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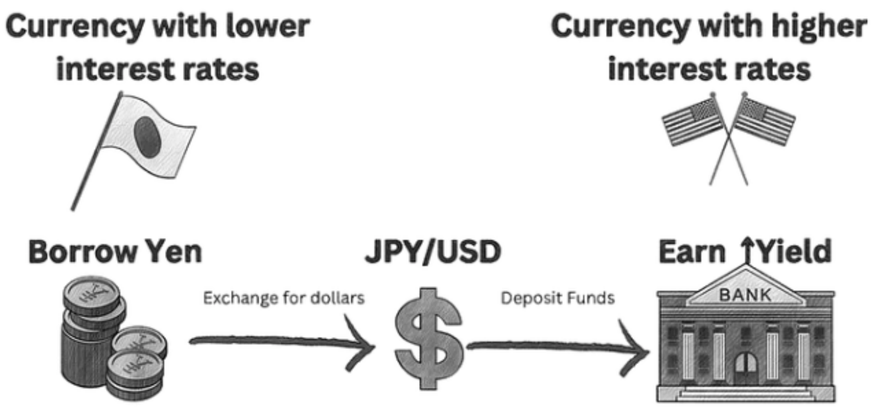
Unwinding of Yen Carry Trade

Why in news?

Recently, global stock markets experienced their steepest decline in decades, driven by fears of a US recession, escalating West Asian geopolitical tensions, and the unwinding of the yen carry trade.

What is carry trade?

- **Carry trade** – It is a popular investment/ trading strategy where *investors*
  - **Borrow money** – In a currency *with low interest rates*
  - **Invest in an asset** – Denominated in a currency *with higher interest rates.*
- **Aim** – To profit from the interest rate differential.
  - **For instance**, a trader may borrow in Country A's currency (1% interest rate) and invest in Country B's currency (5% interest rate), earning a *net interest rate differential of 4%.*



- **Risk factors** - One significant risk is *exchange rate volatility*, as currencies can fluctuate dramatically due to economic factors or geopolitical events.
- The *changes in interest rates or central bank policies* can impact carry trades significantly.
- The *unwinding of carry trades* can also have a profound impact on forex markets.
- **Impact of exchange rate** – Apart from gaining through interest rate differentials, traders also *anticipate capital appreciation of the invested currency* against the borrowed currency.
  - If the higher-yielding currency appreciates – They can benefit from both the interest rate differential and capital gains.
  - If the invested currency depreciates – It can erode or even negate any potential profits.
- **Impact of unwinding carry trades** - When market sentiment changes, traders tend

to unwind their carry trades by
  - *Selling the higher-yielding* currency and
  - *Buying back the lower-yielding* currency
- It can *lead to rapid currency depreciation* and increased volatility.

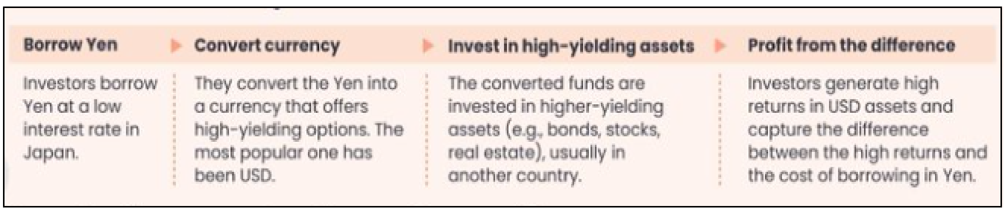
Currency Trade

• **Currency trade** – It refers to *buying and selling national currencies* with the goal of making a profit or hedge business against possible fluctuations in exchange rates.
• It is also known as foreign exchange (forex or FX) trading.
• **Participants** - Individuals, institutions and sovereign governments.
- *For example*: An Indian tourist planning to attend Paris Olympics will exchange their Indian rupees for Euros.
• **Basis** – There is no central location and is an electronically connected network of traders across the globe.
- A trader in Britain and a trader in Arunachal Pradesh can connect and trade in (GBP/INR) contracts.
• Currencies are *always traded in pairs*, like USD/INR (US Dollars: Indian Rupee).
• In a currency pair, the currency on the left is base currency and the currency on the right is quote currency.
- *For example*: if USD/INR is 73.75 it means that you can buy 1 US Dollar against 73.75 Indian rupees.
• **Pip** - A point in price is the smallest movement (change) in the valuations of the currency pair.
- *For example*, if the USD/INR rate is 73.7502 today and it was 73.7501 yesterday, then the pip is 0.0001 (or 1 pip)
• **In India** – It is typically done *through currency derivatives* i.e. forex spot, forwards and futures contracts and the most traded currencies are the US Dollar, Euro, Japanese Yen, and British Pound.

FOREX, short for Foreign Exchange, is a marketplace where national currencies are bought and sold.

What is Yen carry trade?

- **Stimulants** – Japan's central bank, the Bank of Japan, kept rates at *zero percent between 2011 and 2016*, and below zero since 2016, to stimulate economic activity.
- **Yen carry trade** – The *low-cost borrowing of Yen incentivized global investors to use yen* to fund investments in countries like Brazil, Mexico, India, and the US, seeking better returns.
- Despite global interest rate hikes following the Russia-Ukraine war, Japan's low rates continued to drive these yen carry trades, fuelling international investments.



As per reports, the Japanese Yen carry trade market is estimated to be over 20 trillion USD.

- **Created wealth** – For the Yen carry trade to be profitable, its value must remain stagnant or depreciate against the dollar.
- Historically, there was a prolong period of weakness in Yen, allowing investors to reap substantial returns through this trade.
- **Recent policy changes** – The Bank of *Japan raised its interest rate* from 0.10% to 0.25%, for the *first time in 15 years* that has triggered volatility in global markets.
- **Unwinding of the Yen Carry Trade – I**nvestors sell off assets purchased with borrowed yen to repatriate funds and take advantage of the higher returns in yen.
- **Appreciated Yen** – This policy shift has led to a rapid 12% appreciation of the Japanese Yen against the USD, from the peak 160 Yen to 142 Yen.

How unwinding of Yen carry trade impacts global markets?

- The strengthening of Japanese Yen has adversely impacted the Yen carry trade borrowers.
- It contributed to a significant *drop in global stock markets*.
- It could contribute to *global market jitters* amidst other factors like potential US recession and geopolitical tensions.
- It leads to *shift in global investment patterns* due to changes in interest rates and currency values.
- **Impact on India** – While Sensex remained resilient, the Nifty 50 crashed 2.68% recently.
- India's trade balance with Japan can be affected by Yen fluctuations.
- A weaker Yen may benefit Indian exports to Japan, while making Japanese imports more expensive for Indian buyers.
- It can impact the cost of travel and trade between India and Japan.
    - **For example**, a weaker Yen might make Japan a more attractive destination for Indian tourists, while also affecting trade costs.

What lies ahead?

- Investors should prioritize high-quality stocks with a proven track record of delivering consistent returns.
- Maintain a strong focus on large-cap stocks, as they tend to offer more stability and resilience, especially during periods of market volatility.

References

1. Indian Express | Global Impacts of Unwinding of Yen carry trade
2. Business Standard | Yen Carry Trade blowback