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Currency Conundrum **27/03/11**

I could never be a currency trader. Uncertainty exists in all markets but in currency markets, you can be certain about very little. Currencies react to many varied factors, at lightning speed, and sometimes in the completely opposite direction to what you'd expect.

Why for example, did the Japanese yen rise in value following their earthquake, tsunami and nuclear fallout?

When considering the desirability of a particular currency, generally a strong currency is one that is considered reliable, with characteristics such as a stable political system, consistent monetary and fiscal policies, and economic growth. A soft currency on the other hand is one that is unreliable, due perhaps to political instability or unrest or general unpredictability relative to other currencies.

I was taught that a currency will rise or fall depending on the demand for it. If a country's economy is doing well, relative to other countries, its currency should be in demand and buyers will push its price up.

It is therefore counterintuitive that Japan's currency would be in demand following an earthquake and tsunami that will take billions off the country's GDP. This is a country that was hardly the poster child for growth before the earthquake – it has been in recession for two decades and its debt load is more than twice its economic output.

It turns out that my university professors were right. The yen has lifted because of demand and supply. The yen is going to be in enormous demand as the country deals with the aftermath of their disasters, and the rising value of the Yen reflects this demand.

Japanese banks and insurers will be called on to pay out billions of yen to individuals and businesses in order to begin the rebuild. Japan is one of the largest holders of US debt, and as vast sums of money are taken out of the US, dollars will be sold and Yen will be bought.

Japanese investors are known for their tendency to liquidate overseas assets in times of uncertainty. In the three months after the 1995 Kobe earthquake, the yen gained 20% against the US dollar. Speculators began buying yen soon after last week's earthquake, though the yen has stopped soaring, at least in the short term, as a result of the quantitative easing undertaken by the Japanese central bank, along with support from Europe and the US who have sold some of their yen holdings to keep the price down.

It is not just speculators who are driving the yen higher. In times of global turmoil investors seek 'safe haven' currencies. The yen is considered safe because Japan is the world's third largest economy, and because most of the country's debt is owned by Japanese investors, capital isn't likely to rush out of the country.

So, who would try and pick where the yen is headed? Not me. As I said at the outset, the drivers behind currency movements are many and varied, and in some instances, totally contradictory to logic or common sense. As if investing wasn't hard enough already.

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