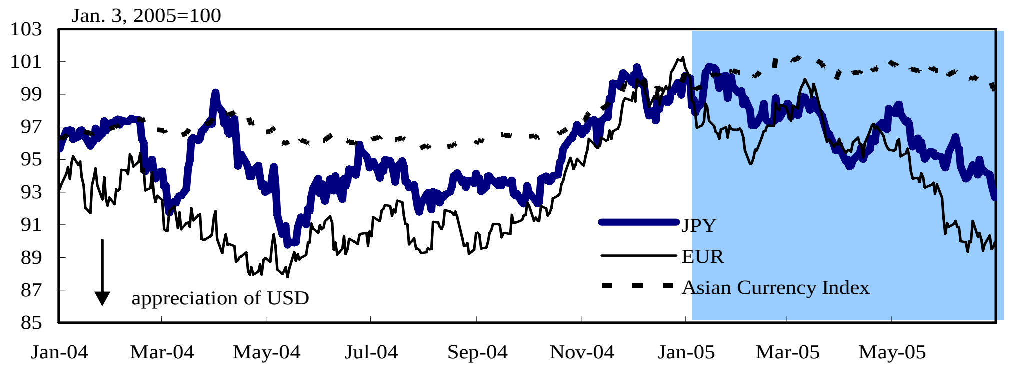
5. Foreign exchange markets

In 2004, from fall to the end of the year, the US dollar (USD) weakened substantially against all major currencies. In 2005, due to the relative strength of the US economy and short-term interest rate differentials with Europe and Japan, the USD has moved upwards (Chart 36). The Japanese yen (JPY) has fallen against the USD from around 103 yen at the end of 2004 to 110 yen in June. In July, with the revaluation of the Chinese yuan (CHY) (July 21st), the JPY strengthened temporarily, but has fallen back.

The euro (EUR) has fallen sharply since late May, reflecting weak economic conditions together with the rejection of the EU Constitution at referendums in France and the Netherlands. The JPY has strengthened against the EUR from 139.18 yen at the end of 2004 to 134.28 yen at the end of June.

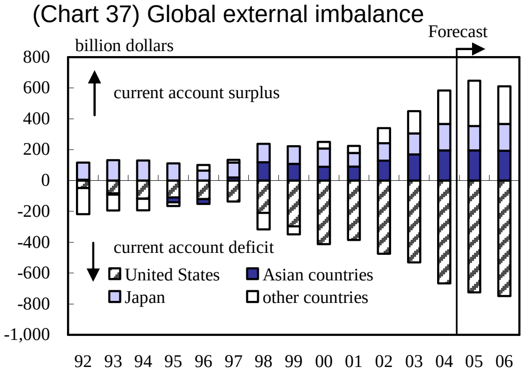
Asian currencies have moved slightly upward, as the economies generally maintained their growth paths. As attention remained on the large trade surpluses against the US and the subsequent build up of foreign exchange reserves, expectations of a revaluation of the CHY increased (Chart 37, 38). In July, reforms to China's exchange rate regime (e.g. a move to a managed floating rate system with reference to a basket of currencies, and revaluation against the USD) were announced and implemented.

(Chart 36) JPY, EUR and Asian currencies USD exchange rates



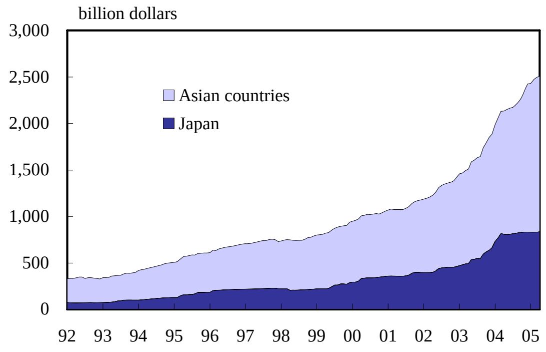
Notes: Asian Currency Index is from JP Morgan. Figures are from exchange rates against the USD, weighted using trade volume and liquidity conditions of ten Asian currencies (Chinese yuan, Hong Kong dollar, Korean won, Malaysia ringgit, Philippine peso, Singapore dollar, Taiwan dollar, Thailand baht, India rupee, Indonesia rupiah).
Sources: Bloomberg, JP Morgan

(Chart 37) Global external imbalance



Note: Data are for IMF member countries and contain estimates and forecasts by the IMF. Asian countries consist of currencies of ten countries; China, India, NIEs (Korea, Taiwan, Hong Kong and Singapore), ASEAN 4 (Thailand, Malaysia, Indonesia, the Philippines).
Source: IMF World Economic Outlook (April, 2005)

