

Japan economy

The U.S. Dollar's Amazing Strength in the Deepening Financial Crisis

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Amid the deepening global financial crisis triggered by the U.S., the dollar has encountered mounting downside pressures, including large interest rate cuts by the Federal Reserve. Nonetheless, it has actually appreciated in value since March 2008. This can be explained by its role as a key currency, which requires central banks to provide significant amounts of dollar liquidity amid the financial crisis.

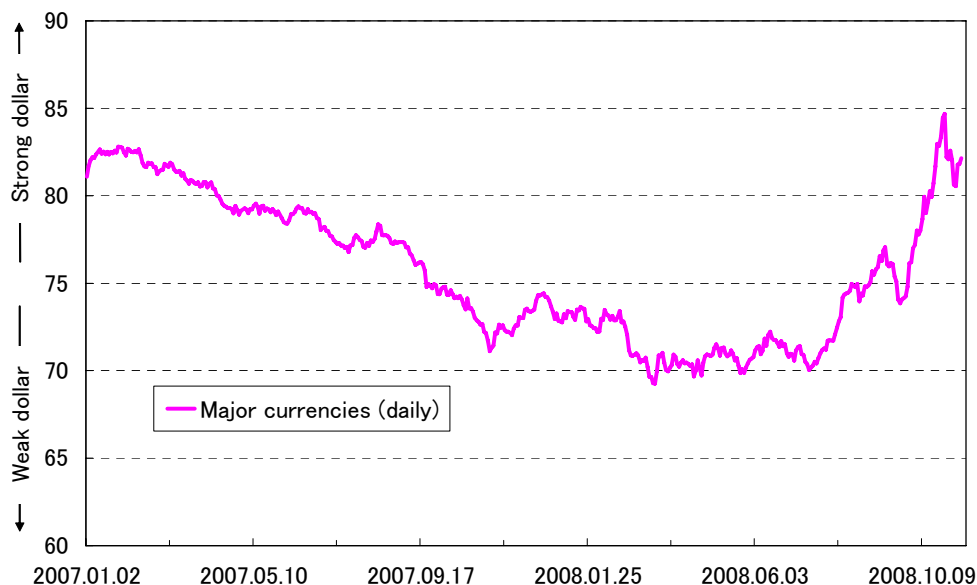
Normally, when a country's economic fundamentals deteriorate due to financial or economic turmoil, its currency depreciates in value. By this reasoning, since the U.S. has recently suffered from both, the dollar should have been battered down by weak fundamentals. Moreover, aggressive rate cuts by the Federal Reserve have reduced the federal funds rate target from 5.25% to 1.0%, adding further downside pressure on the dollar. Yet amazingly, the dollar's value has actually appreciated in currency markets this year.

Indeed, the nominal effective exchange rate index of the dollar has risen persistently since bottoming out in the Bear Stearns crisis in March 2008.

Despite deteriorating confidence in the dollar, global financial markets face significant dollar funding pressures due to the dollar's role as a key currency for international trade settlement. To address dollar funding pressures amid the growing credit crisis, central banks have significantly expanded their dollar liquidity-providing operations, bidding up the dollar.

Meanwhile, in contrast to other currencies, the yen has been appreciating even against the dollar (Exhibit 2). Two powerful forces explain this phenomenon. First, based on purchasing power parity, the yen exchange rate was undervalued for a long time, and has been making a correction to the appropriate exchange rate level, seen as a dollar rate in the 90 yen range.

Exhibit 1 Nominal Effective Exchange Rate Index of the U.S. Dollar



Source: U.S. Federal Reserve.

The second factor is the reversal of the yen carry trade. Domestic investors who were heavily invested abroad due to low domestic interest rates have reacted to the global financial crisis by pulling out of dollar and euro-denominated positions. Meanwhile, foreign investors engaged in the yen carry trade (borrowing low-interest yen loans to invest in currencies that offer a higher interest rate) have aggressively bought back the yen to cover yen positions and repay loans. These activities have exacerbated the yen's movement toward the appropriate exchange rate level, causing temporary overshooting.

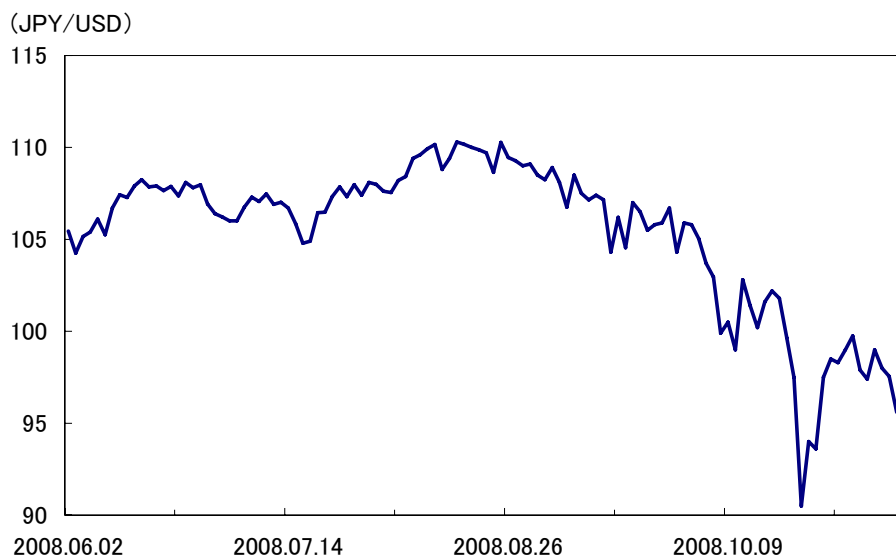
Since October, the yen has made large gains in currency markets. In particular, the yen surged from October 22, when the stock market slumped, and on October 24 rose above the 100-yen exchange rate level for the first time in 13 years. In response, on October 27 the G7 issued a joint statement regarding "excessive yen gains" as follows: "We are concerned about the recent excessive volatility in the exchange rate of the yen and its possible adverse implications for economic and financial stability." It was the first joint statement on the yen since the Tokyo Summit in January 2000. On October 31, the BOJ cut its overnight lending rate by 0.2%, the first cut of this size since the quantitative easing and near-zero interest rate policy were launched in March 2001. However, this action was not enough to restore the dollar rate to the mid 100 yen level, where it had been last summer.

Recent interest rate trends in the short-term dollar funding markets suggest that the dollar liquidity shortfall will continue for some time. However, as countries strive to mitigate the financial and economic crises, the dollar liquidity shortfall should eventually ease up. When this happens, upward pressure on the dollar will gradually abate.

When dollar funding pressures eventually subside, several scenarios appear possible for the dollar. For example, a belief that the financial crisis has subsided could restore confidence in the U.S., thereby strengthening the dollar. Alternatively, upward pressure on the dollar could simply dispel, causing demand to shift to the greatly undervalued euro, or else renewing fondness of the yen.

The financial crisis has caused large and sudden shifts in the balance between national currencies. Looking ahead, with major developments expected to unfold in the financial markets, currency markets will remain highly volatile. Japan's economy now suffers from a domestic demand slump, while exporters confront a severe decline in external demand. As such, further appreciation of the yen is of paramount concern to the economy's recovery.

Exhibit 2 The Yen's Dollar Rate



Source: Bank of Japan.