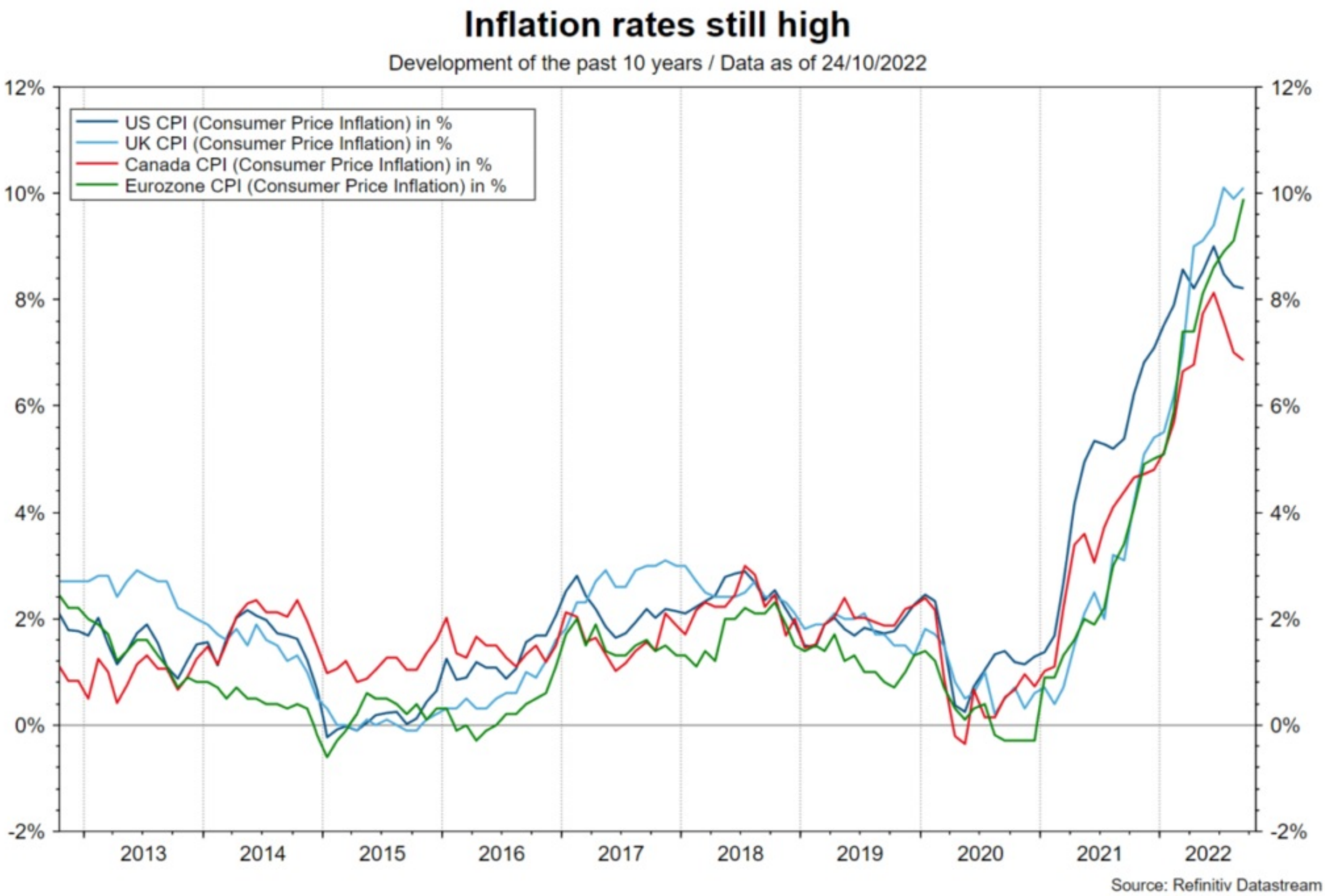
Strong US dollar increases pressure on Japan’s central bank

Gerhard Winzer

The basic formula of “high inflation plus restrictive monetary policies plus deterioration in the financial environment plus uncertainty about further liquidity crises such as in the UK equals global recession risks” still applies. In addition, the so-called exchange rate regime trilemma is receiving increasing attention due to the strong US dollar.

