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Prime Minister Sanae Takaichi is unlikely to support austerity measures. RODRIGO REYES MARIN/ EPA/ SHUTTERSTOCK

Only Bank of Japan Can Arrest Yen's Fall

Higher interest rates are needed to address a growing yield gap with the U. S.

Japanese authorities have found themselves having to step into markets again and again to prop up the yen, this time with assistance from the U.S. government. To escape this "mowing the lawn" dilemma, the country, and specifically the Bank of Japan, has to address the root causes of yen weakness.

Viewed through one lens, the yen appears undervalued. Ask anyone who has traveled to Japan recently and they will rave about the bargains to be had. That is a stark shift from the era of yen overvaluation 15 years ago, when a dollar was worth about 80 yen and a trip to the country was a painful expense. Note

So why the continued yen selling pressure when a dollar buys twice as much of the Japanese currency? The answer appears to be a combination of fiscal and monetary concerns.

On the former, Prime Minister Sanae Takaichi isn't likely to change course. Like former Prime Minister Shinzo Abe, she is convinced of the need for stimulus to keep growth going and pull Japan further out of its long deflationary spiral.

So Takaichi is unlikely to support any kind of austerity to shore up the yen. Indeed, she has just announced a plan to sharply cut consumption taxes on food items. If the lady's not for turning, that leaves the Bank of Japan. Note

The yen's recent slide has largely tracked a widening gap between monetary-policy expectations in the U.S. and Japan. While the market now believes the Federal Reserve is likely to raise rates in the near future, it sees the Bank of Japan moving more cautiously.

That would be an easy perception for the BOJ to change by raising rates at its next policy meeting in September, after an earlier hike in June.

When the Iran war began in late February, markets started pricing in a higher likelihood of rate in--creases by the Fed but less so for the BOJ. The U.S. 2-year Treasury yield, for instance, has risen from 3.39% at the end of February to around 4.25% recently.

The upward move in the yield on 2-year Japanese government bonds has been milder. The result is that the yield gap between Treasurys and Japanese debt has widened to about 2.8 percentage points last week from around 2.15 before the war.

Note

Over that same period, the yen depreciated nearly 5% against the dollar. This suggests that BOJ tightening will be crucial to arresting the fall.

Note

True, inflation hardly looks out of control in Japan; the headline consumer-price index rose 1.7% in June from a year earlier. But the BOJ itself expects that number to climb because of higher oil prices.

In a statement after its last meeting—in which it kept the policy rate unchanged at 1%—the BOJ said inflation is likely to accelerate above its 2% target in the second half of the year.

Note

The weak yen exacerbates this impact by increasing the cost of imported energy. That should provide all the justification needed to start raising rates in September.

Note

Some argue the Bank of Japan is hesitating because it fears higher rates on Japanese government debt would further undermine the country's finances. At roughly 200% of gross domestic product, Japan's debt is famously high.

Note

But the truth is that Japan's underlying fiscal position is stronger than many appreciate. Including the government's huge stock of financial assets, the net debt to gross-domestic-product ratio is about half that, and analysts at Capital Economics see it falling to 80% by 2028.

Note

Moreover, for anyone who is concerned about Japan's fiscal sustainability, a collapse of market confidence in the yen should be the last thing they want to see. Even the growth-obsessed prime minister, who was said in the past to be pressuring the BOJ to keep policy loose, should now see that reinforcing the yen has become paramount to shoring up the country's wider growth story.

Luckily, there is a clear course of action the BOJ can take. This becomes even more obvious if the Fed moves in mid-September—which most market participants currently expect. In that case, the BOJ would have little choice but to follow suit when its own meeting takes place a few days later.

—Aaron Back

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Why Bessent Leans on Fed to Help Japan

BY NICK TIMIRAOS

Note

A little-used Federal Reserve backstop built for the 2020 dollar shortage is being put to a use it was never designed for: bankrolling Japan's defense of the yen. Treasury Secretary Scott Bessent wants the backstop made bigger.

Japan said Monday it planned to draw on the facility, a day after Bessent publicly encouraged the Fed to expand it. The arrangement would let Tokyo raise dollars to halt the yen's slide without selling the U.S. government debt that would otherwise pay for it.

At issue is a lending program created when the Treasury market faced severe strains at the onset of the Covid pandemic. Banks and companies outside the U.S. that had borrowed heavily in dollars found that funding drying up and turned to their own central banks for help. Those without access to the Fed's dollar-lending network for close allies had one obvious source: selling Treasurys into a market that was already struggling to absorb them. The Fed facility let them borrow dollars against those holdings instead.

Note language

Japanese officials have indicated they will use the program to raise the dollars they sell for yen without liquidating the Treasury portfolio that would otherwise pay for the intervention.

Bessent said the Fed could help by raising the $60 billion limit on how much any one counterparty can borrow. "We would encourage it to be upsized in the coming months," Bessent wrote in a social-media post.

Japan held roughly $1.1 trillion in Treasurys at the end of May, so the cap, not the size of its portfolio, is what currently limits how much it can raise this way. Lifting it would let Tokyo turn more of its holdings into dollars quickly, and without selling them.

