**Euro's Rise Against Dollar Unlikely to Concern ECB Yet**

By Clare Connaghan

The euro continued its march higher against the dollar Friday, coming within touching distance of its strongest level of the year in a shift that will likely pinch exporters in a fragile economy. But economists say the currency will need to crank even higher before the European Central Bank raises any concern.

The 17-country currency rose to $1.3704 against the dollar, just shy of the $1.3711 high point for the year hit Feb. 1, amid a broad retreat in the dollar driven by increasingly confident expectations that the U.S. Federal Reserve will keep stimulus measures going for longer after the temporary U.S. budget deal.

"It's dollar weakness," said Lutz Karpowitz, a currencies strategist at Commerzbank in Frankfurt. "The likelihood has increased the Federal Reserve will extend its very expansionary monetary policy for longer than expected and that's a reason to sell the dollar," added Mr Karpowitz.

Congress passed legislation Wednesday to reopen the U.S. government after 16 days of shutdown, but the deal is only until Jan. 15, which means negotiations over the budget and raising the debt ceiling will resume. The temporary solution has driven investors and traders to revise their expectations for the Fed to start unwinding stimulus measures to 2014, which has put the dollar under selling pressure.

"We know there is very dovish stance in the FOMC, so this is a perfect argument for them to go on buying bonds for a longer time," said Mr Karpowitz.

Since Wednesday the dollar has been weakening across the board; notching up losses of 1.5% against the pound and slumping to a four-month low against the Australian dollar of $0.9680.

But it's the eight-month low the dollar has tumbled to against the euro that could raise attention given the euro area's sensitivity to currency strength in the past.

"You might get finance ministers making some noise (about euro strength), particularly with the Ecofin next week," said Neville Hill an economist at Credit Suisse in London.

A strong currency makes exports appear relatively more expensive to trading partners and reduces the attractiveness of foreign investment.

The euro zone's economy grew 0.3% in the second quarter of the year after 18 months of contraction, ending the region's longest postwar slump. The recovery remains weak and a stronger euro could have a "significant drag" on the bloc's economic growth, says Frederik Ducrozet, a senior euro-zone economist at Credit Agricole in Paris.

Although it's not just the currency's strength against the dollar that matters, it's about how the euro trades against a basket of currencies, says Mr. Ducrozet.

"In nominal and real terms I think the real effective exchange rate is not that much above its long-term average so that will be a first reason for officials to be less worried and for the ECB to be less concerned this time around," Mr. Ducrozet added.

Earlier this month European Central Bank President Mario Draghi passed up the opportunity to attempt to talk the 17-country currency down. Asked repeatedly whether he saw the euro, which was trading around $1.35 at the time, as too strong, he said that "the exchange rate is not a policy target".

For now, the euro isn't at the point where the ECB will start voicing any concern, says Mr. Hill. But should the single currency appreciate toward $1.40 against that dollar, then the central bank might start saying it could have a "meaningful impact on inflation" added Mr. Hill.

Eurostat data Wednesday confirmed the bloc's inflation rate was at its lowest in three-and-a-half years in September, at an annual rate of 1.1%.

"In the coming months euro strength could put downside pressure on HICP inflation in euro-zone to be 1% or below and that is something the ECB could react to," says Mr. Ducrozet.

The next ECB governing council meeting is scheduled for November 7.

**Milestone for Yuan Marks Rise of China**

**Yuan Rises to Ninth-Most-Actively-Traded Currency Globally**

By

Nicole Hong,

Clare Connaghan and

Tom Orlik

China for the first time joined the ranks of the most-traded international currencies, underscoring the rise of the world's second-largest economy and the growth of the global foreign-exchange market.

The Chinese yuan vaulted to ninth in the Bank for International Settlements' latest report on foreign-exchange turnover, surpassing the Swedish krona and New Zealand dollar, among other widely used currencies.



Trading in the Chinese currency, also known as the renminbi, has more than tripled over the past three years, to $120 billion a day in 2013, the BIS said, referencing survey data from April. Daily U.S. dollar trading in 2013 has averaged $4.65 trillion.