(Chart 38) Foreign exchange reserves of Asian countries



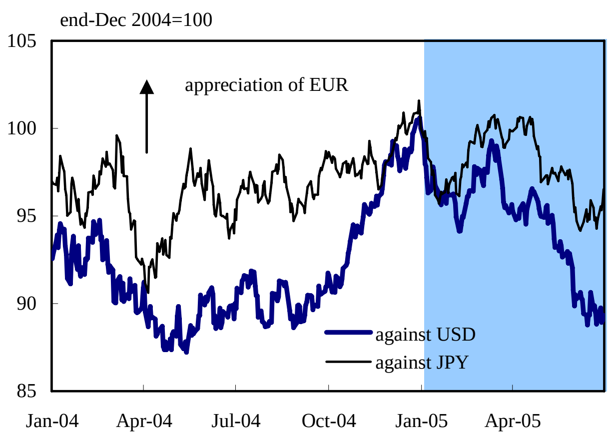
Notes: 1. Asian countries consist of ten countries; China, India, NIEs (Korea, Taiwan, Hong Kong and Singapore) and ASEAN 4 (Thailand, Malaysia, Indonesia and the Philippines).
2. The latest figures are from April, 2005.
Sources: IMF, Bloomberg, The Central Bank of China, CEIC

The highlights of the foreign exchange market during the first half of 2005 are, (1) the overall weakness of the EUR, and (2) heightened expectations toward an upward revaluation of the CHY.

(Weakness of the EUR)

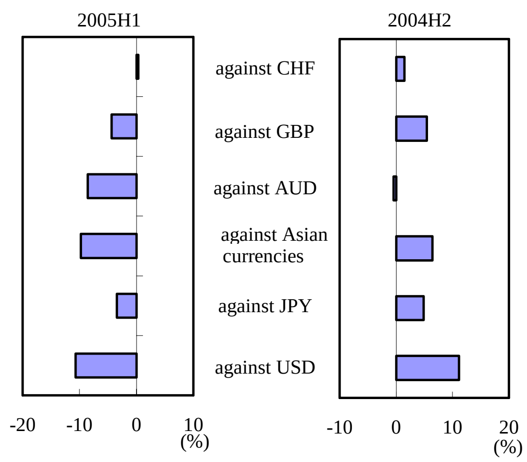
The EUR rose in the latter half of 2004 (Chart 39), as the market remained attentive of the US external imbalance and as investors moved to increase the share of their EUR-denominated assets for diversification purposes. However, in 2005, (1) the outlook for the euro area economy weakened, and (2) among increased concerns toward expanding budget deficits in major member countries, the Economic and Financial Affairs Council decided in March to modify the Stability and Growth Pact. Furthermore, at the end of May and early June, the Treaty on the EU Constitution was rejected in referendums held in France and in the Netherlands, increasing uncertainty regarding the politics and economic policies of the EU. As a result, the EUR fell against the major currencies, losing most of its gains from 2004 (Chart 40). The USD/EUR rate at the end of June returned to the same level as of September 2004.

(Chart 39) EUR exchange rates



Source: Bloomberg

(Chart 40) EUR exchange rate fluctuations (2004H2 and 2005H1)



Source: Bloomberg

(Expectations for a revaluation of the CHY)

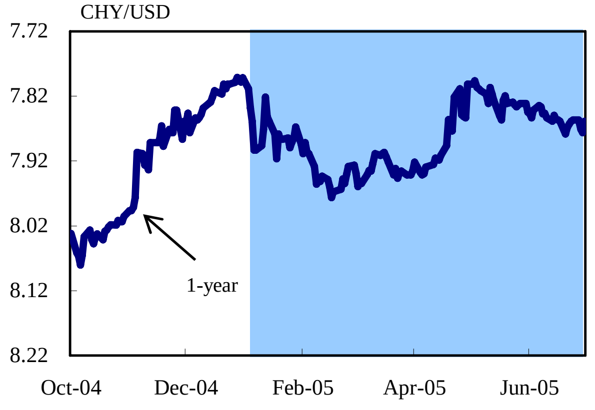
Since 1997, the CHY has been managed as a quasi fixed exchange rate currency with its exchange rate against the USD pegged at around 8.28 CHY. The sharp rise in textile exports from China turned the expansion of the trade imbalance into a political issue in the US and Europe, and calls for an adjustment through the exchange rate mechanism grew. Consequently, speculation toward a possible revaluation increased. At the same time, views were expressed by the authorities from the US, Europe and Japan as well as by Chinese government officials that it would be in China's interest over the longer run to introduce a more flexible exchange rate regime, to support the healthy growth of the Chinese economy which has become integrated into the global economy. It was thought that this would lead to an economic system based on market mechanisms and increase the flexibility of economic policy management. The expression of such a view also was a factor in increasing market expectations for a revaluation.

