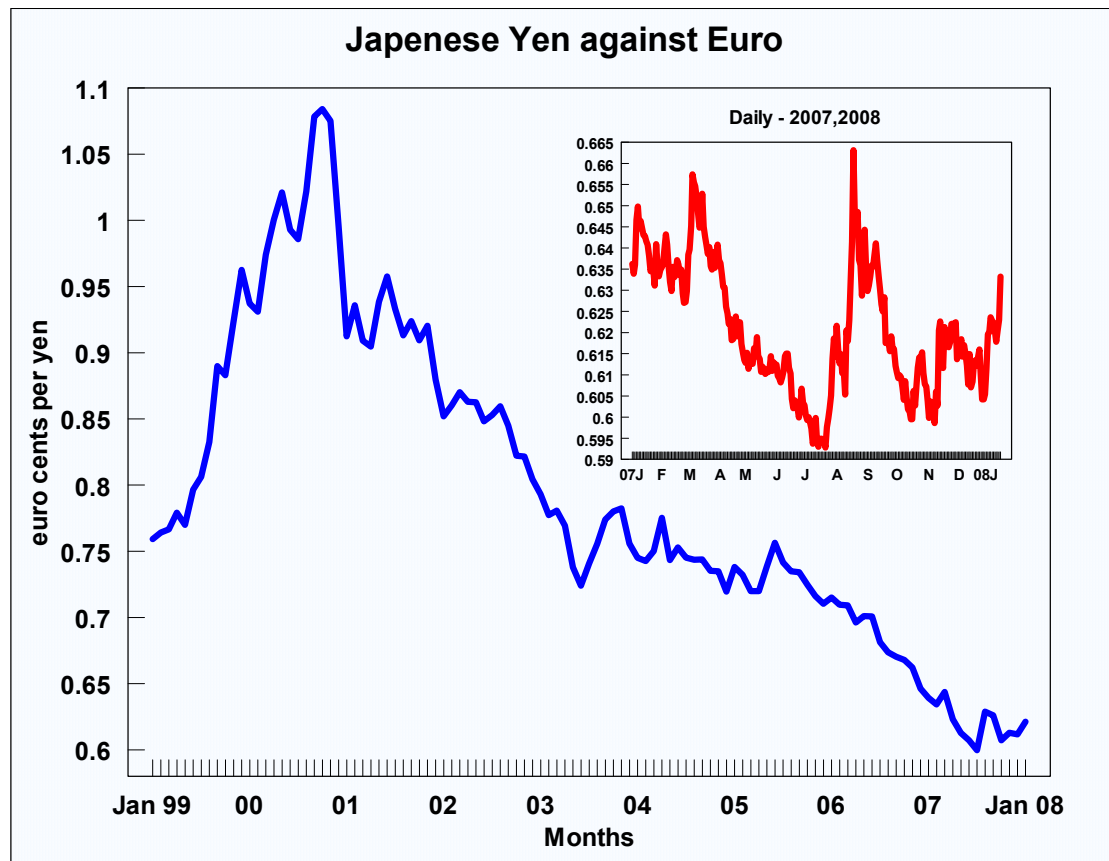


The Yen Carry Trade

The yen carry trade is the practice of borrowing at ultra cheap interest rates in Japan to invest in other economies with higher yields. And Japan's equivalent of Australia's official cash rate - the uncollateralized overnight call rate - has not been above 0.5% pa since August 1995.

But to park funds borrowed in Japan in other countries, the borrower/investor has to purchase the other currency first (and sell yen to buy it), which pushes down the value of the yen relative to the other currency. So the long, steady and significant depreciation of the yen since the late 1990s reflects the operation of the carry trade.

