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Center for Risk Management Strategy at Deloitte Touche Tohmatsu LLC.

Global Risk Watch Newsletter

The background of a possible concerted policy shift by leading central banks, etc.

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《index》

1. # [The background of a possible concerted policy shift by leading central banks \(Tsuyoshi Oyama\)](#)
 2. # [Japanese banks need to step up for IRRBB implementation \(Shiro Katsufuji\)](#)
 3. # [Normalization of monetary policies equal further yen depreciation? \(Toshikazu Kumagai\)](#)
 4. [Seminars, Conference & Publications](#)
- =====

3. Highlight of Indicator for this Month

Normalization of monetary policies equal further yen depreciation? (Toshikazu Kumagai, Senior Staff, Center for Risk Management Strategy at Deloitte Touche Tohmatsu LLC)

Long term interest rates are on the raise in developed countries. Views on normalization of monetary policies such as asset purchase reductions by FRB and ECB is expanding, signaling an end to monetary easing policies. On the other hand, the central bank of Japan (BOJ) emphasized its approach to limit the long term interest rate hikes through bidding and other operations.

Considering the positions each country has over its monetary policy, one needs to recognize the impact interest rates will have on the foreign exchange market. Looking at the movements between the US and Japan interest rates against the JPY exchange rate for the past year (Figure 1) while taking into account BOJ's control of the yield curve, the JPY is moving relatively in accordance to the 10-year interest rate differential, but not to the 2-year interest rate differential since the presidential elections in US.

On the other hand, looking at the 10-year interest rate differential between 2004 and 2007 (Figure 2), the 2-year interest rate differential between Japan and the US was trending upwards while the 10-year interest rate differential in the US was rather moderate, the interest rate gap remained relatively flat. One could argue that market players assume future economic growth could be suppressed by monetary tightening that in return causes economic depression in the US economy. If we then assume that the JPY exchange rate will move in accordance to the 10-year interest rate differential between the Japan and the US, a drastic yen depreciation due to the normalization of US monetary policy is rather unlikely.

Figure 1 : JPY exchange rates vs interest rate differentials (IRD)



*(Source) BOJ, Ministry of Finance (Japan), Federal Reserve Economic Data (FRED)

Figure 2 : interest rate movements during Allan Greenspan's period



*(Source) BOJ, Ministry of Finance (Japan), Federal Reserve Economic Data (FRED)

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