Yuan gains highlight China's ambitions to play a larger role in a market long dominated by the dollar and, to a lesser extent, the euro. Daily global currency flows have risen more than 30% in three years. The yuan ranked 17th in the previous BIS survey, in 2010. The shift also highlights the international nature of the manufacturing supply chain and the flexibility U.S.-based firms can gain by using yuan.

The report also showed the continued dominance of London as a foreign-exchange hub: 41% of daily average currency trading took place in the U.K., up from 32.6% in 1998. The U.S. share of the currency market grew slightly over the same period, rising to 18.9% in 2013 from 18.3% 15 years earlier.

Like the rising yuan, the Mexican peso ranked among the top-10 most-traded currencies. It cracked the list for the first time since 1998, demonstrating the breadth of the ascent of emerging-market currencies. Both the yuan and peso roughly doubled their shares of the market. The Russian ruble, Turkish lira, South African rand and Brazilian real all also accounted for a bigger slice of global flows, while the Korean won and Polish zloty accounted for slightly smaller shares.

In developed-market currencies, flows in the Japanese yen also shot higher in this year's survey, with turnover surging by 63% from 2010. Trading in the dollar against the yen was up by about 70%, the BIS said.

China's central bank on Thursday raised the prospect of a further loosening of controls on cross-border investment, broadening access to the economy and banking sector. Officials have signaled they don't believe efforts to ease restrictions should be slowed by market volatility or other external factors, such as the U.S. Federal Reserve's plans to reduce monetary stimulus. Observers said the shift could hasten more-widespread use of the yuan.

"As China starts loosening up its banking regulations, companies will eventually see the renminbi on par with the euro," said Anil Sawrup, a senior vice president at currency-exchange firm Cambridge Mercantile Group. "Now that it's in the top 10, more businesses will realize the urgency of making payments in the Chinese currency."

Yuan payments by American companies were up almost 90% in the first half of 2013 from the same period a year ago, according to a survey from global payment-services firm Western Union Business Solutions. The survey showed yuan transactions now represent 12% of all U.S. payments to China, up from 8.5% in the first half of last year.

The Chinese government began liberalizing the currency in 2009, but controls still made it difficult for businesses to make payments directly in the yuan. In early 2012, the central bank announced that all Chinese companies could settle their trades in yuan and more directly swap foreign currencies with it.

"Five years ago, it was next to impossible to help our clients pay Chinese suppliers in renminbi because of the government controls," said Guido Schulz, global head of strategic management at AFEX, an international payment service. "Now, it's just another transaction."

Anbo International Ltd., a U.K.-based wood-flooring manufacturer and distributor, has been paying its Chinese suppliers in renminbi for more than two years as a way to cut costs. Since Chinese factories usually raise prices on foreign currency transactions as a cushion for potential exchange-rate fluctuations, paying in the local currency allowed Anbo to get a 3% to 4% discount on the kitchen tops and hardwood flooring it imports from China, said Guren Zhou, managing director at the company.

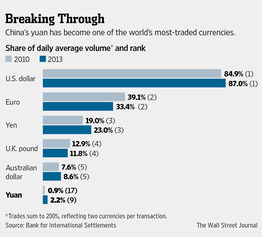
He estimates Anbo has saved about $1 million since it switched to yuan payments, which also allowed the company to sell their products to home-improvement retailers in the U.K. at a cheaper price than competitors could.

"If you're an importing business, paying renminbi to China will give you flexibility on pricing and allow you to compete with other people who aren't dealing in renminbi," Mr. Zhou said. "It's a really good thing to do."

This rapid growth of foreign exchange and the rise of the yuan underscore why banks and financial centers around the world are keen to grab a slice of offshore yuan trading.

Since China made Hong Kong its first offshore trading center for its currency in 2009, competition has been fierce among global and regional financial hubs to be key yuan markets as Beijing tries to make the currency a serious rival to the dollar's supremacy in global trade. Singapore and London have emerged as the leading candidates, with Tokyo, Sydney, Luxembourg and Kuala Lumpur also vying for a spot.

