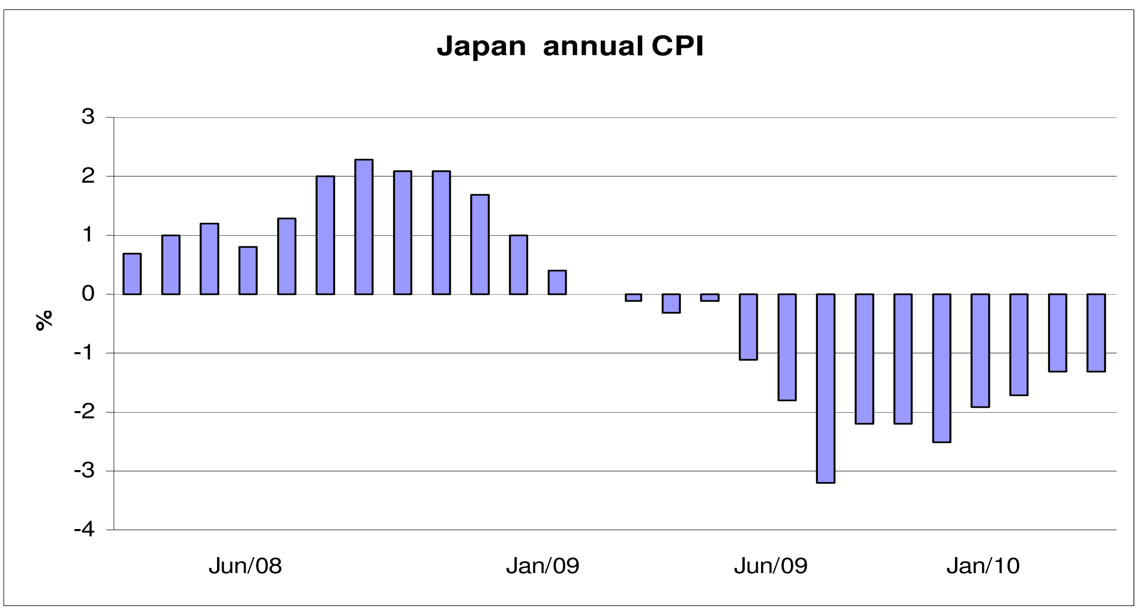
JPY and Japan’s sovereign debt

The JPY is one of the main beneficiaries of safe haven flows related to the EU sovereign debt crisis. JPY continues to trade inversely to risk sentiment and the direction of equities. A stronger JPY contributes to tighter monetary conditions and complicates Japan's effort to combat deflationary pressures. The Japanese government has been pressuring the BOJ to take more aggressive action to combat deflation. Japan’s inflation rate declined for the 13th consecutive month falling 1.2% in March. A panel in Japan recently called upon the BOJ to set an inflation target and a target for the JPY. The BOJ has rejected the call for setting an inflation target and has been noncommittal about the need for intervention to try and cap JPY appreciation. At the beginning of 2010 the BOJ announced a plan to increase its loan program by ¥20 trillion and provide short-term loans to commercial banks for three months at an interest rate of zero. This liquidity add falls short of what the government would like to see from the BOJ. Recent improvement in Japans economy makes the BOJ reluctant to take more aggressive policy measures like buying government bonds.



In that press conference following the April BOJ policy meeting BOJ governor Shirakawa said that deflation cannot be ended by the central bank. In its policy statement the BOJ said that the economy is picking up but faces headwinds from declining public investment, unemployment and continued tight credit conditions. The BOJ went on to say business investment is showing signs of improvement. Japan's economic recovery remains mainly export led. Japan's exports climbed 43.5% in March. This marks the fourth consecutive month of improvement in Japan's export growth. Demand for Japanese exports is attributed to stronger economic outlook in Asia. Japan’s GDP growth has been weaker than expected as business spending is weak and the export recovery has yet to spread to the domestic economy. The quarterly deflator declined by 3%.A strengthening JPY not only contributes to deflationary pressures but may hurt Japans export sales. Strong JPY puts Japan’s recovery at risk. This may increase the risk of intervention if JPY continues to rise. The BOJ aggressively pumped liquidity into the money markets Monday as part of the reopening of a swap facility G-7 central banks pledged to help reduce tensions in the EU financial markets. The liquidity add and firmer equity markets sparked selling of JPY Monday.

The Japanese government wants to reduce Japans dependence on export sales for economic growth. The Japanese government seeks to increase spending to try and boost domestic growth and consumption. The increased government spending raises questions about Japan's sovereign debt outlook. Japan is one of the most indebted industrialized nations. Japan public debt is forecast to reach 200% of GDP by end 2011. Because Japan has a large pool of domestic savings domestic investors can and do support the budget deficit. Ratings agencies warn that Japan's debt rating may be downgraded if the government continues to increase its issuance of JGB bonds to finance the budget deficit. The Greek debt crisis shines light on the Japanese fiscal outlook.

Tuesday, Japan's Finance Minister Kan said that next year's government bond issuance should not exceed the current year sales of ¥44.3trln. Kan recommends a cap on certain government spending. Rating agencies have warned that Japan's JGB bond issuance should not exceed the ¥44trln. Ratings agencies state that Japan's sovereign debt rating could be cut if its JGB bond issuance continues to rise. The Japanese government and Finance Ministry are not on the same page in regard to the size of Japan's debt issuance. According to Kan, Japan's bond issuance in the new fiscal year should not top ¥44.3trln. This is close to the threshold that may trigger a downgrade of Japan's debt rating. Japan's PM Hatoyama said that comments on limiting JGB issuance is not official government policy. If the Japanese government pushes for increased spending and larger issuance of JGB bonds investors may turn away from the JPY. Japan's Strategy Minister Sengoku says that investors may start taking note of Japan's debt burden and Japans debt may unsettle markets. Sengoku went on to say "Japan needs to draw a lesson from Greece's problems and to take steps on fiscal discipline with a stronger sense of crisis than before."

Much of the impact of the EU sovereign debt crisis has been played out in the EUR/JPY cross. The cross experienced a sharp decline as equity markets plunged Thursday. The EUR/JPY cross could experience a reversal in price direction if investors begin to focus on sovereign debt risk in Japan. A shift in focus to sovereign debt risk in Japan will depend on Japanese government spending plans. If the Japanese government fails to heed Kans' warning on debt issuance the JPY may soon experience a de-linking from risk sentiment and begin weakening versus USD and EUR.

By Michael J. Malpede,

Michael J. Malpede is Chief Market Analyst with Easy-Forex and has previously been featured on Bloomberg TV, Bloomberg radio, Reuters, MarketWatch, Wall Street Journal, Chicago Tribune, Chicago Sun Times, Toronto Star and Nikkei press. In analyzing the markets, he draws from 29 years of Foreign Exchange Research as a Foreign Exchange Analyst.