Global Insights

Tokyo Drift: What’s Driving the Yen?

In late April, the Japanese yen hit its lowest level against the US dollar in two decades, a byproduct of the Bank of Japan’s attempt to achieve its 2% inflation target. Haruhiko Kuroda, governor of the Bank of Japan, thinks that a weak yen will have a positive impact on the economy. While we are unconvinced about the impact, so far foreign exchange intervention has not been implemented—meaning that investors may have to live with a weaker yen.

This edition of Global Insights considers the pace of the yen’s decline against the dollar, the possibility of a weaker yen over the longer term and the impact of recent trends on Japan’s economy.
How low can the yen go? The Japanese yen (JPY) recently hit its lowest level against the US dollar (USD) in two decades. In fact, by one measure, the yen is trading at its cheapest level against the dollar since at least 1961 (see Exhibit 10). Interest rate differentials (IRDs)—differences in interest rates between two similar interest-bearing assets in two separate countries—partly explain the yen’s slump (see Exhibit 1). The Bank of Japan (BoJ), worried that higher rates could dim growth prospects, has pledged to maintain an extremely accommodative monetary policy, even in the face of a declining yen. Its stance is at odds with that of other developed economies that have been laser-focused on fighting inflation. In fact, among G-10 central banks, only Japan continues to employ an ultra-accommodative monetary policy. Countries such as Australia, Canada and the UK have rapidly tightened, having delivered 25, 100 and 90 basis points of tightening, respectively, in the past year.

Exhibit 1: Interest Rate Differentials Have Contributed to a Weaker Yen

Still, the BoJ has resisted calls to halt the yen’s slide and is sticking with the contention that low rates should benefit Japan’s economy. Conversely, the Federal Reserve and other central banks continue to tighten policy, fearing that inflation expectations may become unmoored. These policy differences should keep the yen weak against the dollar and other developed market currencies. Indeed, Morgan Stanley & Co.’s foreign exchange strategy team expects the yen to lag G-10 currencies over the next 12 months should policy divergence continue. They expect the yen to trade around current levels through mid-2023.

The yen’s rapid decline has stirred speculation that the BoJ could step in to support it and provide a floor. We think this is unlikely. Although Japan’s $1.3 trillion of reserve assets could support sizable yen purchases (and dollar sales), the BoJ is unlikely to intervene, in part because policymakers have been desperate to fan inflation, which has averaged only 0.7% over the last 40 years. What’s more, the BoJ has not intervened to support its currency in over a decade (see Exhibit 2).

Exhibit 2: Japan Unlikely to Intervene to Support the Yen by Selling US Dollars

Need for speed. The speed of the yen’s decline is a deep worry for many investors. To get a sense of how quickly it has slid against the dollar, we considered the 60-day change in the currency pair. Since 2000, the pace of the recent two-month slide has been matched or exceeded only three times: in 2013, when Prime Minister Shinzo Abe introduced the three arrows (Abenomics) and in 2016 and 2017, when the Fed reversed the policy easing it pursued in the years following the Great Financial Crisis (see Exhibit 3). These occasions all supported swift yen depreciation versus the dollar.

Please refer to important information, disclosures and qualifications at the end of this material.
Stuck in third gear. The widening gap between rates in Japan and other G-10 countries has also guided investors out of yen-denominated assets (see Exhibit 4). The Japanese yen has historically been a popular funding currency, given extremely low borrowing costs in Japan. In fact, foreign investment in Japanese stocks has fallen from last year’s high, which was the highest level since 2014. This has been driven in part by foreign investors selling Japanese-based assets to fund other investments. Investor positioning suggests this trend is unlikely to abate. Ultimately, as captured by yen net noncommercial futures positions, markets are betting that the yen will remain weak longer term (see Exhibit 9).

Continued monetary accommodation from the BoJ and bearish investor positioning have promoted weakening in the yen past the psychologically significant level of 130 against the dollar. According to Eisuke Sakakibara, Japan’s former vice minister of finance for international affairs, that level is likely to alarm the BoJ. That raises the question, now what? BoJ Governor Kuroda thinks that a weak yen will have a positive impact on the economy. However, we are unsure. As the market awaits clear direction, we are focused on the impact of pandemic-related restrictions, the possibility of weak pricing power hitting company margins and the potential for a decline in international trade.