High inflation

The inflation rates published for September are still high or higher than expected. This is true for the US (Sep, 0.4% m/m / 8.2% y/y), the UK (0.5% m/m / 10.1% y/y), Canada (0.1% m/m / 6.9% y/y) and the Eurozone (1.2% m/m / 9.9% y/y). Although there is evidence of easing inflationary pressures – falling energy prices, falling goods price inflation, falling delivery times, little evidence of a wage-price spiral – the risk of inflation persistence anchoring at a high level remains high. Central banks argue that the costs of persistently high inflation are greater than the costs of recession. They show a strong commitment to maintain the basic monetary policy stance hawkish (rapid and synchronous policy rate hikes) and restrictive (dampening the economy) until inflation rates have convincingly embarked on a downward trend.



Source: Refinitiv Datastream, Data as of October 24, 2022

Note: Past performance is not a reliable indicator for future performance.

Key interest rate hikes

This week, the central bank in Canada (BoC) is expected to raise its key interest rate by 0.5 percentage points to 3.75% and the central bank in the euro zone (ECB) is expected to raise all three key interest rates by 0.75 percentage points each (deposit facility: from 0.75% to 1.5%). In the following week, key interest rate hikes are also expected for the US central bank (Fed – upper band: from 3.25% to 4%) as well as for the central bank in the UK (BoE: from 2.25% to 3%).

Tightening of the financial environment

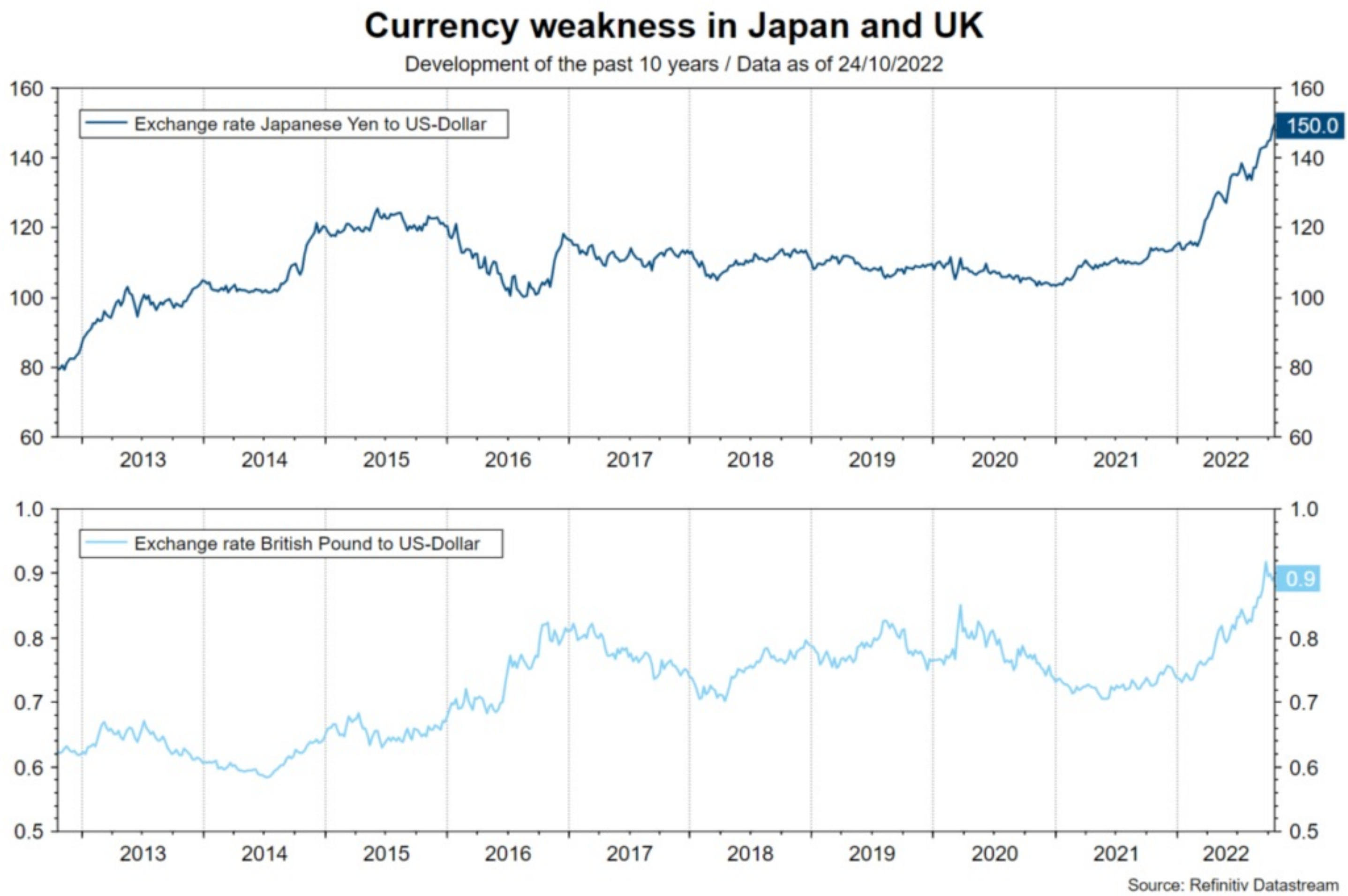
Tight monetary policies are creating a tightening financial environment. Last week, yields on credit-sensitive government bonds rose further. This reduces the present value of future cash flows, and the prices of numerous asset classes are under pressure. In other words, the cost of capital is rising. In addition, uncertainty remains as to whether a liquidity crisis could break out elsewhere as in the UK.

