Bank of Japan policy shift will have global impact

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Last Thursday's decision by the Bank of Japan (BoJ) to end its policy of pumping liquidity into the economy and start returning to a "normal" interest rate regime could see the beginning of a major shift in international financial markets. While the BoJ did not end its zero interest rate policy, and indicated the policy will be kept in place for some months, it has decided to halt the extraordinary measures of the past five years.

The decision was taken after data on the Japanese economy showed that gross domestic product grew at annual rate of 5.5 percent in the last quarter of 2005 and prices in January showed an increase of 0.5 percent over the previous month—the third monthly rise in a row.

Except for a brief period in 2000, the decision is the first by the BoJ to tighten monetary policy in 15 years. Interest rate cuts were introduced in the early 1990s in a bid to boost the economy and counter the effects of the collapse of the stock market after 1989. These measures did nothing to revive the economy, however, and five years ago the bank began a policy aimed at increasing the liquidity of the commercial banks in a bid to combat deflation. In the bank's view these measures have now succeeded.

However, its decision has not been welcomed by the government, which is fearful that deflation is not yet over. Last week Prime Minister Koizumi told a parliamentary committee hearing: "We can't have a situation where they shift policy and then reverse course should things go wrong." Koizumi was referring to the rate rise of 2000, which has been since characterised as "moment of madness" in the midst of deflation.

Apart from the Japanese government, major financial investors and speculators around the world will be closely watching the impact of the BoJ decision. The turnaround in Japan means that all the world's major central banks are now tightening interest rates. In the US the Fed has increased its base rate to 4.5 percent, with further rises expected later in the year, while the European Central Bank has lifted its base rate to 2.5 percent, with a further increase also expected.

The BoJ's decision is especially significant because of the importance to international financial markets of the so-called "yen carry trade". This is the process by which large operators in international financial markets borrow money at ultra low rates in Japan and use the money to invest in financial assets around the world. No one has any precise figures but it is estimated that there are trillions of dollars tied up in the yen carry trade, involving hedge funds, insurance companies and mutual funds.

Shortly before the BoJ made its decision, an article in the British *Daily Telegraph* pointed to the possible financial turbulence that could result from turning off the "cash machine" that has sustained world financial markets.

"The carry trade has pervaded every single instrument imaginable, credit spreads, bond spreads: everything is poisoned," David Bloom, a currency analyst at HSBC told the newspaper.

"It's going to come to an end later this year and it's going to be ugly, even if we haven't reached the shake-out just yet. People have a Panglossian belief in the march of global capitalism but that will change as soon as attention switches back to US financial imbalances," he said.

Low interest rates around the world have played an important role in securing the $2 billion inflow needed to finance the US current account deficit.

An economist at Monument Securities, Stephen Lewis, warned there were "several hundred billion

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dollars of positions in the carry trade" that would be unwound as soon as they started to become unprofitable. "The world has never been through this before, so there is a high risk of mistakes."

The amounts involved are huge. The Bank for International Settlements (BIS) estimated last year that the turnover in the exchange and interest rate derivative markets is $2,400 billion per day.

Besides helping to fund the US deficit, the carry trade has played an important role in providing the financial fuel that has lifted so-called "emerging markets" in the past year.

As the BIS noted in its latest quarterly review issued last week: "Asset prices across emerging markets soared early in the new year. Bonds, equities and currencies all rallied strongly in January and February. This came on top of impressive gains in 2005 and in many cases drove valuations close to or above their historical highs."

The "emerging market" rally, it noted, "was driven in large part by massive inflows of foreign capital". This inflow could not be explained only by an "improvement in fundamentals". "Investors' appetite for risk appears to be just as important a factor."

In other words, given the relatively low rate of return in developed markets, financial investors have been using cheap money to take on riskier investments in "emerging markets" in an effort to secure higher profits.

But to the extent that such investments—in bonds, shares, corporate debt, currencies, land and other assets—are based on easy money, they could rapidly unravel as interest rates tighten.

Last month there was a warning of what could occur. The Icelandic krona fell sharply after a debt downgrade by Fitch, the credit rating agency. The krona sell-off led to weakness in other emerging market currencies as speculators sold off high-yielding investments. While the situation stabilised, the krona sell-off was a reminder of the 1998 financial crisis, which started with a plunge in Thai baht and eventually led to the biggest downturn in the Asian region in the post-war period.

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