"The renminbi has been a big growth story over the last year," said Richard Anthony, global head of foreign-exchange electronic trading at HSBC in London. "Trading volumes are increasing not only from corporate clients off the back of global trade, but also from the investor community."



With a stable economy, healthy banking system, and exchange rate "approaching balance," the timing is right for China to push capital-account opening, wrote Sheng Songcheng, head of the central bank's statistics department in an article in the central bank's own Financial News on Thursday. The capital account reflects investment flows, while the current account measures trade flows.

A shift by the Fed to reduce its $85 billion monthly bond-purchase plan, which could trigger fresh swings in global capital flows, shouldn't be allowed to affect China's plans, Mr. Sheng added.

As part of the steps toward a convertible yuan, domestic media have reported that a new free-trade zone to be set up in Shanghai could feature more liberal rules on cross-border yuan flows.

Allowing freer international investment would be a significant change for a nation that has long imposed restrictions on such flows. A tightly controlled exchange rate has also been a key feature of China's reform-era development. The controls have been seen as a way to keep exports competitive and shield the country from waves of currency speculation.

Economists say loosening controls would help stem a slowdown in China's growth by encouraging more efficient use of capital and speeding a transition away from dependence on exports and toward stronger domestic demand.

But the move also brings risk, as a swing to hefty capital outflows could undermine the stability of an overstretched financial sector.

A sharp rise in lending over the past five years has left banks overextended, with the ratio of corporate and household debt to gross domestic product rising to about 170% at the end of 2012, from 117% in 2008.

"In a country where there's significant fragility in the financial system, rapid opening of the capital account could trigger a crisis," wrote Zhang Ming, a senior economist at the government's Chinese Academy of Social Sciences in a recent paper.

# Yen Play Is Blast From the Past

By Erin McCarthy

March 2012

One of the most popular currency trades is back in fashion, thanks to Japan's efforts to keep pushing down the yen's value. Vincent Cignarella joins Markets Hub to discuss the comeback of the yen "carry trade." (Photo: YOSHIKAZU TSUNO/AFP/Getty Images)

One of the most popular currency trades is back in fashion, thanks to Japan's efforts to keep pushing down the yen's value.

Known as the yen "carry trade," investors are borrowing money in yen, where rates are low, and exchanging it for currencies in countries where rates are high—such as Australia, Canada and Mexico—profiting from the difference. Investors can also execute a carry trade by borrowing the lower-yielding yen to buy bonds denominated in higher-yielding currencies, such as local-currency government debt in places like Mexico and Brazil.

The trade was hugely popular, and profitable, for much of the 1990s, though it had become less so in recent years. That is because central banks' loose monetary policies in the U.S. and Europe kept borrowing rates for banks artificially low, increasing the appeal of using the dollar and the euro instead of the yen.



But the yen is becoming more attractive to fund these trades, investors say. Japan's central bank is widely expected to keep flooding the market with yen, keeping the currency's value and interest rates in check. The yen already has weakened 8% against the dollar this year. At the same time, investors are reducing expectations for how long the Federal Reserve may pump money into the U.S. financial system, and Treasury yields have crept up, albeit slightly.

A weakening currency is key to the carry trade, because it means investors have less to repay when they cash out their trade.

That has brought the yen carry trade "much, much more in vogue," said Douglas Borthwick, managing director of Faros Trading in Stamford, Conn.

Japan's central bank is widely expected to keep flooding the market with yen, keeping the currency's value and interest rates in check. Bloomberg News

"The last time that [yen carry trades] really would've worked was really in the early '90s," he said. With "the view now, though, that the yen is going to depreciate…using it as a funding currency makes a lot of sense."

Mr. Borthwick issued a trade recommendation to clients on Jan. 31 to buy the Canadian dollar against the yen. That trade has since returned about 11%, he said.

The carry trade has seen some currencies soar against the yen. The Mexican peso has skyrocketed nearly 20% against the yen in 2012, compared with a 9% gain against the dollar. The South African rand is up 16% against the yen and nearly 7% versus the dollar, while the Brazilian real is up 11% against the yen and 2.5% against the dollar.

