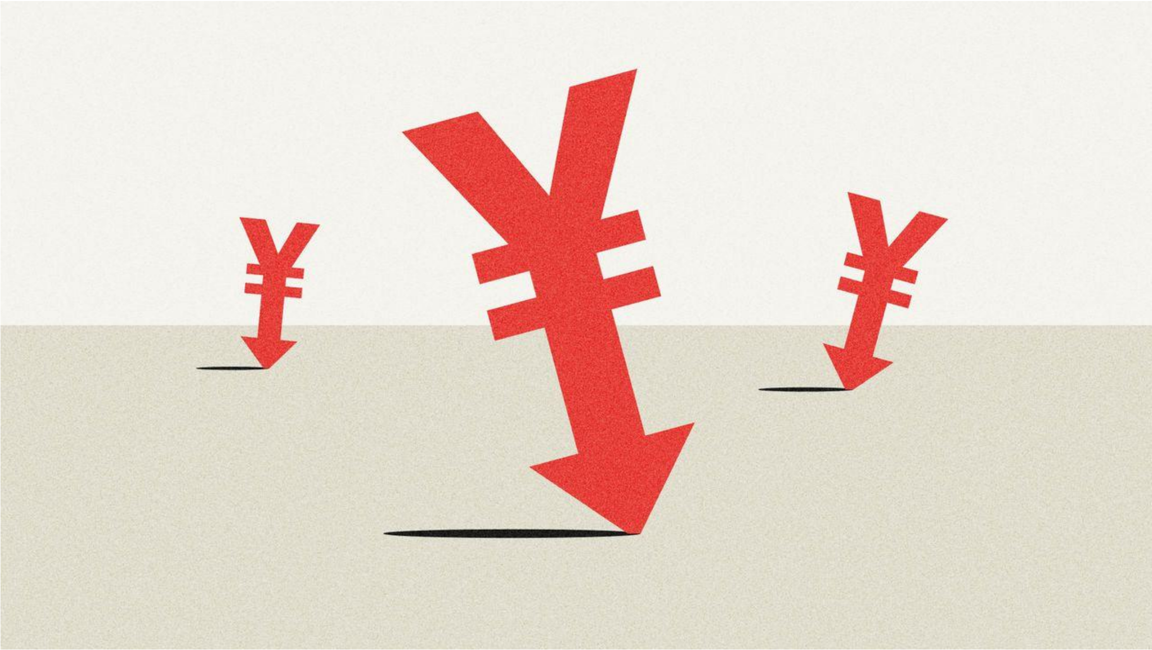
Japan is wrong to try to prop up the yen

Supporting the currency is expensive and futile

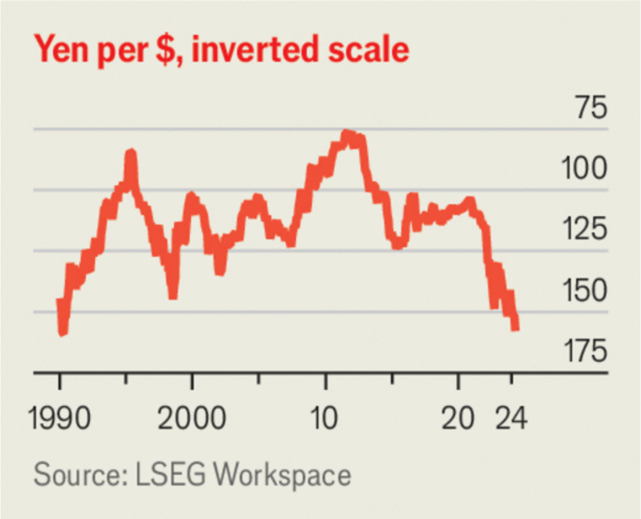


April 30, 2024

It is easy for investors to lose a fortune in the financial markets—and even easier for governments. In 2022 Japan spent more than $60bn of its foreign-exchange reserves defending the yen, its first intervention to strengthen the currency since 1998, after the exchange rate fell to nearly ¥146 to the dollar. And for what? Today the yen is weaker still. Yet instead of learning that fighting the market is futile, policymakers are repeating the mistake. After falling to ¥160 to the dollar on April 29th, its lowest in 34 years, the currency twice moved sharply upwards in the subsequent days. It seems the government is buying again, to the tune of tens of billions of dollars.

The yen has been falling primarily because of simple economic logic. The gap in interest rates between Japan and America is yawning. Although the Bank of Japan raised rates in March, it did so by only a smidgen: they increased from between minus 0.1% and zero to between zero and 0.1%. Rates in booming America, by contrast, are more than five percentage points higher. Investors expect the gap to shrink a little over time, but not by much. As a result a ten-year

Japanese government bond yields just 0.9%, compared with 4.6% for an American Treasury of the same maturity.



The gulf exists because of differences in the outlook for inflation. It is still unclear just how emphatically Japan has broken out of the low-inflation—and at times deflationary—trap in which it has been stuck since asset prices collapsed in the 1990s. Although headline annual inflation has been above the central bank's 2% target for nearly two years, there are signs that price rises have been slowing.

Rightly, rate-setters at the Bank of Japan seem more concerned with hitting their inflation target than with using monetary policy to support the yen. All told, therefore, the country's interest-rate outlook is diverging from America's, where there are growing worries that inflation is not falling as it should and that the Federal Reserve will, as a result, not cut interest rates any time soon.

Given that Japan has an open capital account, an inevitable side-effect of its low relative interest rates is a weak currency. Higher rates abroad make profitable a "carry trade", whereby investors borrow in yen and invest in dollars; that weakens the yen and strengthens the greenback. In theory, the yen must depreciate until its cheapness—and hence the higher likelihood of a rebound in future—means this trade is no longer expected to yield profits. Currencies can overshoot the fundamentals, but it is difficult to tell when they have, and harder still to calibrate an appropriate response. The thresholds at which the Japanese government has chosen to intervene are arbitrary. It says that volatility in the currency has been excessive, but its opaque criteria for selling reserves may well have made that problem worse.

After the last intervention, economic logic was temporarily obscured by good luck. Towards the end of 2022 America's bond yields fell, allowing the yen to strengthen in the months that followed the intervention, before its slide resumed the next year. There is no guarantee that this pattern will be repeated. Instead, resisting the adjustment is likely to create opportunities for speculators, who will gladly treat the government as dumb money. After the apparent interventions, the exchange rate quickly began drifting back towards its previous level.

The Japanese government's urge to intervene is driven by a combination of political calculation and national pride. A cheaper yen makes imports, most notably of energy, more expensive, which is painful for voters. There is no doubting Japan's firepower: at last count it had almost $1.3trn of foreign-exchange reserves to run down. But it is a waste to spend them doing battle with currency traders who—thanks to the choices of Japan's own policymakers not to follow the Fed—have good reasons to be selling yen and buying dollars. ■

The Economist: https://www.economist.com/