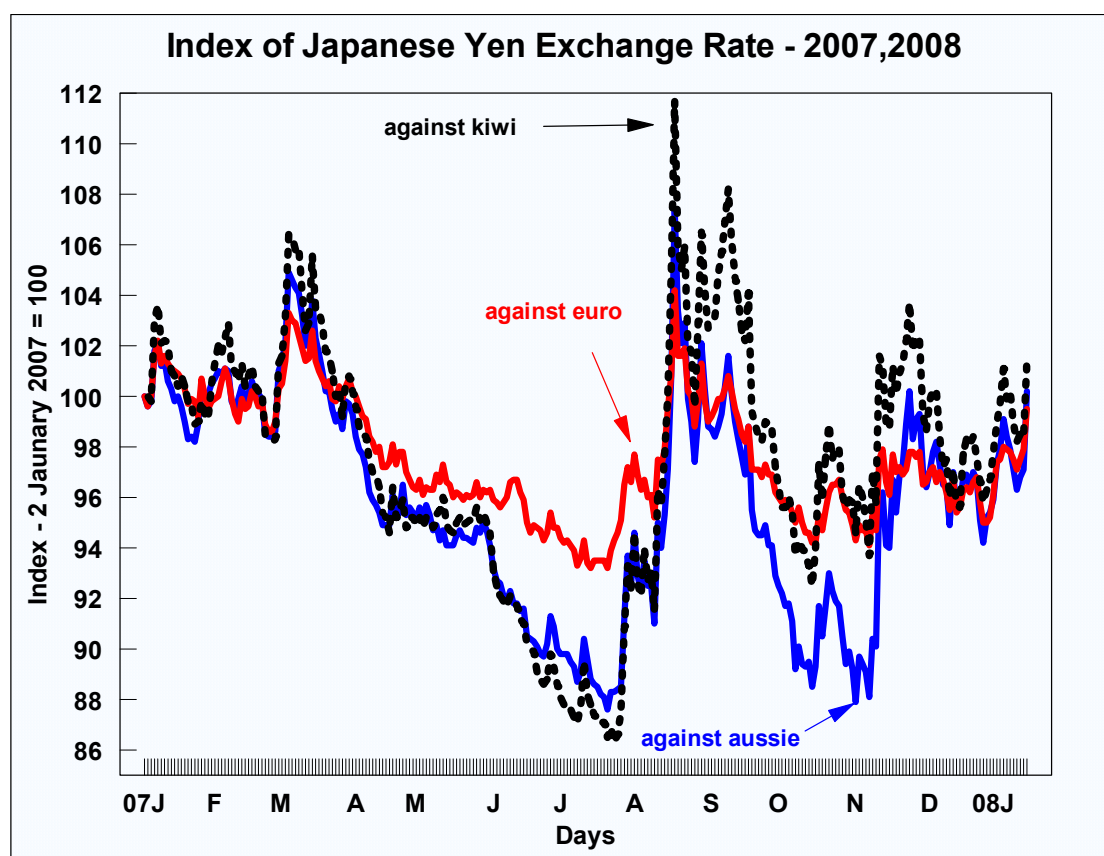


And it is not only borrowed funds. Japanese households have a much higher propensity to save than households in English speaking countries in particular (which conversely have higher propensities to consume), but very low returns in Japan have encouraged households, via savings institutions, to chase higher yields offshore, adding to the carry trade's impetus.

