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In Japan, a Robust Yen Undermines the Markets

By MARTIN FACKLER

TOKYO — Tumbling stock markets and falling currencies are causing global concern, but the Japanese yen is generating high anxiety for rising too much. The yen surged as much as 10 percent against the dollar last week. In the last month, it has gained an astounding 34 percent against the euro.

One reason the yen is rising is investors' flight to quality. Another reason, many economists say, is the sudden end of one of the world's biggest easy-money schemes, the so-called yen-carry trade.

The yen's rise helped hammer Tokyo's beleaguered stock market Monday. Share prices hit a 26-year low and are down 50 percent this year. A strong yen makes Japanese products more expensive during a recession in Europe and North America, hurting the profits of Japanese exporters.

Finance ministers from the world's seven wealthiest nations issued a joint statement as the Tokyo market sank, saying they were "concerned about the recent excessive volatility in the exchange rate of the yen and its possible adverse implications for economic and financial stability." But the yen remained strong as investors signaled their doubt that governments would intervene to stop the yen's gains. Christine Lagarde, the French finance minister, confirmed as much in an interview with Bloomberg News.

The yen's rise is owed, in part, to its status as a safe haven — in turbulent times, investors move money into the currency because Japan is the world's largest economy after the United States', and its banking system has limited exposure to the subprime crisis, even though it faces recession.

But currency analysts say most of the yen's recent gains are because of the abrupt end of the yen-carry trade.

For much of this decade, Japanese and foreigners alike borrowed money in Japan, where interest rates were very low and money was therefore cheap. They invested that money in higher yielding assets across the world, from home loans in Budapest and Seoul to equities in Mumbai.

This turned Japan, with its $15 trillion in personal savings built up by the nation's chronic trade surpluses, into a provider of low-cost capital for the rest of the world.

No one knows for sure how large this outflow of yen was.

Much of the yen-carry trade took place beyond public scrutiny, in the form of currency options or other types of derivatives trading. Most analysts agree its size was in the hundreds of billions of dollars, with some estimating it reached well more than half a trillion dollars. As the yen-carry trade grew, currency analysts warned it was a bubble of cheap credit, which one day would burst.

Now that day has come, say currency analysts and economists. Investors have been unwinding their yen-based loans as part of a panicked flight from risky assets — like Budapest home loans and Mumbai equities — and into safer havens like the yen and the American dollar, which is also rising against the euro and British pound.

The prospect of global recession has also led central banks in many countries to cut interest rates, reducing the appeal of borrowing in Japan: South Korea cut interest rates by three-quarters of a point Monday, its biggest one-day move ever.

The result has been a huge reversal in the flow of money, back into Japan and its currency. “This is the end of the yen-carry trade, and the yen bubble,” said Tohru Sasaki, chief exchange strategist in the Tokyo office of JPMorgan Chase Bank. “The yen is coming back home.”

As this money flows back into Japan, currency analysts expect the yen to keep gaining. Mr. Sasaki says his company’s forecast is 87 yen to the dollar, but it could go as high as 80 yen.

Mr. Sasaki said the size of the yen’s rise in recent weeks suggested that at least several trillion yen, or tens of billion of dollars, had flowed back to Japan. He said the last time he had tried to calculate the size of the entire yen-carry trade was three years ago, when he estimated that it totaled 40 trillion yen, or $425 billion. He said it could have easily grown much larger than that in recent years.

All this money from Japan added to an excessive abundance of cheap capital that many economists now blame for causing the current financial crisis. Some of the biggest players in the carry trade were American and European hedge funds and banks. But Japanese individuals also fed the outflow of yen by pouring their savings into overseas investments, like emerging markets funds, in search of higher returns.

Japan’s normally conservative homemakers even got into the act by trading foreign currencies online, becoming a force in global foreign exchange markets, known collectively as the Mrs. Watanabes.

One indicator of the recent return of money to Japan has been a surge of individuals here cashing out of mutual funds that invest overseas. A survey of Japan’s 40 largest such funds showed individuals had withdrawn more than $3.5 billion since Sept. 12, Mr. Sasaki of JPMorgan said.

The end of the yen-carry trade could have serious consequences, economists say.

In Japan, the higher yen has worsened the already darkening outlook for the nation’s export-driven economy, hurting companies like Toyota and Sony. The yen, and the prospect of a recession in crucial overseas markets like the United States, have helped drive the benchmark Nikkei 225 index down some 50 percent so far this year.

Globally, the carry trade’s demise could contribute to an overall increase in borrowing costs, especially for developing countries and lesser-known companies in developed nations, by cutting off a major source of low-cost capital, economists say.

“The unwinding of the yen-carry trade is just one more way of taking excess credit out of the system,” said John Richards, head of Asia research at the Royal Bank of Scotland’s Tokyo office. “Higher borrowing costs will go up disproportionately for riskier investments.”

A major reason for the end of the yen-carry trade has been a narrowing in the gap in interest rates between Japan and other developed countries. For years, Japan’s low interest rates — the benchmark overnight rate is 0.5 percent — were attractive enough to entice investors to borrow money here and invest it in countries with higher rates of return, despite the foreign exchange rate risks.

Now, investors are unwinding those loans as interest rate differences between Japan and the rest of the world shrink, making yen borrowing less lucrative. When its board meets later this week, the United States Federal Reserve is widely expected to cut its overnight rate again, from its current rate of 1.5 percent. That is already way down from 5.25 percent when the subprime problems first hit financial markets in July 2007.

Since that time, the yen has risen 24 percent against the dollar as investors have repaid their yen borrowings. Indeed, some currency analysts said this dissolution of the yen-carry trade may already be reaching its climax.

Koji Fukaya, senior currency strategist in the Tokyo office of Deutsche Bank, said he expected the yen's gains to continue into November, before settling down at a value of about 90 yen a dollar.

"The unwinding and liquidation will continue for a few more weeks," he said. "Most of the yen-carry trades have already been unwound."