaden the retail investor base and increase investment volume by retail investors. Retail investors can invest in domestic and foreign securities and investment funds free of capital gains and dividend tax.

A significant portion of investment through NISA could go into offshore assets, considering the falling home bias among retail investors as evident in investment trusts' consistent buying in foreign equities (Exhibit 4). The direct impact may not be decisive immediately, but the indirect impact of a broadened investor base could be substantial over time (see: Liquid Insight: Phase 3 of JPY's structural decline in 2024?).

Another important point is that, since 2021, *tsumitate* NISA (dollar-cost-average) has been increasingly utilized by retail investors where investors set a dollar-cost-averaging program for mutual funds. Flow through *tsumitate* NISA is likely less price-sensitive than regular form of investment.

If global inflation remains high and the scope for the Fed's rate cuts is limited, households may be urged to diversify away from yen cash and deposits to protect purchasing power, pressuring JPY.

Exhibit 5: Annual purchase volume by retail investors through NISA accounts (¥bn, regular NISA and tsumitate = dollar-cost-averaging NISA)
Retail investors have been increasingly buying financial assets through NISA



Source: BofA Global Research, Haver

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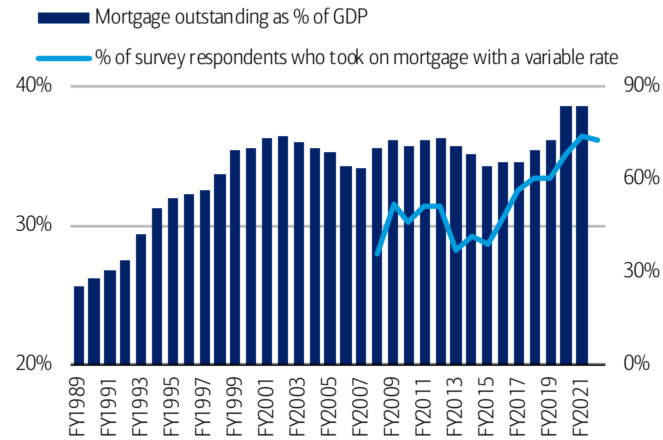
Exhibit 6: Japan's mortgage outstanding
Mortgage balance has risen, likely led by variable rate mortgage



Source: BofA Global Research, Haver, Japan Housing Finance Agency

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Policy trilemma

The question is if Japanese policymakers are willing to impose any form of capital control, or compromise on interest rate stability in such a scenario. We think it is unlikely.

- Capital control goes against the government's push for a shift from saving to investment. The Kishida administration says 2023 is the first year of Japan's path for "doubling investment income" and promotes a shift from saving to investment. The expansion of NISA is a key policy to achieve this objective. Any explicit or implicit capital control measures would go against the government's key policy and hence, would be politically less feasible.

- Interest rate stability is also hard to compromise on. Japan's internal imbalance remains highest among major economies with public debt to GDP ratio above 250%. A rapid increase in interest rates could destabilize the government's financing and could even lead to a JGB downgrade (see: Japan Rates and FX Viewpoint: JGB downgrade risks, 22 February 2023). Also, Japan's mortgage balance has risen and the percentage of survey respondents who took on mortgage with a variable rate has increased to 72% this year from 37% in 2013 after years of low interest rate (Exhibit 6). Rapid rate hikes on the front-end could meet strong public opposition.

As a result, we think FX stability would continue to be the one compromised on first.

How can JPY rebound/rise in inflationary environment longer-term?

How can policymakers maintain the stability of JPY in a high inflation regime? The best case is that a "virtuous inflation cycle" supports domestic investment and incentivizes companies to invest at home to raise productivity. The market may also buy Japanese assets without FX-hedges in such a scenario.

Otherwise, FX intervention would be the first tool to defend JPY, which is what the government resorted to in 2022. However, if households start to rebalance away from yen deposit to foreign assets, FX intervention may not be enough. Japan's foreign reserves stand at $1.25tn, or 16% of households' cash and deposit balance (Chart of the day).

Ultimately, policymakers may need to conduct a set of policy reforms:

- Fiscal reform to enhance efficiency of fiscal policy and restore fiscal discipline.
- Monetary tightening to attract capital seeking carry.
- Structural reform to increase Japan's growth outlook.
- Capital attraction policy, such as tax benefits for repatriation and inward FDI

However, the pain of JPY's diminishing purchasing power may need to be felt before the public opinion supports policy reform.

This is not our base case, but the lack of substantial rate cuts by the Fed in 2024 could lead to this risk scenario. Even if the Fed's rate cuts proceed in 2024, we may see the same problem in the next cycle. Japan may have to face policy trilemma sooner or later if inflation will remain higher in coming years than before the pandemic.

Notable Rates and FX Research

- **Global Rates, FX & EM Year Ahead 2023 –** Year Ahead 2023: Pivot ≠ Peak, 20 Nov 2022
- Carry resurrection; the reports of its death were greatly exaggerated **Global FX Weekly**, 14 July 2023
- Price is right **Global Rates Weekly**, 14 July 2023
- To carry or not, **Liquid Cross Border Flows**, 10 July 2023

Rates, FX & EM trades for 2023

For a complete list of our open trade recommendations, as well as our trade recommendations closed over the past 12 months, see the reports below:

Global FX weekly: Carry resurrection; the reports of its death were greatly exaggerated 14 July 2023

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