During this period, foreign speculative accounts and other market participants were active in the non-deliverable forward (NDF) market for CHY against the USD, especially close to various events such as the G7 meeting, which lead to a widening in the discount of the USD against the CHY. By early May, the markets had measured in a roughly 5% appreciation within one year (Chart 41).

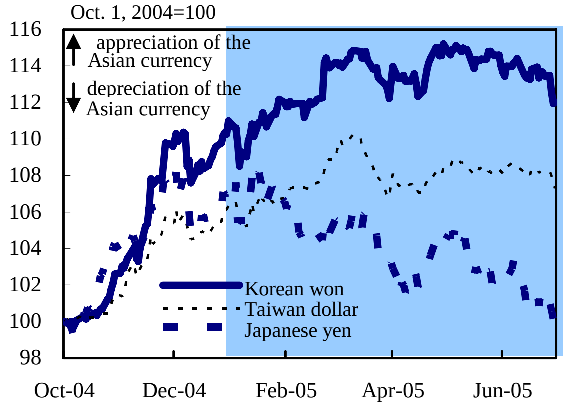
Another feature of the first half of 2005 was that, in certain situations, speculation regarding the CHY lead to broad based Asian currency buying (Chart 42). Proxy trades buying currencies which are assumed to have a relatively stable relationship to the CHY over a longer period, and the expectations that the increased flexibility in the CHY exchange rate system would increase the export competitiveness of Asian countries, were both factors behind these moves. Furthermore, there were expectations that the review of Chinese exchange rate policy would lead to reforms in other Asian currency regimes.

However, beyond June, (1) attention on the strength of the USD against major currencies, and (2) concerns toward a deterioration in the external balance of Asian countries due to higher crude oil prices resulted in a general weakening of the Asian currencies. In such an environment, the CHY was revalued on July 21st. The initial impact on financial markets in various countries has been limited (as of July 26th), but the way the new regime will be managed and its consequences on markets will need to be monitored closely.

(Chart 41) Implied CHY/USD rate from the NDF market



(Chart 42) Asian currency/USD exchange rates



Note: NDF (non-deliverable forward)
Sources: Bank of Japan (yen: rate at 5 p.m. Tokyo time, Asian currencies: rates at 8 p.m. Tokyo time), Bloomberg

6. Concluding remarks

In the first half of 2005, as the Japanese economy moved sideways, market movements in Japan's financial markets generally reflected the cautious view toward the pace of economic recovery. Long-term interest rates fell slightly, and equity prices initially rose but fell subsequently at the end of June to return to levels seen at the end of last year. Extremely accommodative conditions were maintained in the short-term money markets and favorable financing conditions continued in the credit markets.

With regard to the outlook, while the search for more convincing signs of economic recovery continues, market movements will likely be influenced by views toward economic fundamentals including crude oil prices and overseas economic developments. In July, following the release of stronger than expected economic indicators and the strength of overseas equity markets, both long-term interest rates and equity prices have edged up. Nonetheless, they are still below the yearly highs experienced in March (as of July 26th).

From a longer-term perspective, the following factors have formed the underlying conditions for the Japanese financial markets. They are: (1) the corporate sector's high cash-flow levels and their propensity to reduce interest-bearing liabilities; (2) changes in the equity ownership structure (i.e. reduction in equity holdings by domestic investors and increase in purchases by overseas investors); (3) growth in cross-border outward bond investments based on interest rate differentials (compared with relatively low levels of inward bond investments), and (4) search-for-yield investment behavior in an extremely low interest rate environment. Although, this fundamental trend has remained basically unchanged, some signs worth taking note have emerged in the first half of this year.

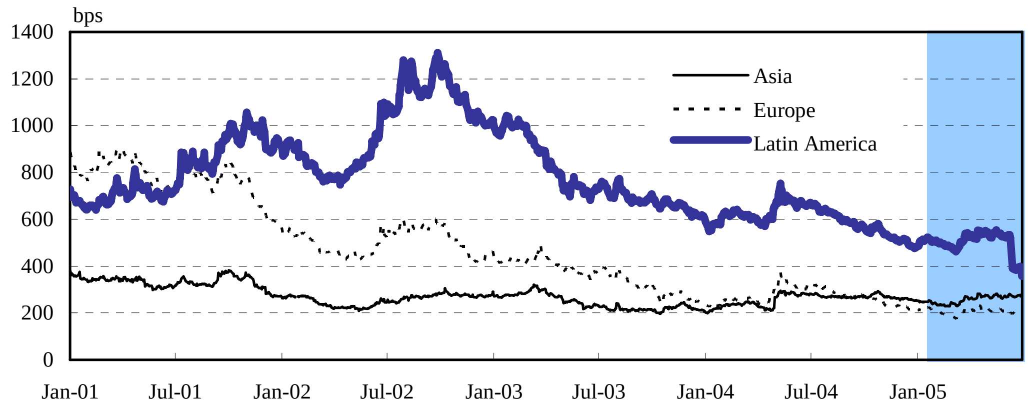
First, the change in corporate behavior in using their cash-flow. In recent years, firms had allocated most of their ample cash-flow to reducing interest-bearing liabilities, and this has influenced the supply-demand conditions in the credit market and in bank lending. However, more recently, the pace of reduction in interest-bearing liabilities has slowed, and some firms have started to increase capital expenditures and/or dividend payments. It remains to be seen whether this change in corporate behavior will develop into a longer-term trend.