Tourism in a post-pandemic world. Historically, a weaker yen has boosted international tourism. In fact, when the yen declined 12.9% against the dollar in 2013, foreign visitors increased by 24%. This time, however, it is unlikely that Japan’s economy will see a boost from tourism. An outlier among developed nations, Japan remains closed to international tourists given COVID-19-related concerns. In fact, according to Bloomberg, Japan is missing out on an estimated $37 billion tourist windfall that would have typically resulted from a sharply weaker yen. According to the Organisation for Economic Cooperation and Development, pre-pandemic tourism accounted for 2% of Japan’s total GDP and 9.6% of employment. Japan’s inability to cash in on a weaker yen is a missed opportunity for the still-fragile economy.

While a weaker yen should help Japanese companies, it is not that straightforward. The pull-forward in demand driven by emergence from COVID-related lockdowns helped Japanese companies in early 2021 (see Exhibit 5). In fact, the total export value of electronics from Japan was 10.8 trillion yen in 2021. As goods demand slows and investors shift their spending preferences to services, however, companies will have to increasingly rely on domestic demand to support profits.
Exhibit 5: Japan’s Growth Trajectory Depends on Exports

![Exhibit 5: Japan's Growth Trajectory Depends on Exports](image)

Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of Dec. 31, 2021

In addition to headwinds related to a decline in the demand for goods, we worry that companies will be impeded by their inability to set prices above marginal cost increases. The Bank of Japan’s Corporate Goods Price Index for raw materials has accelerated alongside commodity prices; however, price pressures for intermediate and final goods have lagged (see Exhibit 6). Many investors are deeply concerned that Japanese companies will struggle to pass along higher costs to customers, thereby weighing on profits. In addition, stagnant real wages may hurt the Japanese economy (see Exhibit 8).

Exhibit 6: Japanese Companies Have Thus Far Been Unable to Pass Higher Costs to Customers

![Exhibit 6: Japanese Companies Have Thus Far Been Unable to Pass Higher Costs to Customers](image)

Note: Base year is 2015
Source: Haver, Morgan Stanley Wealth Management Global Investment Office as of March 31, 2022

Investment Implications

A weaker yen might not help Japan’s economy. Although easy monetary policy could reflate the country’s economy, we find little evidence that a weaker yen will have similar benefits. The shift from spending on goods to services and potentially slower global growth could hit Japan’s main export, electronics. While a weaker yen should boost exports, we see evidence that they are starting to roll over as a percent of GDP. We also note that exports as a percent of GDP are only moderately higher than those of the US, at 12%, and well below those of Germany, at 39%. We worry that slower global growth, supply chain challenges and geopolitics will weigh on Japan’s economy in the near term.

Additionally, stagnant real wages will weigh on Japanese consumers and limit the ability of companies to pass on higher costs, which will hurt margins. In anticipation of an economic lull, Morgan Stanley & Co.’s Japan economists have cut their 2022 growth outlook from 2.3%, on a year-over-year basis, to 1.9%, but they expect above-trend growth to continue.
Charts You Can't Miss

**Exhibit 7: It Is Unclear if Yen Weakness Will Boost Corporate Profits**

Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of Dec. 31, 2021

**Exhibit 8: Stagnant Real Wages Could Weigh on Economic Growth**

Source: Haver, Morgan Stanley Wealth Management Global Investment Office as of March 31, 2022

**Exhibit 9: Traders Hold Net Short Positions Against the Yen**

Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of May 6, 2022

**Exhibit 10: Japan Purchasing Power Parity Lowest Observed Since Data Collection Began**

Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of Dec. 31, 2021

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Current Readings From Our Quantitative Framework

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Ongoing Development Spotlight

The Bank of Japan recently prevented Japanese government bond (JGB) rates from rising above 0.25%. The central bank’s intention to maintain extremely accommodative monetary policy has led it to develop and execute yield curve control, or outright purchase of JGBs along the curve. Bond investor bets on Japanese rates rising along with those of other developed markets have not materialized as the BoJ recently pledged to buy an unlimited amount of 10-year bonds at a price corresponding to a yield of 0.25%. With inflation expected to meet its 2% target, the BoJ will most likely maintain its stance as it tries to secure more normalized inflation and set Japan on a higher growth trajectory. — Brad Fulton

Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of May 12, 2022
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Disclosure Section

Index Definitions

CORPORATE GOODS PRICE INDEX BY STAGE OF DEMAND AND USE measures the price developments of goods traded within the corporate sector.

OECD JAPAN PURCHASING POWER PARITY INDEX measures the rates of currency conversion that eliminate the differences in price levels between countries and is given in national currency units per US dollar.

JAPAN REAL EARNINGS INDEX measures earnings adjusted for inflation.

For other index, indicator and survey definitions referenced in this report please visit the following: https://www.morganstanley.com/wealthinvestmentsolutions/wmir-definitions

Glossary

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