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The uncertain political economy of the weak yen

Key takeaways

- The Japanese government is suspected of intervening in foreign exchange markets again, highlighting ongoing concerns about the impact of yen weakness on key constituencies.
- Prime Minister Kishida Fumio is under pressure to provide relief, but his options are limited – and it is unclear how much desire there is for higher interest rates.
- The Bank of Japan has offered few additional signals about its intentions for short-term rates at its next meeting.

The yen jumped sharply against the dollar and euro Friday, prompting suspicions that the Ministry of Finance (MOF) bought an estimated JPY 3-4tn and reportedly conducted a rate check of the yen-euro exchange rate, considered a precursor to intervention. If the Japanese government were to intervene against the euro – against which the yen has fallen to its lowest rate since the introduction of the single currency – it would be the first-ever intervention against the euro. Neither Finance Minister Suzuki Shunichi nor Chief Cabinet Secretary Hayashi Yoshimasa confirmed that MOF had acted. The move may have been timed to coincide with consumer price index (CPI) data from the United States, which showed that inflation slowed again in June, increasing the likelihood of an interest rate cut by the Federal Reserve.

If MOF did in fact intervene in foreign exchange markets, it shows the degree to which yen weakness remains a source of anxiety for the Kishida government, given the Liberal Democratic Party's (LDP) ongoing struggles in elections at every level. Dissatisfaction with the yen is present throughout the economy. Kobayashi Ken, the head of the Japanese Chamber of Commerce and Industry, which represents small- and medium-sized enterprises, earlier this month called on the government and BOJ to adopt foreign exchange policies that take the struggles of SMEs into consideration. Meanwhile, Niinami Takeshi, chairman of the business federation Keizai Doyukai, somewhat unusually called on Friday for a rate hike to provide relief from the weak yen; his Keidanren counterpart, Tokura Masakazu, last month acknowledged the importance of interest rate differentials for the currency but said he did not think that the BOJ should make monetary policy decisions based on the exchange rate.

It is not only businesses that are feeling the pain. Yen weakness is devouring the nominal pay increases that the Kishida government has mobilized to deliver, pay increases that the Bank of Japan (BOJ) suggests are spreading to workers at small- and medium-sized enterprises. Despite wage increases that averaged over 5% in this year's *shuntō* negotiations between large employers and labor unions, the latest wage data shows that real wages fell 1.4% year-over-year in May, falling for the twenty-sixth-straight month. The BOJ's import price index for June, also released this week, showed that import prices in yen terms rose 9.5% year-over-year, compared with 7.1% year-over-year in May. The rising cost of imported goods has led to a mood of despair on Japan's opinion pages, as editorial writers and experts lament Japan's relative "impoverishment" and decline. In these conditions, until there is a sustained reversal of the yen's position vis-à-vis other major currencies, MOF intervention to strengthen the yen remains likely. Between Prime Minister Kishida Fumio's struggle for survival and the LDP's fears of an electoral disaster, political decisionmakers are strongly incentivized to signal that they are taking the issue seriously, even if their tools are limited.

It is unclear whether the government's determination to do something about the yen extends to preferring that the BOJ raise interest rates at its 30-31 July policy board meeting. The government will of course not express an explicit position on the BOJ's monetary policies, but nevertheless may communicate its preferences quietly. But it is not clear what the prime minister's, his government's, or the LDP's preferences are in these conditions. Even if they recognize that the yen's weakness is hurting households and small businesses to an extent that has dampened public's support for the government and ruling party, the uncertainty about another small rate hike – weighing the impact it could have on the exchange rate versus the impact it could have on household and small business balance sheets – suggests that the government is not necessarily enthusiastic about an interest rate hike this month, ahead of the LDP's leadership election in September. Aside from Chairman Niinami's call for an interest rate hike, there has not been much clamor from the public or the business community for higher rates.

The BOJ itself, which has been conducting conversations with market participants regarding its plan for tapering government bond purchases that will be announced this month, may likewise be inclined to wait for more data – and more political clarity – before its next move. It may also wait to see whether reducing its JGB purchases reduce long-term interest rate differentials. Against this backdrop, survey- and market-based forecasts suggest that expectations for a July interest rate hike are receding.

Nevertheless, it may take the release of Japan's June CPI data – which will be released by the Ministry of Internal Affairs and Communications on Friday, 19 July – to gain more insight into the BOJ's intentions.