MHRT Brief January 30, 2024

New NISA expected to have a limited impact on the USD/JPY exchange rate

Hardly a better factor than the interest rate differential

Takeshi Higashifukasawa, Economist, Planning & Financial Market Research Team, Research Division

The yen has weakened against the dollar since the beginning of the year

A clear trend of yen depreciation against US dollar has emerged since the new year. In addition to the widening interest rate gap between Japan and the United States, demand for the dollar may rise with the start of the new NISA program (small amount investment tax exemption program) (Chart 1).

Two main factors have contributed to the widening of the Japan-US interest rate differential.

(1) A decline in yen interest rates based on the view that the Bank of Japan will delay normalization of monetary policy in the wake of the Noto Peninsula earthquake.

(2) A rise in US interest rates, following the decline in expectations of an early interest rate cut reflecting the resilience of the US economy, as the US employment data and Consumer Price Index (CPI) for December 2023 confirmed a strong labor market and price growth exceeded market expectations.

The yen appreciated against the US dollar as the interest rate gap between Japan and the US narrowed in late 2023 on the back of the Bank of Japan's expected normalization of monetary policy and the Federal Reserve's anticipated interest rate cuts, but this trend has recently reversed.

It is also pointed out that since the beginning of 2024, yen selling by individual investors following the start of the new NISA may have contributed to the dollar's appreciation. One reason is that the dollar has appreciated so significantly that it cannot be explained solely by the widening interest rate differential between the US and Japan. Furthermore, although the recent dollar/yen exchange rate is strongly linked to the moves of speculators, the yen's depreciation since the beginning of the year has not been due to speculators' selling of the yen[1] (Chart 2). This suggests the strong willingness to buy dollars by market participants other than speculators. The possibility that yen selling by individual investors may have boosted the dollar cannot be ruled out.

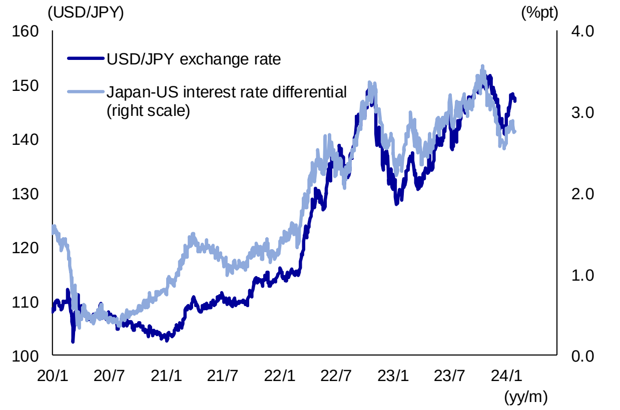
The new NISA program is unlikely to impact the direction of the dollar-yen

However, we do not believe the selling of yen by individual investors associated with the new NISA will be a sustainable factor impacting the direction of the dollar-yen, because while household investments in foreign currency assets are reflected in the financial balance in the balance of payments statistics, it is unlikely that

[1] The most recent data is as of the 23rd, although yen shorts have accumulated on a net basis. Net shorting of the yen at the beginning of the year (at 140 yen to the dollar) and on January 16 (at 147 yen to the dollar), when the yen rapidly depreciated thereafter, remained almost unchanged. The recent yen depreciation seems to have prompted speculators to accumulate yen shorts as they became more cautious about the yen's prospects.

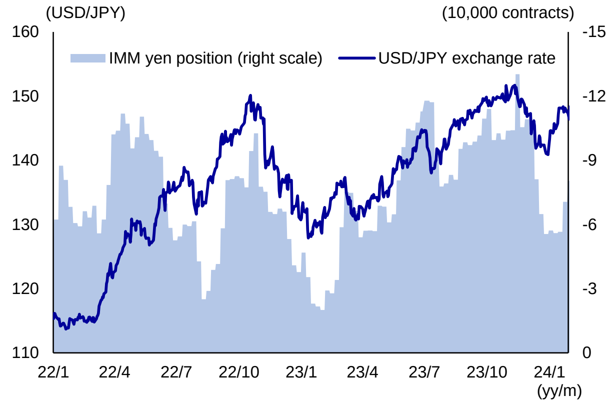
changes in the financial balance will have an impact on the dollar/yen exchange rate.

