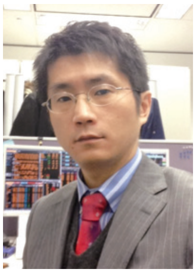
The Medium-Term Outlook for the Dollar/Yen Exchange Rate



Author Kengo Suzuki

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The dollar/yen exchange rate, which fell sharply beginning in 2007, has been rebounding since the end of last year. Currency flows, Japanese domestic factors, and overseas factors all contribute to a weaker yen and are expected to continue doing so to some degree, while on the dollar side the direction of monetary policy against a backdrop of recovering fundamentals contributes to the appreciation of the dollar, and is also expected to continue doing so. As a result, over the next two to three years, we anticipate that the dollar/yen exchange rate will trend gradually in the direction of further dollar appreciation and yen depreciation.

Strong Dollar/Weak Yen Through Mid-2013

Looking back on the dollar/yen exchange rate over the past five or six years, as seen in *Chart 1*, for a few years from 2007, when the yen stood at 124 to the dollar, there was a steady, one-way weakening of the dollar and strengthening of the yen. The rate fell as low as 75 yen to the dollar in 2011, the lowest ever value for the dollar against the yen (or the highest ever value for the yen against the dollar). Subsequently, the rate hovered around 80 yen through the end of 2012 before entering a period of rapid dollar strength and yen weakness that lasted through mid-2013 and briefly brought rates of greater than 100 yen to the dollar.

In thinking about medium-term trends for the dollar/yen rate over the next few years we must look at why the weakening of the dollar and strengthening of the yen that began in 2007 reversed course in 2013, and ask also whether this is a temporary phenomenon or one that will continue over the medium term.

People tend to think about exchange rates as if any given rate moves like a stock price. In fact, exchange rates are quite different from the prices of stocks and bonds. Even when the dollar is being bought, if the yen is being bought even more then the dollar/yen rate will move in the direction of a weaker dollar and stronger yen. It is necessary, therefore, to look separately at dollar trends and yen trends. As *Chart 1* shows, from the end of 2012 through mid-2013 the dollar/yen exchange rate appears to have moved only in the direction of a stronger dollar and weaker yen. In fact, when looking at the dollar and the yen separately, as in *Chart 2*, one can see that dollar appreciation and yen depreciation do not progress consistently: while the Bank of Japan (BOJ) yen index moved sideways after dropping between the end of 2012 and mid-2013, the Federal Reserve Bank (FRB) dollar index began trending upward at the start of 2013 after moving sideways previously. Therefore, when thinking about the dollar/yen exchange rate we must consider the trends and outlook for the yen and the dollar separately and only then in relation to one other.

First, on the yen side, let us look at why the trend toward yen appreciation reversed itself at the end of 2012, the context for this change, and the medium-term outlook. We can point to three factors that led to selling of the yen, which until then had been bought, at the end of 2012: 1) capital flows, 2) domestic factors, and 3) overseas factors.

Yen Side

1) Capital Flows

Ever since the adoption of a floating exchange rate in the 1970s, the dollar/yen exchange rate has followed a long-term trend toward yen appreciation. One background reason for this is constant trade surpluses. In the past, Japan grew by exporting automobiles and household appliances to the world. The result was a positive balance of trade that supported a stronger yen through capital flows. As shown in *Chart 3*, however, this picture has changed in recent years. After 31 years of trade surpluses through 2010, the trade balance turned negative in 2011. Japan's largest ever trade deficit was recorded in 2012 and it has been growing at pace to set a new record in 2013, greatly influencing the dollar/yen exchange rate.

