The G7 sends Japan a sympathy card

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THE G7 has waded into foreign exchange markets to push down the yen, its first coordinated currency intervention in more than a decade. The actions have, in the short-term, worked: the yen, which had risen to a post-war high of 77 per dollar a few days ago fell back to almost 82 and is now around 81.

Christine Lagarde, finance minister of France, which chairs the G7, reportedly wants discussion of other steps to help Japan including buying its bonds. How that could be done without also pushing up the yen clearly needs some thought.

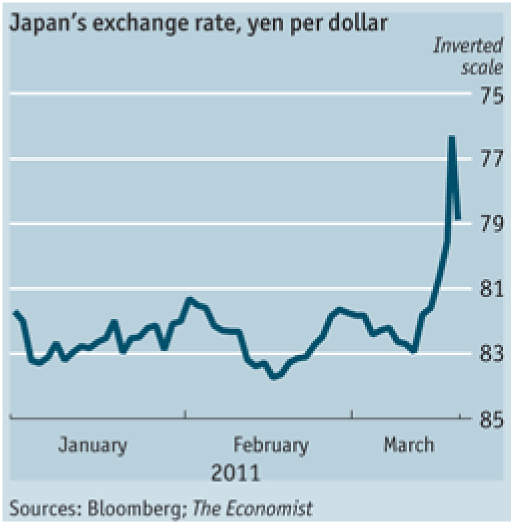
Central banks and finance ministers have generally shied away from forex intervention in the last decade both over a conviction, in particular in America, that it doesn't work, and a lack of alignment between the various countries' objectives. Most countries in recent years have wanted weaker, not stronger, currencies, and countries that sought intervention to hold down their currencies have had to do so by themselves.

Two things altered the calculations for the G7 this week. The first was an overriding desire to show sympathy for Japan's economic plight. That this was primarily a humanitarian rather than economic gesture was belied by the G7 statement: "We express our solidarity with the Japanese people in these difficult times." Japan may need logistical and technical help but it doesn't need financial help the way Pakistan or Haiti did. Nudging the yen down will help soften the impact on Japan's export sector (which is why Japan asked for the intervention), but the long-run impact will be minimal.

The second factor weighing in favour of action was that the yen's move could not be justified by economic fundamentals. <u>While there might be some Japanese repatriation of foreign investments to pay for reconstruction, there is no evidence such flows have begun in earnest. The run-up in the yen seemed to be driven by short-term trading dynamics. There may be speculative buying in anticipation of repatriation flows, but more important, many investors have built up huge short yen positions over the years as part of the carry trade. Many had to rush to close them as the yen climbed, fueling the rise. In the long run, weaker Japanese growth and easier monetary policy seem to dictate a weaker, not stronger, yen</u>. Intervention that pushes a currency back in the direction favoured by fundamentals is more likely to be successful.

One of the concerns at the back of the G7's minds is the political capacity of the Japanese government to handle its combined economic and humanitarian crisis. Yoshihiko Noda got the finance minister job less than a year ago, replacing Naota Kan when he became prime minister. Prior to the crisis, Mr Kan's government was grappling with multiple setbacks. His respected foreign minister had resigned over a campaign finance scandal and the opposition, which controls the upper house, was threatening to block bills necessary to fund the government.

Amid the general chaos of Japan's political apparatus, the Bank of Japan has emerged as a beacon of competence. Masaaki Shirakawa, the governor, is respected and familiar face in western circles (it helps that he is fluent in English). <u>Within hours of the disaster the bank began, and continues, to inject massive sums into the money markets and it expanded its asset purchase programme by ¥5 trillion (or $60 billion) to ¥40 trillion. These moves should tamp down panic-driven demand for cash, add some monetary stimulus, and weaken the yen</u>. The bank has often been criticised in the past for the timidity of its response to Japan's slowly-unfolding deflationary torpor. The same could not be said for its response to the rapidly developing events of the last few days.



<u>Note</u>: "Carry trade" refers to investors borrowing low-yielding currency (currency of an economy with a low interest rate) to invest in high-yielding currencies. Compared to the dollar and the euro, the yen can be considered a low-yielding currency.

Q1. Explain why an investor that has borrowed yen and invested them in US financial assets may wish to buy yen when the yen appreciates (think, alternatively, of an American citizen who has purchased a house in the US after converting into dollars a loan in yen).

Q2. Explain why, in the long run, easier (= expansionary) monetary policy dictates a weaker (= less valuable) yen. Refer in your explanation to models explained in class.

Q3. Explain how the BoJ's expanded asset purchase programme tends to weaken the yen. Refer in your explanation to models explained in class.

Q4. What does the chart in the following page suggest: that the interest rate in Japan is high or low? Provide explanations using the information furnished by the two curves.