[Chart 1: USD/JPY exchange rate and US-Japan interest rate differential after 2020]



Note: Japan and US interest rate differential = US OIS rate (10 years) - Japan OIS rate (10 years)
Source: Made by MHTR based upon LSEG.

[Chart 2: USD/JPY exchange rate and trends of speculators]



Note: The larger the negative IMM yen position, the greater the selling pressure on the yen.
Source: Made by MHTR based upon LSEG.

The reasons why the new NISA is considered a factor in the yen's depreciation can be broadly classified into (1) unilateral outflow of funds and (2) large expected outflow of funds.

As for (1), since the NISA program is designed for long-term asset building, it is difficult to expect investors to buy the yen against the dollar,[2] even though they may sell yen to buy dollars. Especially regarding the *Tsumitate* (regular investment) Quota, transactions of selling yen and buying dollars occur on a fixed date each month, given that long-term continuous investment enhances the compounding effect, which makes it difficult to trade in response to the market environment.

Concerning (2), we expect the annual flow of yen sales to be in the trillions of yen. If we assume the same average growth rate of NISA and Tsumitate NISA under the old NISA system, we estimate[3] that the Growth Quota and the Tsumitate Quota under the new NISA system will generate an annual yen-selling pressure[4] of about 6.5 trillion yen[5].

In light of these two points, we hold that pressure from the new NISA to weaken the yen and strengthen the dollar will be limited and unlikely to affect the direction of the USD/JPY exchange rate. Household investment in foreign currency assets is reflected in the financial balance in the balance of payments statistics, but the connection between the USD/JPY exchange rate and the financial balance is weak.[6] Rather, financial accounts tend to lag the USD/JPY exchange rate (Chart 4). In other words, while the dollar-yen may act on the financial

---

[2] Although purchases in foreign currencies other than the US dollar are expected, looking at the breakdown of net assets in foreign currencies of contract-type publicly offered mutual funds, about 70-80% of net assets in foreign currencies are held in US dollars. Hence, the currency most likely to be bought by individual investors selling yen under the new NISA is the US dollar.

[3] We assumed that 70% of the Growth Quota and Tsumitate Quota will be in foreign currency. It is estimated that about 80% of the inflows into publicly offered domestic investment trusts since the beginning of 2024 have been into global equity-linked and S&P 500 index-linked trusts. Using this figure as a reference, we assumed a foreign currency denominated ratio of 70%. We also assumed that all the foreign currency denominated assets would become pressure to sell the yen, since many of the foreign currency denominated assets are likely to be held without currency hedging. https://moneyworld.jp/news/05_00118510_news

[4] On the other hand, dividends and distributions earned from investments become a factor that improves the primary income balance. Although an improved current account balance is a factor in the yen's appreciation, we do not consider that dividends and distributions would become pressure to buy yen, because (1) they account for only a small percentage of the total amount invested overseas and (2) many investors are likely to maximize the compound interest effect by reinvesting dividends and distributions for long-term asset building.

[5] If use of the new NISA program progresses at a higher rate than the previous trend, there is a good possibility that the yen will come under further selling pressure.

[6] The correlation coefficient between the USD/JPY and the monetary balance (trend component extracted using the STL method) from January 2010 to November 2023 stood at 0.266.

account balance with a lag due to one factor or another, the possibility of the financial account balance affecting the dollar-yen is very small.

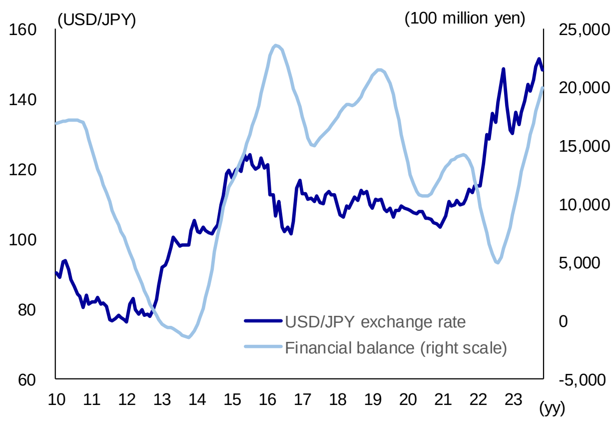
The average daily trading volume for the dollar-yen is approximately 145 trillion yen.[7] We believe the flow of yen sales from the new NISA will account for a small percentage of the overall dollar-yen transaction volume. Since the USD/JPY rate tends to follow the same direction as the Japan-US interest rate differential (Chart 1), the narrowing of the interest rate differential is expected to continue driving the yen higher and the dollar lower, regardless of the amount invested in the new NISA system.

