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DEutsche JApan View on FX

Special Report

Secrets of the Yen (8): Yen rises with Japan or US QE

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Quantitative easing (QE) tends to produce yen appreciation, whether it is conducted in Japan or in the US, or in both countries.

In the previous issue, we highlighted the coincidental cyclical pattern of the Bank of Japan's (BoJ's) monetary easing bringing yen appreciation and its monetary tightening leading to yen depreciation. This theory also basically holds when QE is conducted or expanded. Figure 1 plots monetary bases supplied by the Japanese and US central banks against the dollar/yen rate. It shows a historically close correlation between the two data sets. A typical and straightforward explanation holds that relatively large money supply promotes currency depreciation via lower interest rates if the environment is not inflationary, and by adding to inflation if conditions are inflationary.

Although Japan conducted QE and substantially expanded its monetary base between 2001 and 2004, the yen still appreciated over this period. Since the end of 2008, the US-Japan relationship has been dominated by growth in the US monetary base, even as all G4 members (US, EU, UK, Japan) adopted an ultra-monetary easing mode. This has led to depreciation of the dollar and appreciation of the yen, which is the other half of the currency pairing.

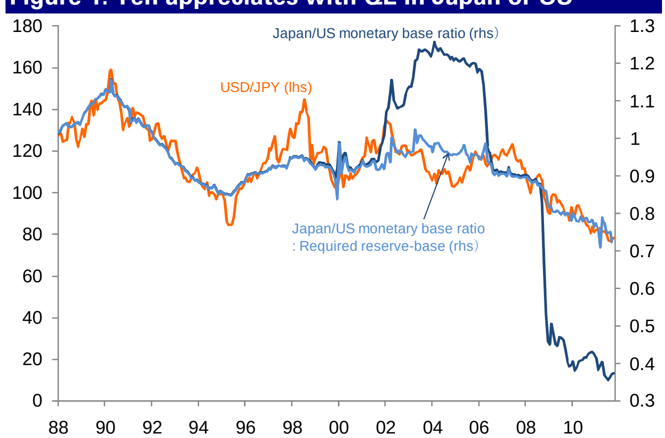
When QE is implemented or expanded, we think the scale of the action is a measure not so much of the degree of monetary easing as of the extent of financial paralysis. The impact of monetary easing can be understood as the extent to which people make use of the ready availability of a large volume of low-cost money. QE has been implemented in abnormal conditions when balance sheet adjustments have stalled, policy rates have been lowered to zero, and money is not circulating. In this sense, we can interpret the US's QE2 of only $600bn, compared with the conjectured $1.5trn, as the result of the initial action coming fairly close to delivering the impact of monetary easing.

Let's return to Japan between 2001 and 2004. At the time, conditions in Japan were close to a liquidity trap in a deflationary environment, pressuring the BoJ to conduct QE. As Japan is a creditor nation, reduced risk tolerance and strengthened investors' "home bias" resulted in yen appreciation. No matter how much monetary easing the BoJ conducts, yen appreciation does not lead to growth in yen borrowing overseas. Japan's QE thus did not deliver a monetary easing impact, and the vicious cycle of yen appreciation and deflationary effects persisted.

In contrast, when conditions in the US left its authorities no option but to conduct QE, the dollar depreciated as the inflow of funds into this debtor nation stalled. As a key currency, the dollar is in wide use globally. Even if financial paralysis continues in the US, high-growth nations such as emerging economies move to make increasing use of readily available dollar funds. This sentiment favoring a weaker dollar is reinforced by carry trades. If QE in the US leads to dollar depreciation, monetary conditions in the nation will ease even after interest rates are lowered as far as possible, and a reflex impact overseas benefits US exports as well. The US authorities appear to want to break free of balance sheet adjustments in 3-5 years, compared with the more than 15 years taken in Japan.

Whether the tool is QE, interest rate cuts or self-sustaining improvements in the markets, the impact of monetary easing should be reflected in increased lending, deposit growth, and growth in cash in circulation. We thus think that much of the trend in the dollar/yen rate in Figure 1 can be explained not by headline monetary base ratio, but by required reserves-base monetary base ratio between Japan and the US. Conventional monetary easing in the US appears to have had a greater impact than QE in Japan from 2001-2004, tilting the monetary base (reserves basis) toward a stronger yen. Supported by dollar deprecation, QE in the US in recent years has led to an enhanced monetary easing impact, and on a reserves basis has tilted the exchange rate toward dollar depreciation/yen appreciation. In conclusion, we think QE tends to favor yen appreciation, whether it is conducted in the US or in Japan, or in both.

Figure 1: Yen appreciates with QE in Japan or US



Source: Deutsche Securities, BoJ, FRB, Bloomberg Finance L.P.

Appendix 1

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