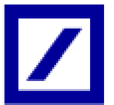
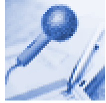


Talking point



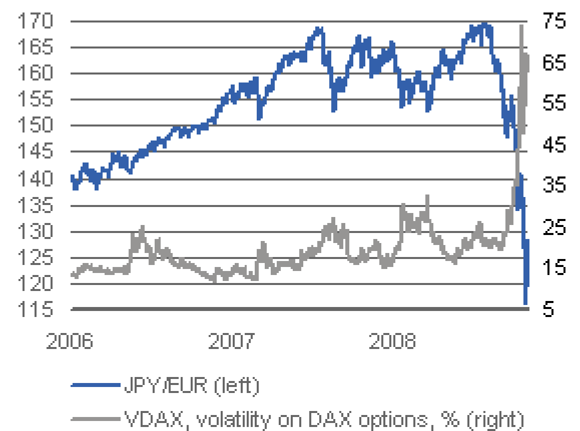
The yen strikes back for now - The unwinding of JPY funded carry trades

October 31, 2008

Before the sub-prime crisis hit global financial markets, JPY funded carry trades were said to be popular among international investors that were willing to take risks. A yen carry trade describes an investment strategy in which investors borrow cheaply in JPY to invest in higher-yielding assets such as US stocks or Australian bonds. During times of strong global growth, abundant global liquidity, strong risk appetite, surging asset prices and low financial market volatility, yen carry traders benefited from both considerable exchange rate gains due to an ever weaker yen and a positive interest rate differential arising from low JPY borrowing costs and higher yields in most other markets.

Now with the US credit bubble having burst and spill-over effects spreading to the world economy, the Japanese currency appreciated both suddenly and massively against most major currencies, especially vis-à-vis the high-yielding Australian and New Zealand dollar. Meanwhile, the yen has appreciated against the USD and the EUR to JPY/USD 90 and JPY/EUR 115 (from around JPY/USD 110 and JPY/EUR 160 in mid-August), although it has shed some of these gains earlier this week. It is astonishing to note that the 1-month implied exchange-rate volatility of the yen against the US dollar has recently shot up to levels never seen before, not even during the 1998 yen strength episode. Interestingly, the yen exchange rate (expressed as JPY per foreign currency) and implied equity market volatility have been inversely correlated over the past few years (see chart). Given the Japanese economy is headed for recession and not at all doing better than most of its peers in terms of GDP growth, how can the recent yen strength been explained?

JPY/EUR exchange rate and equity market volatility: Mirror image



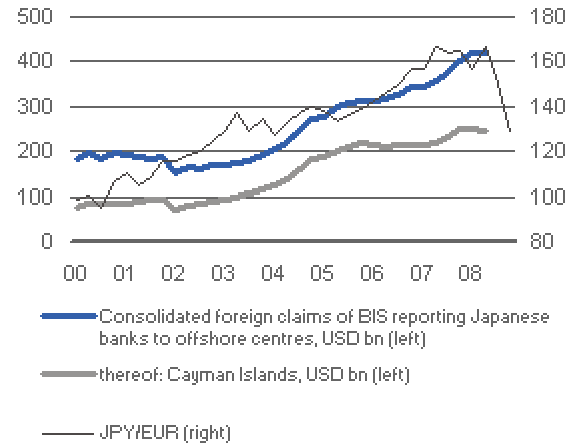
Sources: Global Insight, Bloomberg

It seems that two factors are at work. First, a shrinking interest rate disadvantage of the yen to other currencies. Second, higher global risk aversion, plunging asset prices and hence the need of some investors to unwind carry trade activities.

Back to the first point, the short-term interest-rate differentials of major economies versus Japan have come down significantly as central banks have slashed policy rates to stabilise their economies. As such, the short-term interest rate advantage (as measured by the 3-month interest rates) of New Zealand and Australia has declined from 8.1 pp at the beginning of 2008 to currently 5.6 pp and from roughly 6.4 pp to just 4.3 pp, respectively. Given that the BoJ cut its benchmark rate for the first time in seven years this Friday, Japan has even less room for monetary easing now given an already low policy rate of just 0.3%. Hence, the interest-rate disadvantage of the JPY to other currencies could narrow even further as other major central banks are set to cut rates more aggressively over the near term.

Regarding the second point, it seems that carry trade activities built up over the past few years are now being suddenly unwound, thereby giving rear cover to the yen. Although global carry trade activities are difficult to track and the total size is even more demanding to estimate, empirical evidence suggests that JPY funded carry trades have been clearly cut back since the onset of the credit crisis. For instance, Japanese balance-of-payments data indicates that net loan outflows from Japan to the rest of the world have softened since mid-2007. Moreover, non-commercial JPY future positions have been abruptly reversed from net short to net long since July 2007, according to the US Commodity Futures Trading Commission. Furthermore, the amount and percentage share of foreign banks' borrowing in Japanese money call markets has decreased considerably for more than a year now.

Another indicator for carry trades – the amount of foreign assets held by Japanese households – speaks the same language. While the stock of foreign assets skyrocketed over the past few years to a peak of JPY 38 tr in October 2007, it has shrunk since then to below JPY 30 tr (to roughly USD 300 bn) in September 2008. However, it is not clear to what extent this reduction is due to yen appreciation and how much it is driven by net foreign asset selling.Last but not least, another gauge for carry trades is the net foreign claims of BIS reporting Japanese banks to offshore centres where many hedge funds are reported to have their offices. According to this gauge, yen carry trades could have been as large as more than USD 400 bn in Q2 2008 (see chart). Overall, empirical evidence points to an unwinding of yen carry trades.



To sum up, given heightened global risk aversion, the plunge in global asset prices and a reduced interest-rate disadvantage between major economies and Japan, the JPY may trade sideways or even appreciate further over the short to medium term against the USD and EUR even after its recent rally. Although the BoJ trimmed its benchmark rate to 0.3% from an already low 0.5%, the JPY's interest rate disadvantage should nevertheless shrink further as other major central banks have still more room for monetary easing over the next couple of months. However, the issue of the sustainability of the recent strength of the yen and the Japanese currency's long term prospects are a completely different story. (Please see more in our Chartbook on "The Unwinding of Yen Carry Trades")

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