

CHAPTER 7 – International Arbitrage and Interest Rate Parity

Yen Rises Most in Seven Weeks Versus Euro on Growth Outlook

By Min Zeng

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Oct. 22 (Bloomberg) -- The yen rose the most against the euro in almost seven weeks on speculation slowing economic growth will encourage carry-trade investors to reduce investments financed by borrowing in Japan.

Japan's yen increased against all of the 16 most actively traded currencies after the Group of Seven nations said in a statement on Oct. 19 that the rising cost of credit, record oil prices and the U.S. housing slump will sap global expansion. European and Asian equities fell on the G-7 outlook, while the Dow Jones Industrial Average erased an earlier decline and rose for the first time in six days.

“There is only one game in town, risk aversion,” said Alan Ruskin, head of international currency strategy in North America in Greenwich, Connecticut, at RBS Greenwich Capital Markets Inc. “The credit issue is back in the front of people's minds.”

The yen rose 1.4 percent to 161.56 JPY/EUR at 2:40 p.m. in New York after touching 160.48, the highest since Sept. 18. Japan's currency strengthened 0.3 percent to 114.12 JPY/USD after touching 113.26, the strongest since Sept. 10.

In the carry trade, investors borrow in countries with low interest rates, such as Japan, and invest the proceeds where rates are higher. Overnight lending rates in Japan average 0.5 percent, compared with 6.5 percent in Australia and 8.25 percent in New Zealand. The yen rose about 1 percent against the AUD and NZD, two beneficiaries of the carry trade. The AUD was trading at 100.2 JPY/AUD. Japan's currency also increased 1.2 percent against Brazil's real and 0.8 percent versus the South African rand.

“Bit of Pressure”

“Risk appetite is under a bit of pressure,” said Paul Robson, a currency strategist in London at Royal Bank of Scotland Group Plc. “The yen is benefiting.” Japan's currency pared its gain against the dollar after U.S. stocks rebounded. The Dow and the Standard & Poor's 500 Index both increased more than 0.2 percent.

The USD rose the most against the euro since July 2006 as investors sold higher-yielding holdings and sought safety in some U.S. assets. The U.S. currency also got a boost as some investors sold the euro to pare carry trades, said Neil Jones, head of European hedge-fund sales in London at Mizuho Capital Markets.

The dollar appreciated 1 percent to 1.4155 USD/EUR after falling to 1.4348 USD/EUR, the lowest since the European currency's debut in January 1999. The New York Board of Trade's dollar index measuring the currency's value against six counterparts including the euro and the yen increased about 1 percent, the most since July 2006, to 77.978, after earlier dropping to the weakest since the index began in 1973.

Euro-Yen Volatility

Volatility on one-month euro-yen options rose to 12.4 percent, the highest since Sept. 18. The volatility increased to 26 percent on Aug. 17, the highest since Bloomberg started to track the data in January 1999. Higher volatility may discourage carry trades because it implies the bets will be exposed to bigger exchange-rate fluctuations. The dollar-yen and pound-yen options also rose.

Oil fell from last week's record high and gold and copper prices dropped on speculation credit-market losses may stunt economic expansion, curbing demand for energy and metals.

G-7 finance ministers and central bankers urged investors to address “shortcomings” in risk management. It was the first time they met since a collapse in demand for assets backed by U.S. subprime mortgages sparked a surge in international borrowing costs.

G-7 on Dollar

The policy makers who conferred in Washington set aside differences over the dollar's drop to a record low against the euro, sticking to past language in saying "excess volatility" in currencies is "undesirable" and that they should trade in line with fundamentals. Aside from urging China to let the yuan appreciate, no specific currency was mentioned.

"The G-7 ministers don't seem to be taking concerns about dollar weakness seriously," Mizuho's Jones said. "The statement can be seen as a green light to sell."

Former Federal Reserve Chairman Alan Greenspan said the dollar's decline may reflect less demand for U.S. debt. "Obviously there is a limit to the extent that obligations to foreigners can reach," Greenspan said in a speech in Washington yesterday. The dollar's decline may be "an indication America is approaching this limit."

International investors sold a record amount of U.S. financial assets in August, with total holdings of equities, notes and bonds falling a net \$69.3 billion, after an increase of \$19.2 billion in July, the Treasury said last week.

Questions

1. Describe a carry trade for a Japanese firm doing business with Australia. Calculate the profits for the Japanese investor.
2. Are "carry" trades arbitrage trades? Explain. Describe a scenario where a carry trade does not work.
3. Refer back to your answer to question 1. Could an Australian firm benefit from arbitrage in the same manner as Japanese firms? Explain.
4. Calculate the one-month Forward rate for the JPY/AUD exchange rate. Is arbitrage possible?
5. After October 22, 2007, the Federal Reserve reduced interest rates by .25 points. Explain the effect of this interest rate cut on the USD/EUR forward premium.