CHART 1

Dollar/Yen chart

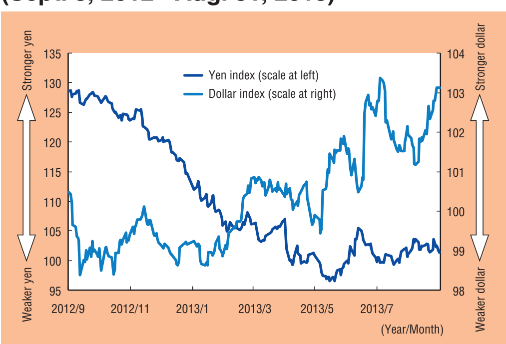
(June 1, 2006 - Sept. 10, 2013)

Source: Mizuho Securities (based on various data)

CHART 2

Yen index & dollar index

(Sept. 3, 2012 - Aug. 31, 2013)

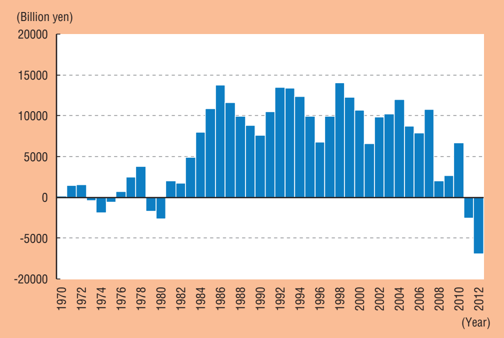


Source: Mizuho Securities (based on materials from BOJ and FRB)

Among direct causes, we can note the increase in fossil fuel imports that resulted from the nuclear power plant shutdowns in the wake of the Great East Japan Earthquake on March 11, 2011. Nevertheless, the trade deficit for 2012 reached 7 trillion yen, greatly exceeding the 3 trillion yen attributable to the effect of the nuclear plant shutdowns. There must also be other factors, perhaps including structural changes in the Japanese economy: the effect of Japan's manufacturing industry moving overseas in the context of a much stronger yen,

CHART 3

Japan's customs-cleared trade balance (Calendar years 1970-2012)



Source: Mizuho Securities (based on materials from Ministry of Finance)

TABLE

Mundell-Fleming model for open economies

	Exchange rate regime	
	Fixed rate	**Floating rate**
Financial policy	Effective	Ineffective
Monetary policy	Ineffective	Effective

Source: Mizuho Securities

stagnant domestic demand, and the cheap labor and growth potential offered by emerging nations. When accompanying such structural changes, there is a high likelihood that trade deficits will settle in for the long term. Furthermore, given issues with contaminated water in Fukushima and the difficulties surrounding the investigation of active faults beneath nuclear power plants, any large-scale restarting of nuclear power plants in the next few years seems unlikely. As a result, we believe trade deficits will continue for at least the next few years with capital flows providing support for a weaker yen.

2) Domestic Factors

Abenomics

On Nov. 14, 2012, then Prime Minister Yoshihiko Noda announced the dissolution of the House of Representatives. In a speech the following day, the president of the Liberal Democratic Party, Shinzo Abe (now the prime minister and then considered the most rightwing of those contending to take Noda's place), identified the biggest problems facing the economy as "deflation and yen appreciation". After retaking political power, Abe indicated his intention to make a strong push to move forward with bold policies of "unprecedented dimension" in order to shake off the long-term economic stagnation of the "two lost decades". He defined the core of his "Abenomics" program as the "three arrows" of a bold monetary policy, a flexible fiscal policy, and a growth strategy to promote private investment. Markets reacted positively, moving in the direction of buying Japanese stocks and selling the yen, sparking the dramatic weakening of the yen that continued, as noted above, through mid-2013.

With regard to inducing a weaker yen as a matter of policy, the Feb. 12, 2013 statement by the G7 nations would later incorporate wording reaffirming its members "commitment to market-determined exchange rates" and their commitment not to "target exchange rates" in their policies. As one of the G7 nations, Japan of course confirmed that it was not making a weaker yen a policy objective, and announced that the weaker yen was the result of easing policies and other measures designed to overcome deflation. Nevertheless, the markets remember the basic stance taken with the adoption of Abenomics and have tended to react by selling the yen when Abenomics moves forward and buying the yen when it takes a step back.

The ruling coalition of the LDP and the New Komeito party followed their victory in the House of Representatives at the end of 2012 with another in the House of Counselors election in July 2013, putting an end to the divided Diet. With no national elections scheduled until 2016, the environment is ripe for the Abe administration to continue pushing Abenomics. We believe this will be a yen-weakening factor over the next few years.

