

## The Japanese Yen Carry Trade

### What exactly is it?

Carry trading is borrowing money in a nation's currency where interest rates are very low in order to purchase assets in the currency of a country where interest rates are higher – and profiting from the difference.

At present, the Bank of Japan has set interest rates at .5%. With rates in other countries considerably higher (in the U.S., for example, the Fed's federal-funds target rate is 5.25%), traders capture the difference between the rates by borrowing yen to buy higher-value assets, such as U.S. bonds. If the bonds return 5.25%, the carry trader makes a profit of 4.75% from borrowing yen – as long as exchange rates do not change.

That's where the Japanese government's support for a weak yen, which it views as key to fueling the country's export-led economic growth, plays a crucial role. Traders will continue to borrow yen to exploit global interest rate differences as long as they are confident that the Japanese government will keep the yen weak.

### How confident are traders of the Japanese preference for a weak yen?

As of early 2007, US \$1 trillion is estimated to be at play in the global yen carry trade.

### How does the carry trade affect the yen?

The carry trade feeds off and reinforces the already weak yen. Carry traders have to sell their borrowed yen to convert them into higher yielding assets in order to earn a profit. When large blocks of yen continue to flow out of Japan into the global trading system, the yen is further weakened, thus reinforcing the cycle. If Japanese interest rates were to rise, the value of the yen would increase.

### Why is the carry trade a problem?

At some point, it will unwind. The key question is how quickly and in what form.

*“...The carry trade may reflect a dispersion of risk which has made the global system more resilient to shocks. That said, the fact that little is known about who actually bears the risk, and the exact degree of market exposure, may also imply that a significant systemic impact could arise if a problem were to occur.”* -- OECD Economic Outlook, June 2007

A broad range of economic analysts and financial publications – including the *Economist* and the *Financial Times* – have warned that a rapid, market-driven end to the carry trade could result in massive global financial instability, decreased financial liquidity, and sharply declining stock markets around the world.

A slow unwinding would result in a gradually increasing yen and gradually decreasing current-account deficits. Many economists, including the authors of a recent Peterson Institute for International Economics report on the topic, believe that the Japanese government must carefully manage this outcome by gradually increasing interest rates to facilitate a smooth unwinding of the carry trade.

**The Japanese government has a choice – move now to manage the rebalancing of the yen or risk a global financial crisis by waiting for the markets make it happen.**