In the week ended March 13, speculators placed their largest bets that the yen would depreciate against the dollar since April 2011, with bearish yen wagers exceeding bullish positions in the futures market by $6.4 billion, according to the Commodity Futures Trading Commission.

The yen on Monday strengthened slightly against the dollar, which bought ¥83.35, from ¥83.43 late Friday. But it weakened against the euro to ¥110.34, from ¥109.74 Friday.

In the 1990s and early 2000s, the yen was the main currency used to fund carry trades, because interest rates in Japan were well below those elsewhere. The difference became less stark during the financial crisis, as central banks in the U.S. and Europe cut their rates.

Investors are still using dollars and euros to put on carry trades. And that is likely to continue as long as interest rates stay low in the U.S. and Europe.

"If they've all got zero rates, why not fund in all three?" said [Goldman Sachs](http://quotes.wsj.com/GS?mod=DNH_S_cq&lc=int_mb_1001) Asset Management Chairman Jim O'Neill. "But what is changing at the margin…is the yen is the most attractive to use."

Not everyone agrees the yen will continue to fall. During the periods of market turmoil last year that accompanied developments in Europe's debt crisis, investors flocked to the safety of the yen, driving it to post-World War II highs.

[John Taylor](http://topics.wsj.com/person/t/john-f-taylor/330), chairman of FX Concepts, one of the world's largest currency funds, said investors also shouldn't be too quick to rule out any further easing by the Fed.

"If the U.S. economy does go into the same kind of slowdown [as in 2011], then I would expect to see the yen strengthen again," Mr. Taylor said. He added that the U.S. economy could start to weaken in the second quarter—which could prompt Fed action later in the year—so the window for yen-funded carry trades should stay open just for the next month or so.

Amer Bisat, a partner at Traxis Partners, a $1.5 billion hedge fund, says investors are switching to the yen from the euro to fund bets on Asian currencies, including the Korean won and the Taiwanese dollar. "The market seems to have really turned this time," Mr. Bisat said.

**Carry Trade Ripping Across Wall Street**

* [Steven Russolillo](http://topics.wsj.com/person/A/biography/7443)

What happens in Japan doesn’t stay in Japan.If anything, the big daily moves in Japanese markets are reverberating across the globe in the form of unwinding “carry trades,” where investors who had been borrowing cheaply in yen and investing in higher-yielding markets are now feeling the pain.

In his morning note, Art Cashin, UBS’s czar of the NYSE trading floor, explains how the recent strength in the yen and the tumble into bear-market territory for Japan’s stock market is rippling across Wall Street. From Cashin:

The carry trade has been around for decades. To over-simplify – a U.S. hedge fund borrows money in Japan at virtually zero. They try to lever that almost cost-free money and use it to buy some asset (gold, stocks, real estate). In order to make this all work, you need to avoid currency risk – so you short the yen.

A couple of months back, when Mr. Abe announced Abenomics (aggressive QE, purposeful increase in inflation, etc.), hedge fund wizards around the world flocked to what they saw as a “no-brainer” carry trade – short the yen (which QE should push lower) and buy the Nikkei (which would benefit from higher inflation and more trade from the lower yen). Scores of hedge fund managers reached for this too easy brass ring.

For weeks and weeks, it all worked like a cash machine. The Nikkei soared and the yen plunged. The cash registers at the hedge funds rang incessantly and, in all likelihood, many hedge funds doubled down, adding billions more to the trade.

Those are just one (most popular) of the carry trades. There are many others. And, when the yen spikes, it is like a margin call on each of those trades. We all painfully remember [what] forced liquidations looked like and felt like in late ’08 and early ’09. That’s what markets fear – possible random liquidations.

He said this development played a role in why the Dow Jones Industrial Average started Wednesday’s session with a triple-digit-point gain, but finished the day down 126 points, capping its first three-day losing skid of the year.

On Thursday, major U.S. stock indexes have wobbled their way to slim gains, even after Japan’s Nikkei Stock Average fell more than 6%.

The way the U.S. markets have been behaving of late, don’t be surprised to see another choppy finish to today’s action.