Secondly, the change in the equity investment structure. This year, especially since early spring, overseas investors who had been the key driver of the Japanese equity market in recent years, sharply slowed their purchases compared with the preceding two years. This movement became more evident after events such as the GM downgrade. At the same time, sales of stocks by domestic institutional investors have also slowed. Whether stock purchases by overseas investors will recover to earlier levels, and whether domestic institutional investors will change their asset allocation once again towards equities, will likely affect stock price developments going forward.

Thirdly, the drop in overseas long-term interest rates and changes in cross-border bond investments. Since last fall, US and European long-term rates have declined at a more rapid pace than Japanese rates and term spreads are currently wider in Japan. This has attracted more inward bond purchases by overseas investors causing a slight change in capital flows where inward investment had remained at very low levels for sometime. Meanwhile, trends in overseas bond purchases by domestic investors remained basically unchanged.

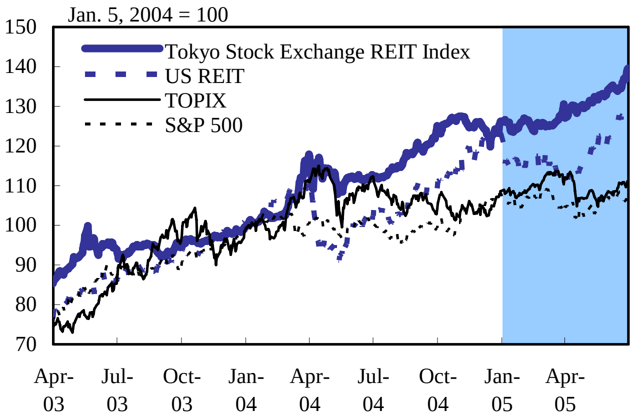
Additionally, as long-term interest rates globally trend downward, investors abroad have stepped up their search for instruments with higher returns, while, at the same time, moving to further diversify their portfolios and to introduce more advanced investment techniques. As a result, spreads in credit and emerging markets have tightened (Chart 43). Also in Japan, investments in lower rated bonds have gradually increased, and, although overall levels are still small, funds are starting to actively flow into REITs (Chart 44) and newly developing stock markets (Chart 45). Therefore, the future movement of global long-term interest rates, which had so far been on a declining trend, and its possible impact on global capital flows, position taking and pricing in financial markets, requires close monitoring going forward.

(Chart 43) Emerging market bond spreads



Note: EMBI (Global Diversified), sovereign spreads over US treasuries.
Source: JP Morgan

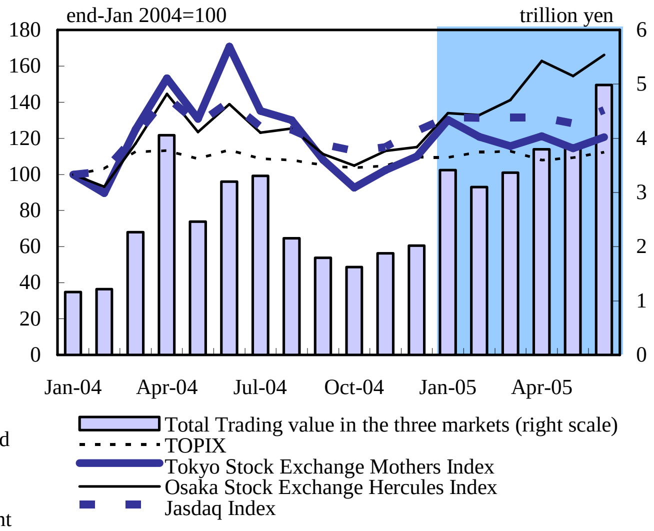
(Chart 44) REITs



Notes: 1. Tokyo Stock Exchange REIT Index is a capitalization-weighted index based on all REITs listed on the TSE.
2. US REIT is the price index of all publicly Traded REITs published by the National Association of Real Estate Investment Trusts.

Sources: Tokyo Stock Exchange, Bloomberg, National Association of Real Estate Investment Trusts

(Chart 45) Newly developing stock markets



Sources: Osaka Stock Exchange, Bloomberg