

Forex Focus: Bank Of Japan Should Leave The Yen Alone

By Nicholas Hastings

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LONDON (Dow Jones)--What the Bank of Japan needs now is patience.

As the Japanese economic recovery stumbles and as the yen rises to a new 2010 high against the dollar, pressure for the central bank to intervene is likely to become extreme.

But, if the bank waits long enough, the market may well do the job for it and push the yen back down again of its own accord.

The big test for the Bank of Japan isn't far away.

As the dollar falls towards Y85, Japanese exporters are likely to suffer, putting the Japanese economy at even greater risk and the central bank's intervention policy under deeper scrutiny.

See the dollar's recent slide against the yen:

<http://www.dowjoneswebservices.com/chart/view/4340>

For diplomatic reasons alone, Japan would prefer not to intervene.

The last thing Tokyo wants to do is justify currency manipulation to Washington, where U.S. officials are still pressing the Chinese to let their currency rise. An official from the ruling DJP has already been floating the idea of easing monetary policy rather than employing market intervention to halt the yen's rise.

The problem for Tokyo, though, is that the yen's rally is rapidly gaining momentum.

Last week, confidence in the U.S. economic recovery took a hard knock, with even one of the more hawkish governors of the Federal Reserve, James Bullard, warning that the risks of deflation have risen in the U.S.

This coincided with more bad news from Japan, showing that the recovery is even more reliant on export growth than before. Industrial production fell in June, while unemployment rose and consumer prices fell for the sixteenth month in a row.

The net result was a sharp drop in U.S. Treasury yields and a further narrowing of the yield spread with Japanese government bonds.

Given the recent renewed appetite for carry trades and an increase in the correlation between yield spreads and the dollar/yen's performance to nearly 95%, the dollar's fall has picked up momentum against the yen.

A similar rise in the yen against the euro means there will be little headwind to stop the move.

So while the dollar might hesitate if it falls to Y85, with market players looking to see if the Bank of Japan is going to jump in to stop it, chances are that the dollar could fall as far as Y82, a level last hit in May 1995.

It is at that point that the Bank of Japan will have to show its mettle.

Despite all indications, the dollar is unlikely to slip into a free fall.

First, the current bearish outlook for the U.S. economy could well prove overdone and yield spreads could soon bounce back in favor of the dollar.

Also, the mere threat of Bank of Japan intervention remains a powerful weapon that could convince many players to take long dollar positions as the yen falls on the assumption that they want to be on the side of the central bank.

Take into account the fact that the skew in dollar/yen risk reversals still isn't stretched and there is even less reason for the Bank of Japan to move.

So, even though the yen's rise may be nasty and the political fallout may be messy, the Bank of Japan will probably find that if it keeps its nerve and just waits the Japanese currency will fall into reverse with the central bank never having to employ its ultimate weapon for currency control.

Early Monday in Europe, the yen was easing back a little as strong Asian stock markets and relief that China's purchasing managers' index for manufacturing didn't fall under 50, indicating economic contraction, helped to lift risk sentiment.

The dollar was able to rise to Y86.61 by 0645 GMT from Y86.41 late on Friday in New York, according to EBS.

The euro was also up at Y113.22 from Y112.76 and at \$1.3070 from \$1.3053.

Bloomberg TNI FRX POV

Reuters USD/DJ
Thomson P/1066 or P/1074

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