BOJ Monetary Policy

Under the first arrow of Abenomics — a bold monetary policy — Haruhiko Kuroda, a strong proponent of monetary easing, took office as governor of the BOJ on March 18 this year. On April 4, the first Monetary Policy Meeting held under Kuroda introduced quantitative and qualitative monetary easing (QQE) as part of "a new phase of monetary easing both in terms of quantity and quality" while also revealing a target of a 2% rise in consumer prices within two years.

With respect to additional easing, Kuroda has said that if the consumption tax hike scheduled for April 2014 led to an increased risk of economic slowdown then "our monetary policy will be adjusted" and he "would not hesitate" (Aug. 21, *Mainichi Shimbun*).

In Kuroda's statements and past writings one can see glimpses of a monetary policy grounded in the Mundell-Fleming Model, which describes monetary policy as a more effective economic stimulus than fiscal policy in an open economy with a floating exchange rate (free capital movement). Fiscal policy in such an environment brings rising interest rates as well as rising demand, leading to an expansion of imports and upward pressure on the home currency that worsens the trade balance; the shift of demand overseas makes the economic stimulus ineffective. Monetary policy, on the other hand, stimulates demand by depressing interest rates while at the same time applying downward pressure on the home currency. This results in an improved trade balance and substantial economic stimulus effects.

Given that the BOJ has indicated a medium-term inflation target for two years hence, and the strong likelihood that it will engage in an aggressive monetary policy grounded in the Mundell-Fleming Model *(Table)*, we believe the direction of BOJ monetary policy is very likely to lead to increased pressure for yen depreciation in foreign exchange markets over the medium term.

3) Overseas Factors

The third set of factors to consider is overseas factors. As already mentioned, the dollar/yen exchange rate moved in the direction of steep yen appreciation beginning in 2007, yet we can find no reasons on the Japan side for such a dramatic rise during this period. The major events that occurred during this time were global economic crises: the subprime mortgage crisis in the United States in 2007, the collapse of Lehman Brothers in 2008, and the Eurozone debt crisis in Greece and elsewhere beginning in 2009. The trend of yen appreciation grew stronger in tandem with these economic crises.

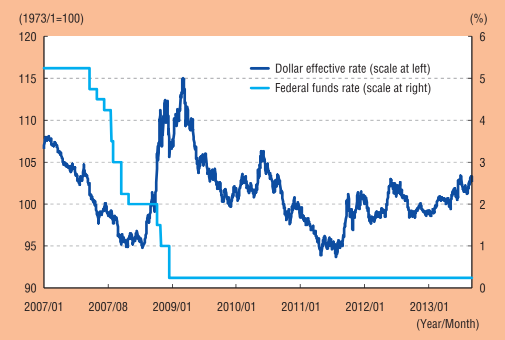
Why did financial instability originating overseas lead to a stronger yen? We believe there are two reasons.

The first is yen buying by Japanese for purposes of repatriation. Japan boasts the highest net foreign assets in the world, accumulated during the long period of trade surpluses dating back to the postwar expansion. In situations when the economic environment becomes especially cloudy, efforts to bring overseas assets home to keep them close at hand are likely to become more active. The same sort of yen buying was observed in the wake of 3.11.

The second reason is the buying of the yen by process of elimination. According to a 2010 survey by the Bank for International Settlements (BIS), the four top currencies (dollar, euro, yen, pound) make up nearly 80% of a day's trading in foreign exchange markets. As the effects of the subprime mortgage crisis and Lehman Shock in the US, and the Eurozone debt crisis in Europe, grew more serious it was only natural that the yen would surface through a process of elimination as a haven for funds. The result was a great deal of yen buying during these global crises.

