BoE, Not BoJ, May Pop the Carry-Trade

The "yen carry-trade" in currency markets is at 97% of its highest volume ever; the Swiss franc carry-trade, about one-third the size, is at 93% of its record volume. As much as $250 billion worth of yen annually, may be being borrowed out of Bank of Japan currency emissions for speculation worldwide—BoJ's discount rate has only just been raised from 0.25% to 0.50%, compared to 5.25% for the Federal Reserve and Bank of England (BoE). Speculators or central banks playing the carry-trade make 1) that rate difference, just in overnight bank lending—potentially much more than in other kinds of speculation—and 2) additional profit from the steady cheapening of the yen against other major currencies, which the carry-trade brings with it. One fund manager acknowledged, "If you didn't have a yen carry-trade on, you didn't make money last year [2006]" in international currency trading.

Combined with the equally huge dollar-printing surge of the Federal Reserve's M3 money supply—for which there have been no published figures for a year, but is estimated by one economist to be growing at over 11% annually—the yen carry-trade is the ultimate source of the apparently vast liquidity, or "leverage," feeding global financial bubbles.

The flood of reserves out of the yen has gone into sterling, euros, and dollars; but first and foremost, into sterling. While the total volume of international currency reserves held by central banks has multiplied incredibly since 1995—from $1.3 trillion to $4.8 trillion—the sterling portion of it has risen from under 3% to 4.3%. But much more leverage-giving, in the 30% of those central bank reserves which are invested in bank lending, and not in government bonds, the proportion of sterling has risen rapidly to 12%. And the center of hedge-fund activity has shifted toward London and Britain's Cayman Islands tax havens.

What might turn the carry-trade's large, "free" profit margins into losses and a "reversed leverage" crash? Closing the interest rate differentials, *and* a reversal in the constant cheapening of the yen. The Bank of Japan is in no position to cause this. It was under so much pressure over the Feb. 21 interest-rate hike, that it printed and emitted 2.1 trillion yen (about $18 billion worth) into the banking system the previous day, to keep the yen from rising—and so far, it has not. Swiss National Bank head Jean-Pierre Roth attacked the carry-trade in the Swiss franc on Feb. 22, and warned of a round of rate increases, but the Swiss also have relatively little leverage.

But the Bank of England, and the City of London, increasingly in the driver's seat in overnight reserves and as a world financial center—*could* pop the carry-trade, by starting a plunge in the pound which would torpedo the dollar. The BoE is threatening. Twice in the past month, BoE governor Mervyn King has issued statements or reports, calculated to send the pound sliding from its landmark highs of late January.

Last time the carry-trade was at record levels and then was punctured and quickly "unwound"—in 1998, with the Russian GKO bond default and subsequent LTCM hedge-fund meltdown—the dollar fell by 20% over the following two years. Lyndon LaRouche has warned repeatedly that London, and some stupid U.S. economic interests—are threatening to trigger a *further* 20% dollar plunge, and international monetary and financial chaos.

—Paul Gallagher