Flash Economics

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Excessive sensitivity of the yen exchange rate to interest rates

Since the beginning of August 2024, we have seen a very sharp appreciation in the yen, linked to a small increase in interest rates by the Bank of Japan (from 0.10% to 0.25% on 31 July 2024).

This violent reaction in the exchange rate, which is very difficult for companies to bear, shows:

- The scale of carry trade positions (financing in yen of asset purchases in other currencies) taken by investors;

- The excessive level of foreign exchange risk associated with the risk of holding other assets (equities) taken by these investors, revealing the lack of supervision of this risk by central banks.

- The inability of central banks to conduct monetary policy in line with the needs of the economy, where speculative positions are too large.

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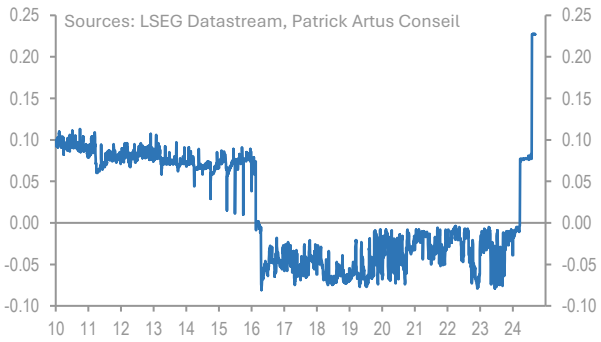
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Very high sensitivity of the yen exchange rate to Bank of Japan interest rates

The Bank of Japan raised its key interest rate from -0.10% in April 2024 to +0.10% and then +0.25% in July 2024 (Chart 1).

Chart 1
Japan: BoJ base rate (as %)



This decision was justified by the normalization of inflation with higher wage increases (Charts 2A/B).

Chart 2A
Japan: Inflation and inflation excl. fresh food and energy

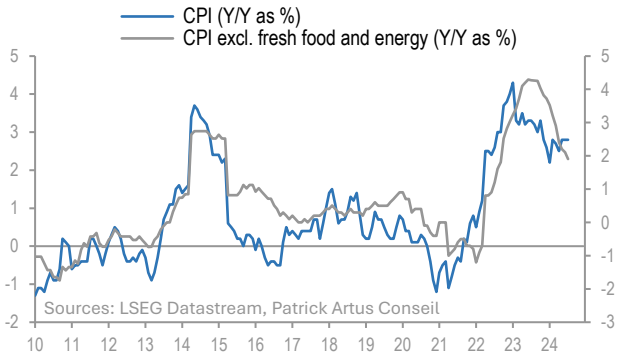
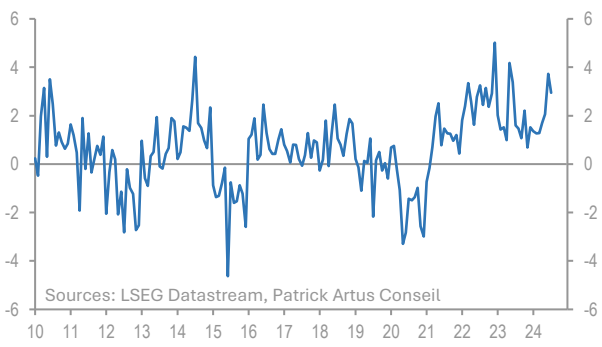


Chart 2B
Japan: Nominal wage (Y/Y as %)



This rise, albeit limited, in yen interest rates caused the yen to appreciate very sharply, whereas it had previously depreciated sharply (Chart 3).

Chart 3
Japan: Yen's exchange rate against the dollar
(USD 1 = JPY...)



What does this strong reaction of the yen exchange rate to the Bank of Japan's decisions tell us?

The importance of carry trades

The high sensitivity of the yen exchange rate to the interest rate on the yen is linked to **the very high level of carry trades on the yen** (borrowing in yen to invest in assets in other currencies). In particular, the short-term correlation in the summer of 2024 between stock market indices and the yen exchange rate (**Charts 4A/B**) shows **that the yen was used to finance short-term long positions in Japanese or foreign equities**; the rise in interest rates led investors to unwind their carry trade positions and therefore to sell assets (particularly equities) that were financed by long positions in the yen.

Chart 4A
Japan: Exchange rate against the dollar and Nikkei index

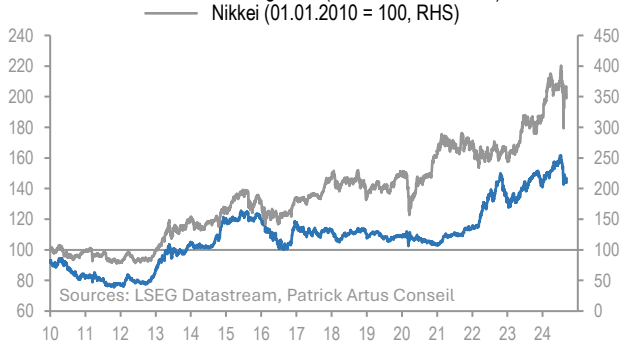
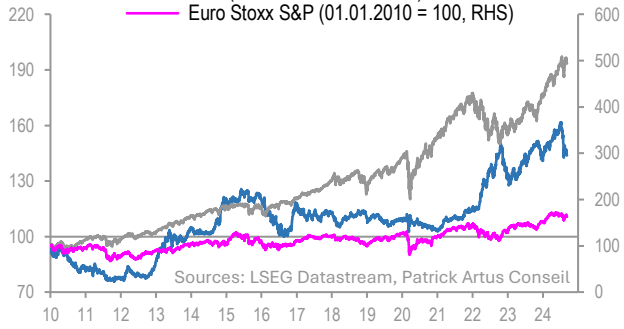


Chart 4B
Yen's exchange rate against the dollar and stock market indices



Summary: What lessons can we learn from this episode, in which a slight rise in yen interest rates caused the yen to appreciate sharply and stock market indices to fall sharply?

The first observation is the **inadequate supervision of carry trade positions, and therefore of the exchange rate risk** taken by investors who invest in various assets proceeds borrowed in a currency with low interest rates.

The second observation is the inability of central banks whose currencies have been massively borrowed to raise their interest rates. The Bank of Japan reacted to the effects on exchange rates and stock market indices of its decision to raise interest rates at the end of July 2024 by declaring that '*the Bank will not raise its policy interest rates when financial and capital markets are unstable*', S. Uchida, Vice-Governor of the Bank of Japan, 7 August 2024.

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