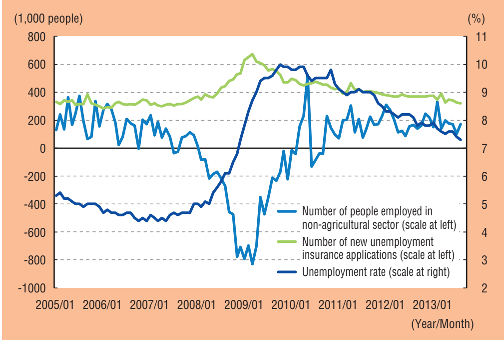
But the global economic environment has changed. A speedy and flexible response by the FRB and other authorities has begun to bring the US economy

CHART 4
Dollar effective rate & federal funds rate (January 2007 - August 2013)



Source: Mizuho Securities (based on Bloomberg data)

CHART 5
US employment-related indices (January 2005 - August 2013)



Source: Mizuho Securities (based on Bloomberg data)

out of crisis. Various economic indicators have improved, providing the context for the FRB to begin to taper its quantitative easing policy (QE3). The debt crisis in Europe is still with us but the situation has improved dramatically. In 2011, news coverage debated in all seriousness what form the Eurozone collapse would take, but one no longer hears such talk. A smoldering insecurity lingers, but the individual members of the Eurozone, together with the European Central Bank (ECB), have for now succeeded in averting a further crisis. It seems very likely that this has substantially relieved the pressure toward yen appreciation through the process of elimination. On the other hand, if there are clearer signs of economic recovery in the US, or of recovery from the debt crisis in Europe, we believe the resulting unwinding of yen repatriation by Japanese and of yen purchases through the process of elimination is likely to serve to weaken the yen.

US Side

Looking at past movements on the US side, the sudden collapse of Lehman Brothers came just a year after the subprime mortgage crisis, rapidly cooling the economy and increasing the sense of financial crisis. Looking at dollar fluctuations in *Chart 4*, it rose rapidly during the six months following the Lehman Shock, but this is believed to be the result of repatriation by Americans, in the same way that Japanese bought yen immediately following 3.11. With the exception of this six-month period, however, the dollar trended generally downward heading into 2012. In addition to worsening fundamentals in the US, the FRB's drastic lowering of interest rates and implementation of quantitative easing, and President Barack Obama's plan to double exports (his strategy to create two million jobs by doubling exports over five years beginning in 2010 was understood by foreign exchange markets as *de facto* approval of a weaker dollar), the policies of government and financial authorities provided support for dollar depreciation.

Since late 2011, however, the brakes began to be applied to the drop in the dollar. Initially this seemed like a rebound in response to the dollar's decline up to that point but particularly from the start of 2013 there began to appear a gentle but steady and appreciable rise in the dollar. There are surely a number of background reasons for this but we believe the largest factor is improved fundamentals signaling the recovery of the US economy.

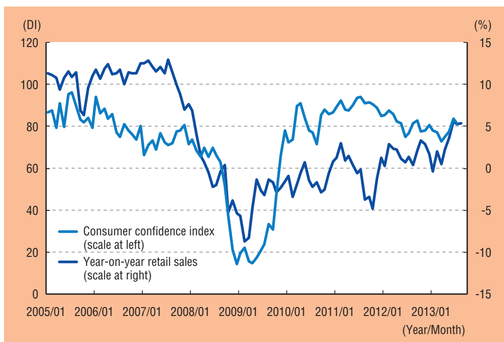
1) Fundamentals

Let's take a look at a number of trends in the fundamentals. Turning first to employment, which the FRB prioritizes most highly, factors such as the increase in the number of people employed in the non-agricultural sector and the level of new unemployment insurance applications improved markedly between 2008 and 2010, nearly returning to the pre-Lehman Shock levels of 2006 and 2007. Meanwhile, the unemployment rate has continued to fall even if not to pre-Lehman Shock levels. There remain causes for concern such as the drop in the labor force participation rate, but overall there is a clear trend toward improvement.

Looking at retail sales and the consumer confidence index as indicators of consumer trends, we can see that retail sales have held steady at a high level after their dramatic recovery heading into 2011 while consumer sentiment has continued to climb gradually *(Chart 6)*.

