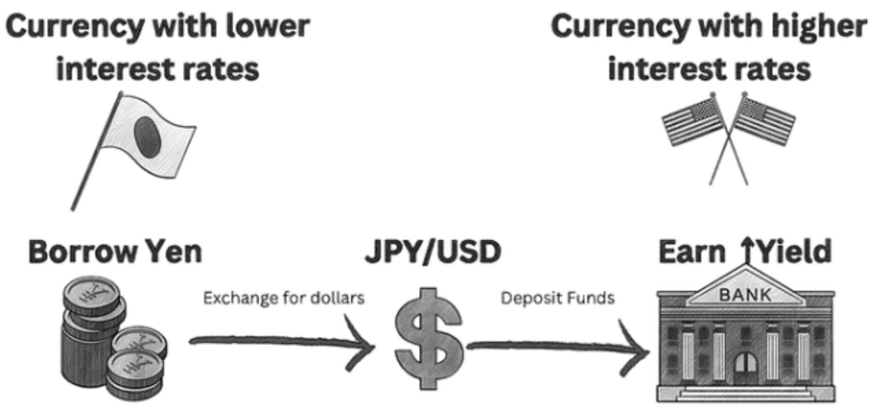
# Unwinding of Yen Carry Trade

## 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.

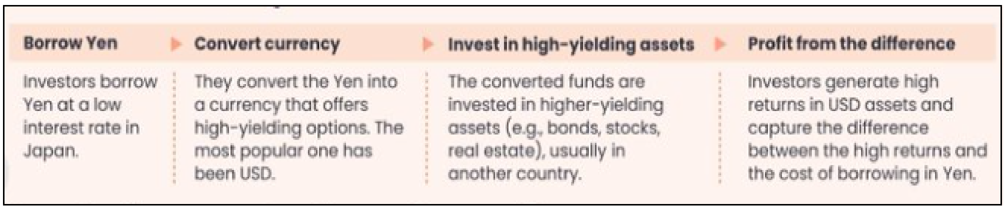
**Currency Trade**

• **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