

## Japan Reenters the Foreign Exchange Market

On September 15, the Bank of Japan (BOJ) responded to a 15-year high in the yen's value against the dollar by selling an estimated 1.76 to 1.86 trillion yen in the foreign exchange (FX) market. The chart captures the telltale trade volume of an FX intervention (buying and/or selling of assets by a monetary authority to influence exchange rates) and the immediate effect: a 3 percent overnight depreciation of the yen against the dollar. To achieve a prolonged impact, however, Japan will need to demonstrate a strong commitment to continued intervention.

Since the summer of 2007, the yen has gained more than 30 percent against the dollar. Analysts attribute the yen's newfound strength to increased investment demand and, more specifically, a diminished global appetite for risk. During times of high volatility and uncertainty, investors trade higher returns for increased confidence in their investments. Japan's current account surplus and deflationary price trend increase the yen's perception as a "safe haven" currency (i.e., a currency with low risk of rapid depreciation). Abnormally low interest rates in the United States and Europe only further encourage demand for the yen, a currency with traditionally low interest rates and thus a low return on investment.<sup>1</sup>

Japanese FX intervention is not without precedent. From 1999 to 2004 Japan unilaterally sold a combined, and unprecedented, 500 billion dollars of yen in the FX market. Recent research estimates that without these interventions, the yen's value would have been 30 percent higher in March 2004, the date of Japan's last intervention (Fatum, 2010). Both in the past and the present, Japanese monetary authorities turned to intervention when they viewed their economy as fragile (Ito, 2005). A lower-valued yen aids economic recovery by making Japanese goods cheaper internationally, thus stimulating exports.

If Japan is successful, it will rely heavily on the signaling channel, one of two main channels economists believe FX intervention works through. The other, the portfolio balance channel, presumes that (i) investors hold investments of varying degrees of substitutability and (ii) intervention affects asset prices by manipulating their supply. Fatum (2010) finds strong evidence of this channel operating in the immediate impact of past BOJ interventions, but the yen's retracement of its gains since September is linked to growing expectations of further U.S. quantitative easing, also reflecting portfolio balance effects (Neely, 2010). Conversely, the signaling channel informs the market of the direction of future policy

actions. The cautious movement observed in the yen following intervention indicates that investors are accounting for the positive probability of future intervention. Without the full credibility of a coordinated multilateral intervention strategy, however, the yen has already risen to a new 15-year high. Only more intervention will convince markets of Japan's commitment.

—Brett Fawley and Luciana Juvenal

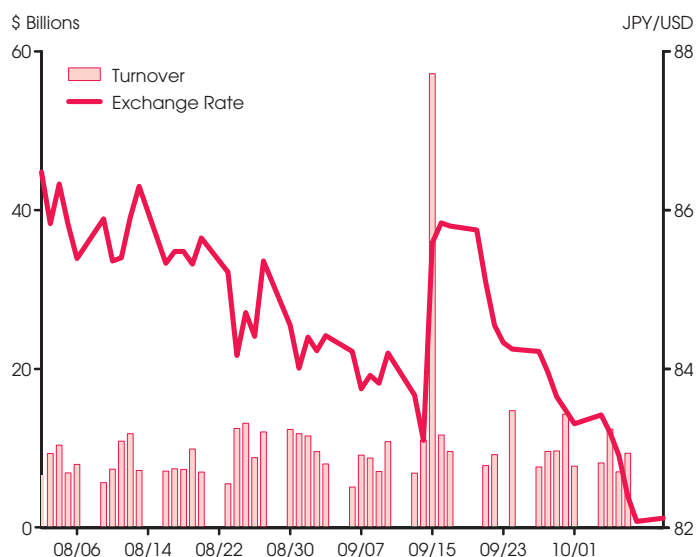
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Ito, Takatoshi. "Is Foreign Exchange Intervention Effective? The Japanese Experience in the 1990s," in Paul Mizen, ed., *Monetary History, Exchange Rates and Financial Markets, Essays in Honour of Charles Goodhart*. Volume 2. Cheltenham, UK, Edward Elgar, 2003.

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<sup>1</sup> Additionally, China is speculated to be diversifying its large foreign reserve holdings away from the U.S. dollar and toward the yen.

Exchange Rate Movement Around September 15 BOJ Intervention



NOTE: Turnover data are from the Bank for International Settlements and include all trades handled through brokerage companies in the Tokyo exchange market, where the BOJ primarily operates ([www.boj.or.jp/en/type/exp/faqkainy.htm](http://www.boj.or.jp/en/type/exp/faqkainy.htm)). The foreign exchange rate is from Haver Analytics. Dates are for 2010. JPY, Japanese yen; USD, U.S. dollars.