Rare Joint Currency Action from the G-7 Central Banks

Pornpinun Chantapacdepong

Economist

Monetary Policy Group

THE RECENT devastating earthquake in Japan with such a magnitude was extremely rare event in the natural world. In the world of financial markets, something extremely rare and worth our attention also happened last week. After the natural catastrophe and unfolding nuclear crisis, the Yen surged to approximately 76.25 Yen per US dollar, a record high since the World War II, breaking the psychological level of approximately 80 Yen per US dollar since the Kobe incidence in 1995. The underlying reason behind the appreciation of the Yen was the expected inflows of repatriated funds and unwinding of the Yen carry trade.

One striking phenomenon, along with the Yen appreciation, was the re-introduction of the joint currency intervention on 18 March 2011. The G-7 launched the first coordinated currency intervention since 2000 and pledged to do more if needed. In face of fragile global economic recovery, the G-7 could not afford to see Japan, the world's third largest economy, going into deep recession as it could cause the widespread economic impact.

Looking around, while the foreign exchange intervention has been common among the emerging market economies, most developed countries do not actively do so. One reason is that intervention has no lasting power to influence the real exchange rate and the competitiveness of the tradable sectors. Secondly, large-scale intervention can hamper the development of its own foreign exchange market. Lastly, private financial markets in developed countries have enough capacity to cope with shocks, so that there is no need to "guide" the exchange rate.

Despite aforementioned limitations of the foreign exchange intervention, such severe event and the potential adverse impact on the global economy necessitated the coordinated intervention. Shortly after the intervention, both actively and verbally, the Yen bounced back and move fairly steadily. Given relatively small size of intervention in the market, the concerted intervention demonstrated its capability to anchor the expectation on the dynamic of exchange rate movement. The success of the intervention was due in part to the credibility of the G-7 actions. Indeed, the joint intervention was called for in order to dampen market volatility rather than to reverse the Yen's strengthening trend.

In sum, given the large size of global financial markets, the long-term movement of the Yen will be driven by paces and timing of Japanese economic recovery. Moreover, with an uncertainty in economic recovery and the ample liquidity in global financial system, the movement of the Yen is likely to be volatile going forward. Therefore, for those who have to do business with Japanese, it is important to be more vigilant and monitor the trend and outlook of the Yen closely. Last but not least, my heartfelt support goes to the Japanese and those who have been affected by this tragic event.

(The views expressed in this column are the writer's own.)

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