The Economist

Carry on living dangerously

Speculators and low interest rates have helped cheapen the yen, putting the world economy at risk

THE yen is perhaps the world's most undervalued currency. It is even cheaper than the Chinese yuan by some measures. Last week the Japanese currency hit an all-time low against the euro and its real trade-weighted value fell to its lowest since at least 1970, according to an index tracked by JPMorgan. But do not expect the G7 finance ministers and central bankers meeting in Essen, Germany, on February 9th and 10th to spend much time discussing the yen, let alone to do anything to support it.

American and European policymakers do not see eye to eye on the yen. The Europeans would like some action to push up the currency, which, they say, is not bearing its fair share of the dollar's decline. Our latest update of *The Economist*'s Big Mac index[1] suggests that the yen is a massive 40% undervalued against the euro. America's big carmakers have also complained that the weak yen makes imported Japanese cars unfairly cheap. However, neither the American nor the Japanese government thinks there is a problem. Hank Paulson, America's treasury secretary, says he is not worried about the yen's weakness because it is market-driven and reflects economic fundamentals — namely low interest rates and a fragile economy. China, in contrast, is accused of manipulating its currency with heavy intervention.

Mr. Paulson is being short-sighted. Even if Japan is not intervening to hold down its currency, the yen is still misaligned. A country with one of the world's largest current-account surpluses and low inflation (but no longer deflation) should have a much stronger currency. Japan's economy is no longer flat on its back. Last year it grew by an estimated 2.3%, and it is forecast to maintain a similar pace this year. As a result, Japan does not need such low interest rates or a super-cheap currency any more. Indeed, Japan's abnormally low rates could be viewed as a form of intervention to hold down the yen.

The Bank of Japan (BoJ) bowed to government pressure and held rates unchanged at 0.25% in January. But figures due on February 15th, which are expected to show that GDP grew at an annual rate of 3.5 - 4% in the three months to December, could give the bank the green light to raise rates at its next meeting. This weekend the G7 could usefully back such a move.

The yen has been pushed down in recent months by the highly profitable "carry trade". At its simplest this involves borrowing in yen at very low interest rates to buy higher-yielding assets, such as American or Australian bonds, or even emerging-market debt that offers a still more lucrative interest margin. Carry trades weaken the Japanese currency, because investors sell the borrowed yen to convert them into other currencies.

Carry trades make sense only if the investor assumes that the yen will remain weak. If it appreciated, this would increase the repayment cost of yen-borrowing and offset the interest differential. But such an assumption is dangerous when the yen is already so undervalued. In theory, carry trades should not yield a predictable profit because the difference in interest rates between two countries should equal the rate at which investors expect the low-interest-rate currency, here the yen, to rise against the high-interest-rate one. But the carry trade turns this logic upside down by causing the yen to fall, not rise. This, in turn, lures more investors into the same strategy, amplifying the distortion. Mr. Paulson may be revealing

more than he intends when he says the yen is "market-driven": the market is chasing its own tail in defiance of the economic fundamentals.

AN ELUSIVE NUMBER

Nobody really knows how big the carry trade is. Japanese official figures show little evidence of large net lending to foreigners. For much of 2006 Japan actually had a net inflow of bond investment. Estimates based on the short-term net foreign lending of Japanese banks put the carry trade at only $200 billion.

But hedge funds do not need to borrow yen and then buy higher-yielding currencies. Instead, the carry trade is typically done through transactions, such as currency forward swaps, that are off-balance-sheet and therefore do not show up in official statistics. A better clue comes from record net "short" positions in yen futures on the Chicago Mercantile Exchange. Estimates of the total size of the carry trade range as high as $1 trillion.

The term "carry trade" usually refers to leveraged trades by speculative international investors, such as hedge funds. But Japanese households have also shifted money out of their low-interest-rate bank accounts to earn a higher return in, say, New Zealand bonds. These outflows are certainly large, but they are of a very different nature. If markets suddenly become more volatile, hedge funds can very quickly unwind their short yen positions, whereas households are more likely to sit tight. It is the volatile type of trade that central bankers lose sleep over.

The received wisdom in the markets is that yen carry trades will continue as long as the BoJ raises rates only slowly. It would take a rise in Japanese interest rates of at least two percentage points to undermine these trades, and nobody thinks that likely in the next year or so. Furthermore, goes the argument, as long as interest rates stay low, so will the yen.

In fact, the main trigger for an unwinding of carry trades is likely to be not Japanese interest rates, but an upsurge in currency volatility. That is what happened in 1998, when enormous yen carry trades had built up. After Russia's default in August and the subsequent near collapse of Long-Term Capital Management, hedge funds reduced their leveraged positions and the yen started to rise. Then in October the Japanese government announced a plan to recapitalise its crippled banks, which further bolstered the currency, forcing those who had bet against it to cover their positions. The yen jumped by 13% within three days.

Nouriel Roubini, at Roubini Global Economics, says that the lesson of 1998 is that it takes only a small piece of positive news to unravel such trades. Suppose there is suddenly some good news about the Japanese economy at the same time as America's appears to be stalling. An initial rise in the yen could cause today's carry trades to unwind just as rapidly, causing the currency to soar, American interest rates to rise and risk spreads to widen. The volume of yen-related leverage is probably greater now than in 1998.

The G7 should be concerned about carry trades not just because they could suddenly unwind and trigger financial turmoil but also because the yen's misalignment is distorting the world economy. The yen carry trade has amplified global liquidity[2], further inflating asset-price bubbles across the world. The trade has also prolonged global imbalances by making it easier for countries such as America, Britain and Australia to finance their large current-account deficits.

A severely misaligned exchange rate calls for action. It is true, as Mr. Paulson says, that Japan is not intervening to hold down the yen. But since Japan still holds almost $900 billion of foreign-exchange reserves, accumulated a few years ago when it was intervening, it is hard to claim that the currency is truly market-determined. Stephen Jen, an economist at Morgan Stanley, argues that Japan's Ministry of Finance should consider selling some of those reserves to break the one-way bet against the yen. There is a risk that such a move could itself upset financial markets. But the lower the yen slides, the greater the threat of an even sharper rebound. ■

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