Strong depreciation of the yen: are expectations of monetary easing exaggerated?

The yen has depreciated sharply in recent months. It is mainly the latest actions by the Bank of Japan (BoJ), and further actions that are anticipated, that have been weighing heavily on the currency. The return to power of the Liberal Democrats has increased expectations vis-a-vis the BoJ. During the election campaign, they proposed that the BoJ should raise its inflation target and significantly expand its easing measures.

The central bank has met these expectations in part by raising its inflation target to 2% and expanding its asset purchases. By the end of 2013, the BoJ will purchase ¥10,000B (US$110B) worth of assets over and above what was originally planned. After that, an open-ended asset purchase program will take over in 2014. The amounts planned for 2014 seem small at this point. The balance sheet will expand by a mere ¥10,000B over the entire year. This is a rather slim increase compared with the ¥36,000B (US$395B) that are currently planned for 2013. Therefore, other measures are expected.

However, it might be difficult for the BoJ to do much more. Its balance sheet is already quite large. Since 2008, we have had the impression that the BoJ was being fairly timid compared to the other central banks. But we are forgetting that a few years earlier, it intervened on a massive scale to fight deflation and propel the economy forward. If we look at the changes in the balance sheets of the BoJ and the Federal Reserve, adjusted to GDP, since the start of the 1990s, we find that the degrees of monetary easing are similar.

Moreover, the depreciation of the yen should put upwards pressure on consumer prices in the next few quarters, since imports will become more expensive. The doubling of the sales tax, spread through 2014 and 2015, will also stoke inflation, albeit artificially. In the end, the 2% target could be reached more easily, which would tie the BoJ’s hands for future actions.

Implications: If the BoJ disappoints expectations, sentiment about the yen could change. A correction could occur and drive the exchange rate back below ¥90/US$. On this point, we should quickly find out how things stand once the BoJ’s new governor takes office in April, which might, or might not, give a boost to the monetary policy.

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