[Chart 3: Comparison of the old and new NISA system]

	Old NISA		New NISA	
	General NISA	*Tsumitate* NISA	Growth Quota	*Tsumitate* Quota
	Can select one type		Can select both types	
Tax-free period	5 years	20 years	No limit	
Maximum amount of tax-free holdings (per annum)	JPY 1.2 m	JPY 0.4 m	JPY 2.4 m	JPY 1.2 m
Types of investment	Investment trusts, stocks, ETFs, etc.	Investment trusts	Investment trusts, stocks, ETFs, etc.	Investment trusts

Note: Investment trust represents mutual funds, stocks for listed shares, and ETFs for exchange-traded funds.
Source: Made by MHRT based upon the Financial Services Agency.

[Chart 4: USD/JPY exchange rate and financial balance]



Note: Trends in the financial balance are extracted using the STL method[8] through November 2023.
Source: Made by MHRT based upon the Ministry of Finance and LSEG.

Forecast of yen appreciation in 2024 remains unchanged

Regarding the future of the USD/JPY rate, the JPY may weaken further in the short term. However, if the Fed begins to cut interest rates from the April-June 2024 period and the Bank of Japan is increasingly expected to normalize its monetary policy, including eliminating its negative interest rate policy, the yen will turn upward as the Japan-US interest rate differential narrows, and so our forecast remains unchanged. Hence the new NISA will have a limited impact on USD appreciation in the medium to long term.

The USD fell to the 140-yen per dollar level where the 200-day moving average (MA) was located at the end of 2023, and then reversed its course in 2024, rising to a 100 MA (147-yen per dollar level), which is considered an upper resistance line (Chart 5). Since mid-January, the market has hovered around 148 yen to the dollar, but if the yen weakens further, 150 yen to the dollar will be in sight in the short term.

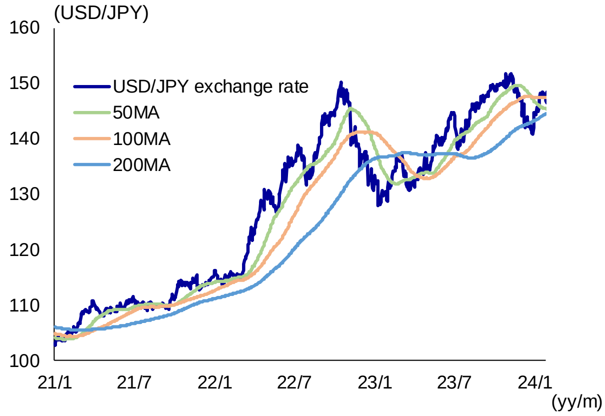
However, we believe the return to a strong dollar will be short lived, and the yen will appreciate from the April-June period onward. The Fed is expected to move into a gradual rate cut cycle in the April-June quarter as US inflation remains under control. Meanwhile, the Bank of Japan is expected to normalize its monetary policy in the April-June period, including eliminating its negative interest rate policy. We expect the yen to strengthen against the dollar as differences in the direction of monetary policy between Japan and the US become more

[7] Average per day in April 2022. In dollar terms the figure is $1.013 trillion. The yen basis is calculated assuming USD1 = JPY145. Source: BIS.

[8] We decomposed the financial accounts into a seasonal variation component, trend component, and residual component using the STL method, and extracted the trend component.

apparent and the Japan-US interest rate differential narrows. As mentioned above, the new NISA may exert limited upward pressure on the dollar, but the medium- to long-term impact is expected to be minimal. However, we expect the yen's appreciation to remain moderate, given that (1) the Fed's interest rate cut will likely have been partially factored into financial markets and (2) the Bank of Japan will drop its negative interest rate policy, but the likelihood of the Bank of Japan raising policy rates into the positive territory thereafter is small at this point.

[Chart 5: USD/Yen exchange rate and moving average (MA)]



Source: Made by MHRT based upon LSEG.

Reference

Refer to the original Japanese report by clicking the URL below for the reference material

https://www.mizuho-rt.co.jp/publication/report/research/express/2024/express-mk240130.html