

## 15 March 2011 - FX Uncertainty in the Aftermath of Japan Earthquake

Generally viewed as a safe haven currency, the yen tends to gain amid major disasters. But what happens when the disaster occurs on its home soil?

The yen is increasingly volatile following Japan's massive earthquake and tsunami, falling to a two-week low against the dollar to ¥83.30 on Friday, and then bouncing back to about ¥82.20. The yen stabilized at about ¥81.85 against the dollar on Monday after the Bank of Japan (BOJ) pumped a record ¥15 trillion (\$183 billion USD) into the Japanese economy over the weekend. Additionally, in a plan similar to QE2 in the United States, BOJ Governor Masaaki Shirakawa and his board spent 5 trillion yen, buying up bonds to provide support for the economy.

At the end of last week, Ira Kawaller, president of Kawaller & Co., and managing director of the Kawaller Fund, said that the impact on the exchange rate was "more muted" than he would have expected, but noted that it is still too early to gauge. "Forecasting exchange rates is always hazardous," he said. "You could make the argument that Japan will necessarily be forced to import more due to a need to rebuild and the loss of domestic production capacity, but at the same time, the disruption to their economy will likely have income effects that will depress imports. I think the consequences are clearer on the export side: This tsunami can only be seen as hurting exports. On balance, my bet would be that the yen should weaken—just the opposite of what's happened so far."

Gareth Sylvester, Director, Klarity FX, said that many Japanese corporates and insurance companies are "liquidating foreign assets, predominantly U.S. treasuries, looking to repatriate the proceeds. They are basically getting ready for the rebuilding of the infrastructure, and cash will be required to do so. And you've also got some carry trade activity being unwound and that's giving the yen some boost. I think a little bit of the yen strength right now is going to be a positive in so much that it helps offset higher energy prices." However, he added, excessive strength in the Japanese yen may be met with central bank intervention and this may be done so with likely blessing of other major economies due to the exceptional circumstances.

Sylvester pointed out that that the BOJ's stimulus and bond buy-up could lead to the yen weakening. "If you were just to look it from an elevated viewpoint and say, 'What does this mean for Japan?' you'd argue that ultimately this is going to set Japan back a number of years in terms of the economic growth and prosperity, and that ultimately would be reflected in a weaker yen," he said.

Sylvester feels that the present uncertainty makes the yen unpredictable in the short term. "Certainly, they're in a situation where they have an ultra-loose monetary policy that isn't at all at their disposal to help to mend the economy," he said. "So there is a concern that if this disaster does drive the economy into a potential recession, then the Bank of Japan does not have that at their disposal. But the flipside is, there's going to be a lot of infrastructure rebuilding, so that could also be a stimulant."

By Andrew Deichler