Japanese banks. Home and away

Dismal domestic prospects make Japan's big banks look abroad

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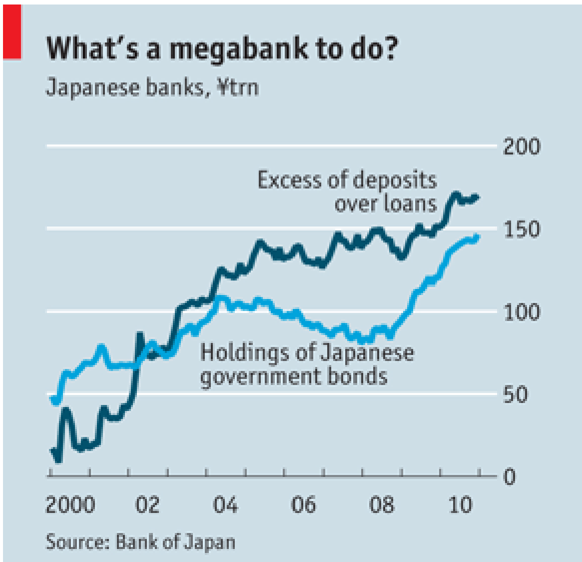
BANKS in Japan have been cast in various roles over the past decades. During the country's economic rise, they were the custodians of the nation's wealth and the catalysts to its industrialisation. Then they were the authors of Japan's bust, and later its victims. Now they want to try acting like proper global businesses.

The industry has cleaned itself up following the non-performing-loan debacle of the 1990s. Its preoccupation with internal problems helped spare it the worst of America's subprime-mortgage fiasco. Japan's three "megabanks"—Mitsubishi UFJ Financial Group (MUFG), Mizuho and Sumitomo Mitsui Financial Group (SMFG)—are stuffed with deposits. MUFG alone has deposits of ¥129 trillion ($1.6 trillion), making it the second-biggest bank in the world on this measure. The problem is knowing what to do with all that cash.

The banks are profitable. In the fourth quarter of 2010, MUFG's net profit jumped by 150% to ¥552 billion, SMFG's net profit doubled to ¥515 billion and Mizuho's soared by 230% to ¥422 billion. But their returns on equity trail their American and European peers. Their business is largely domestic and the long-term prospects for the Japanese economy are dim.

Loan volumes have fallen for 14 consecutive months. There is little capital investment: companies are sitting on a cash hoard of around ¥200 trillion. Almost half of listed firms have more cash than debt. And when they need financing, companies increasingly turn directly to the market rather than to banks. The open secret of corporate Japan is that firms despise banks, which pressed bosses to take loans they did not need during the 1980s.



The retail-banking sector is just as bleak. Japanese savers have assets worth about ¥1,500 trillion, but around half of that is lying in cash or certificates of deposits that earn very little interest. This is not altogether irrational. The Japanese stockmarket has been sickly for years. Persistent deflation means that cash has more buying power over time. The financial crisis has made depositors happier to keep money in the bank, too.

Lenders have long tried to coax savers to shift into higher-yielding investments. The sales of investment trusts (a sort of mutual fund) have risen: MUFG's income from trusts has jumped by one-third over the past two years. But the market is still undeveloped. And since the banks spruced up their operations by shedding workers and consolidating branches, they now have thin branch networks and employees who are ill-equipped to sell investment products to a cautious public.

With few other options available, Japanese banks have increased their holdings of Japanese government bonds (JGBs). In recent months the megabanks have been sellers of JGBs: the profits help explain their good results last quarter. But JGBs still make up a big chunk of their assets (see chart). On February 22nd Moody's downgraded Japan's credit rating; Standard & Poor's did the same in January. The banks' bond holdings, long seen as ultra-safe, are slowly starting to look more like a risk.

Amid the domestic malaise, the Japanese are eyeing foreign markets. Nomura, a broker, made the splashiest acquisition of all with the purchase of the European and Asian arms of Lehman Brothers. MUFG has bought failed banks in America to roll into Union Bank, a Californian lender with assets of $80 billion. It paid $9 billion for a 21% stake in Morgan Stanley in the heat of the crisis, and says its joint venture with the American investment bank is helping it win lending business abroad. The bank also has ambitions in the area of project finance: in the autumn it bought Royal Bank of Scotland's project-finance loan book. For its part, SMFG debuted on the New York Stock Exchange last year, giving it paper for potential acquisitions in America. Mizuho paid $500m for a 1.6% stake in BlackRock, a huge asset manager.

The banks are busy in their own backyard, too. Japanese firms are very active in China, for example, and the likes of MUFG have built up big businesses following them there. Now the task is to diversify their loan books. SMFG's boss, Teisuke Kitayama, is keen to expand overseas lending to non-Japanese firms in Asia. Mizuho aims for alliances or stakes in local institutions and is hiring throughout the region.

The banks' international ambitions may yet be hobbled by new bank-capital rules. Under Basel 3, firms that are designated "global systemically important financial institutions", or G-SIFIs, have to set aside more equity to guard against unexpected losses. Ever conscious of status and hierarchy, some Japanese banks may not want to be left outside a new premier league of international banks. The lenders say they are well-capitalised in the event they are considered G-SIFIs; analysts generally agree. Yet Japanese banks cannot pursue many more foreign deals until they know how much capital they will need.

Previous forays abroad have not ended well. Japanese bankers have a reputation for arriving late, paying too much, mismanaging things and then leaving with losses. Most analysts (privately) say that success is no more likely this time round. The top brass in Tokyo are too insular. Banks continue to parachute in Japanese executives to run operations abroad rather than picking talented foreigners. The megabanks promote their leadership in formation from the various institutions out of which they were cobbled together.

Escaping their domestic obligations will not be easy, either. In 2009 the government forced Japan's banks to accept a three-year debt moratorium for small companies, which quickly soared into the trillions of yen. In January it leant on megabanks to ease life for thousands of small firms stung by losses on foreign-currency derivatives. The banks may have ambitions to play a starry new role, but at home and abroad they will have a hard time not being typecast.