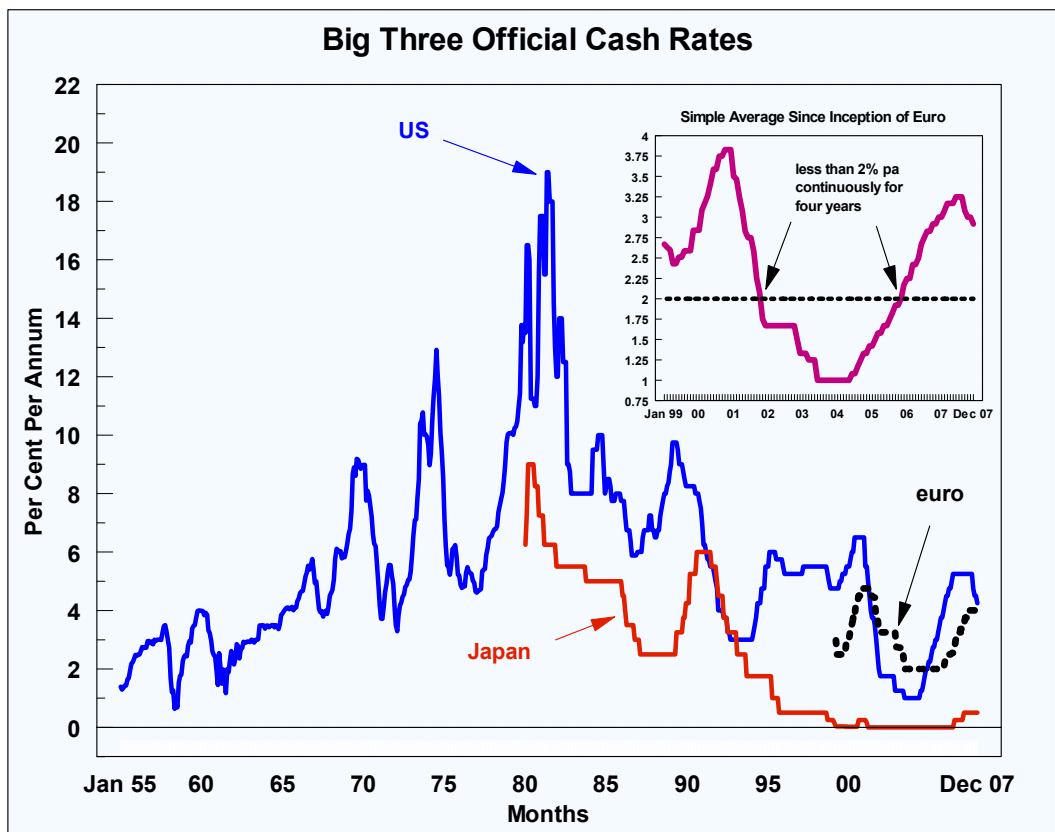
And whereas the federal funds rate dipped as low as 1.0% pa between June 2003 and May 2004, and the single euroland cash rate tracked at 2.0% pa between June 2003 and November 2005, Australia's cash rate troughed at a much juicier 4.25% pa (and even then it only prevailed for five months), while the New Zealand official cash rate only went as low as 4.75% pa. So the aussie and kiwi dollars have been the biggest beneficiaries of the carry trade in recent years.

The unwinding of the yen carry trade is when funds parked outside Japan are divested for repatriation back home to Japan. So just as the \$A and \$NZ were the biggest winners when the carry trade was in full swing, they are also the biggest losers when it unwinds.

When the carry trade unwound sharply between mid to late July and the middle of August, the Japanese currency rose by 12 per cent against the euro, 13 per cent against sterling, 10 per cent against the \$US (even though the greenback itself was faltering); but a chunky 22 per cent against the \$A and a whopping 29 per cent against the \$NZ. Put the other way around, the aussie and kiwi fell more sharply against the yen when the carry trade was unwinding, which was the payback for their relatively strong appreciations when the carry trade was in full swing. The chart below plots indices of the yen's value for selected currencies this year. A downward movement in the indices indicate a depreciation of the yen as the carry trade is active, while upward movements in the indices represent appreciation of the yen as the carry trade is unwound.



The yen carry trade is just the most visible and obvious example of the great cash and carry era of the early part of this decade, as the simple average of the big three cash rates dipped to 1.0% pa between June 2003 and May 2004. Funds borrowed at historically low rates were invested in all manner of risky assets, including sub-prime mortgages and corporate bonds in the US, and commodities. As defaults have piled up in the sub-prime and associated markets (including collateralised debt obligations intertwined with it), inadequate pricing for risk during the great cash and carry era has been replaced by aversion to risk. And one of the biggest risks going around is the exposure the yen carry trader has to a depreciation of the currency of the country where the funds are parked. So it was no coincidence that when corporate bond spreads started to rise sharply, the yen carry trade started to unwind.



16 January 2008

HBOS Australia Economics

| | | |
|------------------|-----------------|--|
| Alan Langford | +61 8 9449 6354 | alan.langford@hbosa.com.au |
| Josh Rubin | +61 2 8235 0726 | josh.rubin@hbosa.com.au |
| Natalie Sullivan | +61 8 9449 6891 | natalie.sullivan@hbosa.com.au |

The information contained in this publication is of a general nature and is not intended to be nor should it be considered as professional advice. You should not act on the basis of anything contained in this publication without first obtaining specific professional advice. To the extent permitted by law, HBOS Australia Pty Ltd, its related bodies corporate, employees and contractors accepts no liability or responsibility to any persons for any loss which may be incurred or suffered as a result of acting on or refraining from acting as a result of anything contained in this publication.