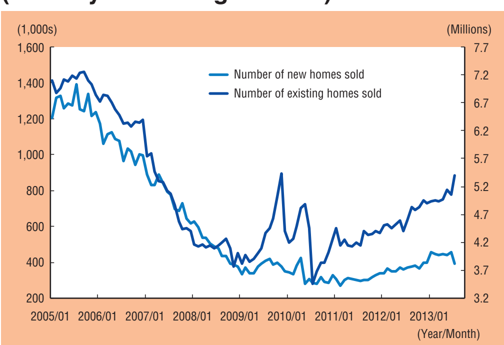
With respect to housing-related indicators, while sales of new and existing homes have not returned to the levels seen during the housing bubble of 2005–

CHART 6
US retail sales & consumer sentiment (January 2005 - August 2013)



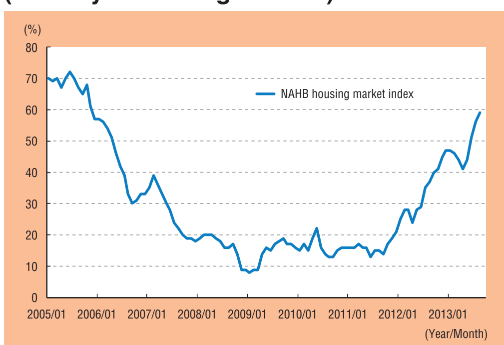
Source: Mizuho Securities (based on Bloomberg data)

CHART 7-1
Housing-related indices (January 2005 - August 2013)



Source: Mizuho Securities (based on Bloomberg data)

CHART 7-2
NAHB housing market index (January 2005 - August 2013)



Source: Mizuho Securities (based on Bloomberg data)

2007, a recovery trend is clearly emerging and there has also been major improvement in the NAHB Housing Market Index, which measures sentiment of home builders *(Charts 7-1 & 7-2)*.

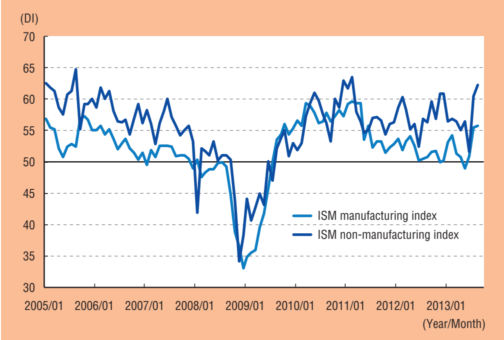
The ISM Manufacturing Index and ISM Non-Manufacturing Index, which indicate corporate sentiment, while retreating somewhat in 2012 after their rapid rise from 2010 to 2011, has clearly begun to rise again in the most recent period leading into 2013 and continues overall to exceed a score of 50, considered the dividing line for determining whether the results are positive or negative *(Chart 8)*.

In general, we can see the beginnings of a virtuous cycle in which improved corporate sentiment brings about a recovery in employment, which leads to consumption and a more robust housing market, which then further improves corporate sentiment.

Looking at other factors, GDP has largely recovered from its decline leading up until 2009. The Dow reached new highs in 2013 and real interest rates, which had been depressed, have also begun to rise *(Chart 9)*. Meanwhile, there has been steady progress in restoring personal balance sheets with the mortgage delinquency rate clearly trending downward and household net worth on the rise *(Chart 10)*.

CHART 8

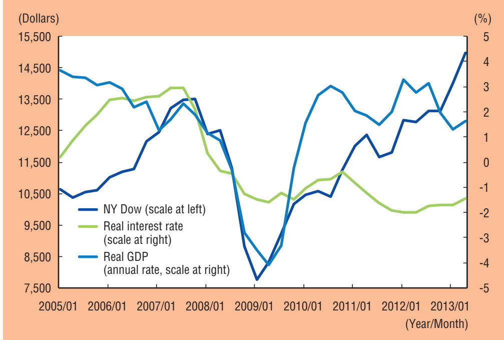
Corporate sentiment (January 2005 - August 2013)



Source: Mizuho Securities (based on Bloomberg data)