Strong US dollar

In addition, the strong US dollar causes problems. It makes it difficult to service debt in dollars, increases inflation in countries with a weak currency (higher energy prices), reduces the attractiveness of countries for capital investment (a problem for countries with a high current account deficit) and is generally detrimental to planning (similar to high inflation).

Yen Intervention

In the developed economies, the problem of currency weakness is virulent in two countries in particular. In the United Kingdom, with an estimated current account deficit of just under 5% of nominal GDP, the British pound is under pressure. In Japan, the Japanese yen has weakened sharply because, unlike the other central banks, the Bank of Japan is sticking to its ultra-loose monetary policy. After the yen climbed to over 150 per US dollar last Friday, the second currency intervention in a month took place, according to media reports.



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Trilemma of the Exchange Rate Regime

As a result of the high inflation rates, the famous trilemma of the exchange rate regime has also come to the fore. The three exchange rate policy objectives of exchange rate stability, monetary policy autonomy and free capital movements cannot be achieved simultaneously. Only two of the three objectives at a time. Because exchange rate stability is no longer a given for an increasing number of countries, they are faced with the choice of either raising key interest rates significantly or intervening in the currency market. Unilateral currency interventions aimed at preventing currency weakness are often unsustainable from a historical perspective. One possibility is concerted currency intervention to the detriment of the US dollar. However, this is not particularly likely.

The “only” thing left to do is to address the underlying problem. In the case of the UK, this involves putting fiscal policy on a credible footing. For Japan, the probability of abandoning ultra-loose monetary policy has increased significantly. Among other things, this means that the Bank of Japan could take the upper band (currently: 0.25%) for the ten-year government bond yield upward. The Bank of Japan’s meeting next Friday will thus be followed with greater interest than usual.

Inflation trend is decisive

Inflation remains the most important factor influencing the markets. Only increasing signs of easing inflationary pressure would enable central banks (the Fed) to reduce the pace of interest rate hikes or even pause. This would be positive for numerous asset classes and negative for the US dollar.

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