Pressures building up in yen carry trade

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One of the consequences of the intensifying contradictions of the global financial system is that an attempt to solve problems in one area often leads to their emergence in another. This is certainly the case with the value of the Japanese yen in global currency markets.

At the end of July, the US and Japan carried out a joint intervention to try to halt the decline in its value against the US dollar.

The US joined the operation with the claim it was "helping out" a friend. In fact, the intervention was undertaken by Treasury Secretary Scott Bessent to defend the US and its financial markets. He feared that Japan would be forced to sell dollars to defend the yen, leading to a decline in the value of US long bonds and a rise in their yield (interest rate).

The intervention was undertaken in such a way as to avoid this problem. The US made available to Japan dollar funds from the US Treasury so that it did not have to sell dollar assets, while its own operations to support the yen were carried out by using euros (unbeknownst to the European Central Bank).

Underscoring the significance of the issue, Bessent warned that "disorderly yen markets can trigger forced unwinds, which could destabilise global markets."

However, the operation largely failed when the yen, after an initial bounce, started to fall again. Bessent again intervened to apply pressure to the Bank of Japan to lift its interest rate, which it did by a quarter of a percentage point last Friday. But so far this has had little effect, meaning that further interest rises will be needed to halt the yen's downward slide.

But significant moves in this direction, while they may arrest the yen's slide, can cause another problem by undermining the so-called yen carry trade, which plays a major role in US financial markets.

For almost 30 years, hedge funds and other investors have been taking out loans in the Japanese currency at low interest rates to make bets in markets around the world, particularly the US.

The size of the trade has been difficult to assess, but it has been estimated to exceed $2 trillion and is at the highest level it has ever been. It has played a significant role in the US Treasury market and more recently in providing finance for the AI boom.

The trade depends on the maintenance of low interest rates in Japan and a low value of the yen.

If either of these begins to rise, then the value of the dollar assets of investors falls in relation to the yen in which their loans have been taken out. This can lead to margin calls from lenders (demands to increase the collateral for their debts) and a sell-off of dollar assets to meet them.

A recent article in the *Financial Times* (FT) on the risks of the carry trade set out some of the sources of instability, citing comments by Masayuki Nakajima, a senior strategist at the Mizuho Bank, one of the three largest in Japan with global operations and assets of $1.9 trillion.

Nakajima characterised the yen carry trade as "one of the main potential sources of market instability."

"Japan is by far the biggest source of foreign direct investment into the US. So if those flows reversed, it would probably have a significant effect on global markets as well as the global economy," he said.

The impact of any unwinding or reversal of the yen carry trade has already been seen, as recently as July-August 2024 when, after a sudden decline in the market value of AI and tech stocks on Wall Street, the value of the yen began to surge.

What followed has been the subject of a detailed study by the Bank for International Settlements (BIS).

"In the first days of August 2024," it said, "financial markets were rocked by an episode of significant volatility. The peak of the stress occurred on 5 August, when the Japanese TOPIX index [one of the two main

Tokyo stock market indexes] lost 12 percent in a single day and the VIX [an index of volatility] registered levels not seen since Covid-19.”

It said that market strategies that relied on extensive leverage and were based on the continuation of relative stability were “forced to unwind. Among them, currency carry trades, especially those funded in yen, were the hardest hit.”

One of the most significant features of the 2024 unwind was that it took place in the wake of what the BIS report characterised as “seemingly minor economic news.”

There was a rate rise by the Bank of Japan, a more cautious approach to rate cuts by the US Federal Reserve and a “disappointing US labour market data release” but nothing that could be taken as “an unequivocal sign of a deteriorating outlook… yet, markets had become hyper-sensitive to any signs of a change in growth momentum and in the associated monetary policy outlook.”

The report concluded that while the volatility passed relatively quickly, the turbulence revealed “structural features” of the financial system, particularly “the build-up of large positions [relying on debt] in periods of calm and necessitate their quick unwinding when volatility rises.”

The reliance on leverage, it continued, meant investors would have to respond more strongly to adverse shocks and if this took place “in a jittery and illiquid market environment, volatility could be further exacerbated, and a negative feedback loop be kindled.” In short, rather than being a passing phase, sharp movements in the yen carry trade could set off a much broader and deeper crisis.

If a major disturbance could be set off two years ago on “seemingly minor economic news” then what of the situation today? The Fed has initiated rate hikes for the first time in three years, the Bank of Japan has now lifted its interest rate to the highest level since 1995, and US long-term bonds are trading with yields higher than they have been in almost two decades.

This new situation has brought warnings that the yen carry trade could be the source of a significant crisis of the entire financial system.

According to Shrikant Kale, an analyst at the major financial firm Jefferies, whose remarks were reported in the FT, cross-border borrowing of yen by hedge funds as well as banks and corporations, increased by 67 percent to $2.3 trillion between December 2021 and March 2026.

This build-up in yen-funded leverage meant that “the current cycle is by far the largest build-up of the past three decades, highlighting the potential vulnerability of global markets to a disorderly unwind.”

The FT noted that for years “the speculative carry trade” had put downward pressure on the yen but now analysts are “wrestling with the prospect of that being reversed” and even the fear of such an outcome is causing investors to rethink how safe their positions really are.

As foreign exchange analyst at Citi, Osamu Takashima, put it: “Once doubts arise about their dollar positions abroad, hedging transactions and repatriating [of capital] this time could be unprecedentedly severe.”