CHART 9

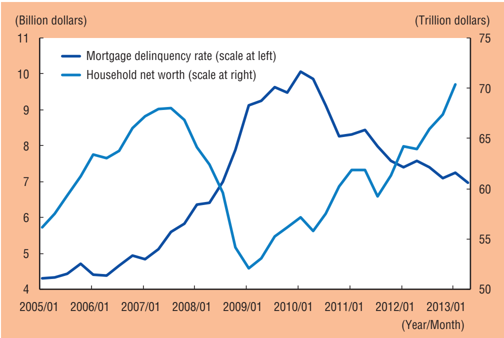
US real GDP, real interest rate, & NY Dow (March 2005 - June 2013, quarterly)



Note: Real interest rate = FF target rate - core CPI year-on-year.
Source: Mizuho Securities (based on Bloomberg data)

CHART 10

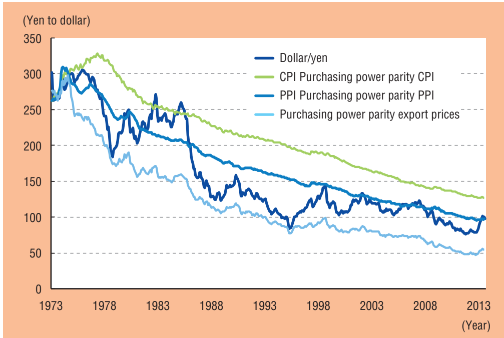
Mortgage delinquency rate & household savings



Source: Mizuho Securities (based on Bloomberg data)

CHART 11

Dollar/yen & purchasing power parity (1973 basis)



Source: Mizuho Securities (based on various data)

Mizuho Securities Research and Consulting forecasts that the US economy will generally continue to expand at a gradual pace with real GDP reaching an annual growth rate in the upper +2% range by late 2014. (The October–December 2012 quarter was +0.1% year-on-year, while the January–March 2013 quarter was +1.1%.) This improvement in US fundamentals over the medium term is likely to continue to support a gradual appreciation of the dollar in foreign exchange markets.

2) Monetary Policy

The improvement in US fundamentals is also beginning to bring a change in FRB monetary policy. A policy of easing has been in place continually since 2007 as an economic stimulus, but in testimony before Congress on May 22, 2013 FRB Chairman Ben Bernanke alluded to the possibility of tapering the policy of quantitative easing. We also know that the Federal Open Market Committee (FOMC), in its meeting on July 30–31, reached a general consensus on tapering within the year.

Adopted in September 2009, the open-ended third round of quantitative easing is unlike QE1 and QE2 with their pre-determined terms. For QE3 to finally begin to taper means we are getting closer to a situation in which economic stimulus through irregular monetary easing is no longer needed — that is, the economic recovery is beginning to hit its stride.

The FRB has indicated (as of August 2013) a strong likelihood that it will begin to taper quantitative easing in the second half of 2013, end quantitative easing in mid-2014, and raise the federal funds rate in 2105. Looking ahead through 2015, this stance by the FRB is likely to be a factor supporting dollar appreciation.

Dollar/Yen Outlook

I have discussed the context for the shift in the dollar/yen exchange rate toward dollar appreciation and yen depreciation and commented on the influence this will have on the exchange rate over the next few years. Generally speaking, we see a picture of a US that is one step ahead in riding the wave of economic recovery and a Japan that is seeking to overcome the two lost decades, and over the next few years believe we will continue to see clear disparities in the fundamentals and differences in the direction of monetary policy. We are of course aware of the risks of a worsening debt problem or a cyclical decline in the growth rate in the US, but believe the picture presented here to be unlikely to change in the medium term. As a result, we believe the most likely scenario is that the dollar/yen exchange rate will continue to move gradually in the direction of dollar appreciation and yen depreciation. Based on the real effective exchange rate and purchasing power parity *(Chart 11)*, at the high end we estimate the exchange rate will reach roughly 110–117 yen to the dollar at some point around 2015 or 2016. JS

Kengo Suzuki is chief forex strategist at Mizuho Securities Co. and was formerly seconded to the Industrial Bank of Japan (now Mizuho Bank). He has extensive experience of foreign exchange-related operations, including dealing, currency transfers, and foreign capital financing.