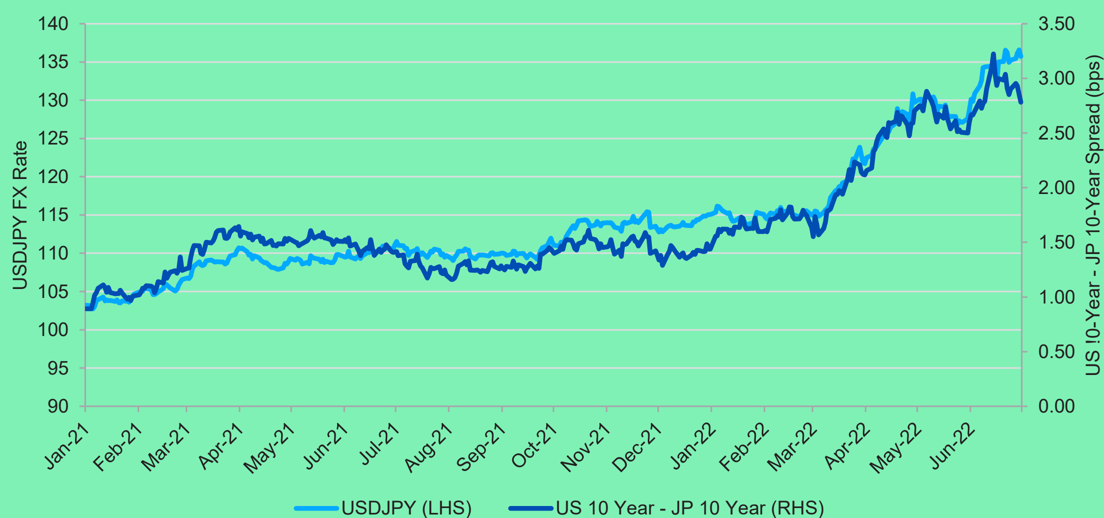
SPOTLIGHT: The Land of the Falling Yen

The first half of the year has not been kind to Japanese currency. This year, the yen has depreciated by roughly 15% against the US dollar, owing – by and large – to the Bank of Japan's (BOJ) dovish monetary policy, which contrasts with other central banks' rate hikes to fight inflation. As global investors scour markets for attractive sources of yield, low nominal returns on Japanese government bonds (JGBs) and the yen have incentivized money managers to aggressively speculate against the currency. With the war in Ukraine and elevated commodity prices hampering economic growth, the devalued value of the yen only adds to the country's economic woes.

Bank of Japan Governor Haruhiko Kuroda faces two equally unattractive prospects. If the BOJ tightens monetary policy to halt the yen's freefall, they likely risk economic contraction as the government and corporations face steeper borrowing costs. On the other hand, if the central bank keeps monetary policies loose to support the export sector, any economic recovery would occur at the cost of domestic consumer purchasing power and the threat of significant capital outflows from local investors. These challenges have caused institutional investors to ask: Where does Japan go from here? And what's the consequence of the yen's collapse on global markets?

Investors have progressively ratcheted up bets against the yen, leaving the currency at its lowest level against the US dollar in several years. But this has not been matched with an increase in long-dated interest rates, as the BOJ still purchases JGBs to maintain its roughly 0% interest rate cap. With other developed market bond yields rising to incorporate higher inflation expectations, widening spreads between US Treasuries and JGBs have exacerbated the yen's decline. Investors looking for safe havens benefit from the higher carry of dollar-based assets compared to the yen and Japanese fixed income.

USDJPY vs. US 10-Year/JP 10-Year Spread



Source: RockCreek, Bloomberg

Ostensibly, a weaker yen should provide a boost to Japanese exporters as their goods become cheaper abroad. But the currency's decline has largely failed to provide the largest manufacturers with sufficient tailwind to stimulate broader economic growth. Japanese exporters rely heavily on commodities as inputs. Almost entirely imported, these commodities have appreciated significantly over the past several months, essentially offsetting any increase in foreign appetite for Japanese goods.

Palladium, a key component in automobile exhaust systems, is largely purchased from Russian mining firms; microchip producers rely on Ukrainian industrial gasses such as neon and xenon, which have risen dramatically in price during the war. Inflationary pressures in other developed markets may also cause foreign consumers to pare back purchases of discretionary goods, reducing demand for Japanese exports, despite their lower price.

Governor Kuroda's recent press conferences have all but confirmed that the BOJ will stay the course, despite a nominal change in tone. In June, Kuroda admitted, "The yen's recent sharp declines are negative for Japan's economy and therefore undesirable, as they make it hard for companies to set business plans." Yet, the BOJ's loose policies have incentivized the government and corporate Japan to issue even more debt, knowing the BOJ will step in and fund the issuance.

The result: the rise of "zombie companies" – firms with no clear plan to achieve sustained profitability that have survived only through issuing new debt, which is immediately purchased by the BOJ. Should Governor Kuroda tighten monetary policy, these zombies will face serious headwinds to meet interest payments at higher and higher rates, likely igniting a wave of corporate defaults on a scale not seen in decades.

The hesitance to raise interest rates and tighten policy in line with other central banks shows that Kuroda is cognizant of this disturbing future; however, many economists believe that this wave of defaults is inevitable – the BOJ is simply kicking the can down the road, and the longer they wait, the worse the fallout will be.

With tightening policy off the table, the BOJ faces the challenge of a weaker domestic consumer. Amid declining real wages owing to below-average wage growth, rising inflation, and a weaker currency, Japanese consumers have rarely felt weaker, less able to purchase foreign goods, and forced to invest their savings abroad to avoid local assets denominated in ever-worthless yen. Japanese savers are all but told to send their money abroad instead of investing in the domestic economy because of the BOJ's accommodative stance.

Should capital flight occur, the Ministry of Finance would likely have to sell FX reserves and/or raise domestic interest rates to prevent total economic collapse, similar to the Bank of England's action during 1992's "Black Wednesday." But in doing so, the BOJ risks eroding the collective buying power by imposing steeper borrowing costs and exhausting their rainy-day fund in the process, a fate Kuroda is looking to avoid but which global investors are deeming more likely than ever.

For decades, the Bank of Japan has shaped the attitudes of global central bankers by being ahead of the curve on policies that would eventually be adopted by their western counterparts, including long-term zero-interest rate policies, active purchases of government bonds, and yield curve control. Yet today, the BOJ is seen as a nostalgic anachronism of a bygone era, clinging to hopes of low inflation and steady economic growth amid the largest inflationary wave in decades. Regardless of the path Kuroda and his colleagues embark upon, if history is any guide, their actions will likely shape the course of global economic development, just like their predecessors before them.