Bessent's request represents an early test of how Fed Chairman Kevin Warsh intends to draw the line between the central bank and the administration that installed him. Raising the cap is subject to approval by at least a subset of the Federal Open Market Committee, the 12-person body that sets interest rates and oversees monetary policy. A Fed spokesman declined to comment.

The committee typically engages such tools if a clear market- functioning or financialstability risk threatens to --impair monetary policy, a bar that current conditions don't appear to meet.

Note

The ask can be read two ways. As a signal to markets that Tokyo's limited tools are less limited than they look, it is shrewd posturing at no cost. As pressure on the central bank, it invites scrutiny of where Treasury's authority ends and the Fed's begins—a boundary made more delicate by the change in Fed leadership. Bessent, who speaks regularly with Warsh, made the request publicly Sunday on X.

"There are a few things that are odd about it," said Derek Tang, an economist at Monetary Policy Analytics, a Washington-based consulting firm. "One, that it's being done in public," which could be "a way to exert pressure on the rest of the FOMC."

Bessent can raise dollars on his own, by issuing Treasury bills and routing the proceeds through the roughly $200 billion Exchange Stabilization Fund. But a defense funded that way is more visible and finite in a way that a Fed backstop isn't.

"If Bessent doesn't have the Fed on board, then his rhetorical power—the credibility of this threat—is lessened," Tang said.

It comes days after Friday's joint action, the first time since 1998 that the U.S. bought yen alongside Tokyo to strengthen the currency. Bessent's Japanese counterpart, Satsuki Katayama, said Monday that Tokyo planned to use the Fed's Foreign and International Monetary Authorities Repo Facility, or FIMA, to finance future intervention.

Note

The operation is designed to avoid the one thing Washing--ton wants to prevent—Japan selling U.S. government debt to pay for the intervention. Currency interventions that aren't backed by a shift in central bank policy or fiscal policy historically buy weeks but can fizzle out after that. The prospect of greater firepower from the Fed facility could make it more costly to short the yen.

Note

Washington's stake in the yen runs through the Treasury market. When a country de--fends its currency, it buys its own currency and sells foreign reserves. Japan's reserves are overwhelmingly U.S. Treasurys. A sustained defense financed the conventional way would mean Tokyo unloading them at a moment when the yield on the 30-year U.S. bond has risen to its highest level since 2007.

Note

Behind that is a slower-moving problem. A weak yen feeds expectations by investors of higher Japanese inflation, leading them to demand more compensation to hold Japanese government bonds.

Note

Because Japanese institutions are the world's largest cross-border creditors, rising yields at home weaken the case for owning foreign debt and give capital parked in U.S. Treasurys, German bunds and British gilts a reason to come home.

The Fed's insulation from the White House is conventionally understood to cover interest rates because those decisions are most vulnerable to political pressure and most consequential if politicized. It has never been as clearly drawn around the Fed's other work, including loans offered to foreign central banks.

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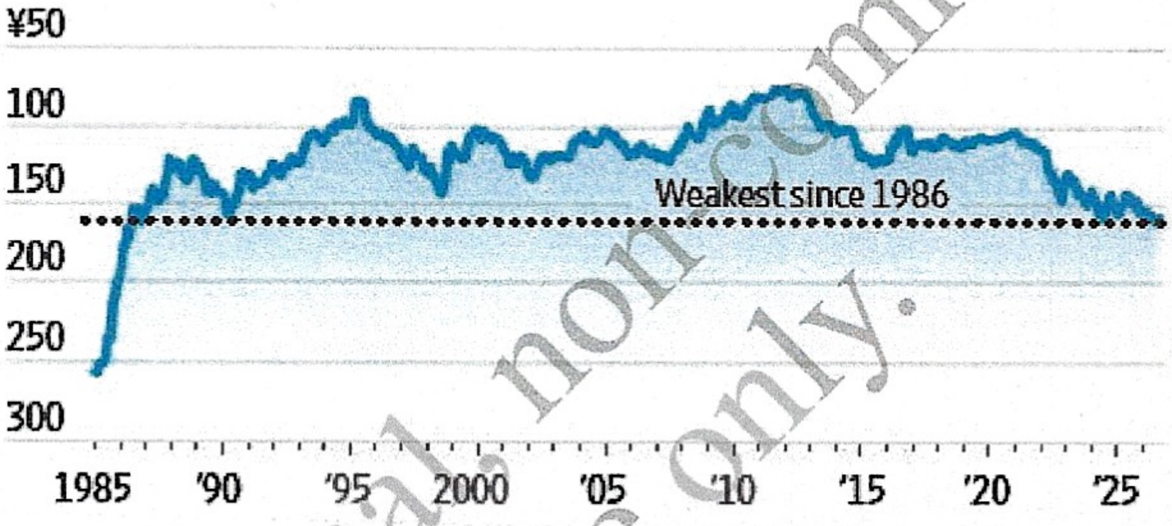
The Pressure Behind U.S. and Japan Teaming Up to Buy Yen

How many Japanese yen $1 buys



Note: Month-end data. Scale inverted to shows yen's appreciation.
Source: FactSet

Scan this code for five charts that tell the story: Japan is worried about inflation, while the U.S. doesn't want Tokyo to sell Treasurys. Their joint move to boost the yen marks a historic intervention in currency markets.

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