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Black & White Exchange Rate Currency Model

Lie Chun Pong

MSc (HKUST)

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ABSTRACT

This comprehensive study seeks to thoroughly analyze the trend of the Japanese yen exchange rate by utilizing advanced economic methodologies. By employing an innovative black & white exchange rate monetary model, the research aims to extrapolate future trajectories of the yen's value within the currency market. Additionally, the study will make informed predictions regarding its exchange rate, providing valuable insights for investors and policymakers alike.

Keywords: black-and-white exchange rate model, currency market dynamics, yen patterns, black-and-white mechanism.

Introduction

This study seeks to analyze the trends of the Japanese yen exchange rate, extrapolate its future trajectory, and forecast its exchange rate utilizing an innovative advanced black-white exchange rate monetary model.

Recent news reports have indicated a significant depreciation of the Japanese yen in 2024, with the exchange rate falling below 160 against the US dollar. This trend of depreciation has persisted for nearly a year, beginning in 2023. According to the information released on July 2, 2024, the yen's continued weakness is evident in the Asian foreign exchange market, where it has now dropped to 161.4 yen per US dollar, which equates to approximately 4.83 Hong Kong dollars for every 100 yen, and has fallen below 5 yuan.

While there are numerous explanations for the trend of yen depreciation, some experts attribute this decline to the phenomenon of "yen wives," referring to Japanese housewives who engage in currency speculation from their homes. Others highlight the impact of Japan's aging population and its fragile economic framework, while some analysts cite the country's unfavorable development prospects as contributing factors.

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Starting with money supply theory, we see that the exchange rate is determined by money supply, influenced by the Bank of Japan's monetary policy choices. Since the 1990s' structural recession, Japan has implemented a low or zero-interest policy, which has been consistently effective. This approach not only prevents deeper recession but also encourages low-interest loans that stimulate economic growth.

Trends in economic policy occasionally diverge from prevailing assumptions and expectations. The current monetary policy, which has been in effect for nearly three decades, has experienced a profound transformation under the stewardship of the new central bank governor, Kazuo Mata. He has been a crucial proponent of transitioning away from the longstanding practice of quantitative easing, a strategy that involved the central bank purchasing financial assets to inject liquidity into the economy. In a decisive shift, the central bank has substantially reduced its bond purchasing activities, aiming to extricate the economy from a liquidity trap—a situation where low interest rates fail to stimulate economic growth due to a lack of demand. (

The deliberate scaling back of bond purchases leads to a contraction of the money supply in the financial system, which typically results in elevated interest rates as the cost of borrowing increases. However, an intriguing question arises: why did the yen’s interest rate experience a decline instead of an anticipated rise following the exit from the zero interest rate policy? This paradox may stem from various factors, including market predictions of future economic conditions, investor sentiment, and the overall demand for yen-denominated assets in relation to global economic stability.

Additionally, the interplay between domestic and international economic factors, such as foreign investment flows, geopolitical events, and the monetary policies of other central banks, can also influence interest rate dynamics beyond the direct effects of domestic policy adjustments. Understanding these complex interrelationships is pivotal for comprehending the current economic landscape and the implications for currency valuation and monetary stability.

To address the surrounding (the response to this inquiry) it necessitates a comprehensive evaluation of both the black market and the formal open market for foreign exchange. In the context of the formal (or open) foreign exchange market, it is posited that should the monetary policy measures previously mentioned—particularly the strategic reduction of government bond purchases—prove to be efficacious, we could anticipate a pronounced escalation in interest rates in the near to medium-term horizon.

However, the structural ramifications of these monetary dynamics reveal deeper implications: Japan's financial apparatus is displaying signs of significant strain. This problematic trajectory can be attributed to several interrelated factors, notably the demographic transformations

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characterized by an aging population, the diminishing impact of the demographic dividend that once underpinned economic growth, and the persistent failure to adequately address entrenched structural contradictions within the Japanese economy. These indicators collectively underscore a critical need for strategic policy interventions to enhance fiscal sustainability and restore economic vitality.

From another perspective, it can be observed that in the black market, the Bank of Japan undertakes bilateral operations. On one hand, it intervenes in the foreign exchange market by buying yen and selling US dollars to support the exchange rate. However, the market may perceive that its central bank is significantly increasing the supply of yen, which is the root cause of the decline in the yen exchange rate.

Spearhead foreign exchange operations

As previously discuss in this analysis, the dynamics of currency supply play an integral role in influencing the exchange rate fluctuations. Should market participants lose confidence in the credibility and interventions of the Bank of Japan, they may initiate actions to bolster the stability of the yen's valuation. This scenario arises when the market suspects that the Bank is engaged in covert bilateral operations—specifically, categorized as Spearhead foreign exchange maneuvers. These operations entail the clandestine issuance of substantial currency supplies while ostensibly maintaining a facade of being a marginal participant, a phenomenon often termed as Black & White Spearhead operations. This situation implies that the Bank of Japan may be participating in reverse bilateral operations, effectively concealing market behavior rather than solely executing unilateral acquisition strategies as professed by the Bank itself. Such intricate undertakings underscore the complexities inherent in central banking strategies and their implications on market perceptions and exchange rate mechanisms.

Market reactions to the black and white markets have led to the emergence of a gray market. This new gray market creates a balance between the black and white markets. The foreign exchange market operates in a unique gray area and may involve bilateral market operations. For instance, to mitigate the risks of pure unilateral operations, a passive "big stone" approach allows machine buyers to take bilateral actions. This includes buying long positions in the open market and selling short positions in the black market.

Black & White FX Spearhead Currency Model

With the assumption of dilution stemming from a substantial increase in the number of share portions available in the market, we can infer that the potential for price depreciation over the long term will be directly correlated with the established rise and fall ratio of these share values. This correlation implies that, irrespective of the market trends—whether the stock price

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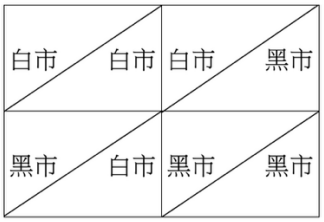
experiences an upward surge or a downward decline—each scenario is assigned a minimum probability of 0.5.

Furthermore, should we posit that there is a downward movement in the exchange rate, and if institutional investors decide not to exercise their rights to subscribe to additional shares, it indicates that the resultant decrement in the prices of their securities has already been accounted for within their strategic decisions and market participation. Consequently, this scenario reinforces the notion that the probability remains evenly balanced at a 50-50 split, illustrating the complex dynamics at play in financial markets, especially in relation to investor behavior and share valuation under varying economic conditions.

Black & White Fx Spearhead Operation Model



Dynamic Currency Model: Black & White

Black & White BS-Model

$$Black \times \left[\frac{\partial v}{\partial t} + \frac{1}{2}\partial^2 S^2 \frac{\partial^2 v}{\partial s^2} + rs\frac{\partial v}{\partial s} - rV\right] \times White = 0$$

Probability (long Option)

(0-1)

Or

$$White \times \left[\frac{\partial v}{\partial t} + \frac{1}{2}\partial^2 S^2 \frac{\partial^2 v}{\partial S^2} + rs\frac{\partial v}{\partial s} - rV\right] \times Black = 0$$

Let Black = $\alpha, White = \beta$

Modify Approach: $\alpha \times \left[\frac{\partial v}{\partial t} + \frac{1}{2}\partial^2 S^2 \frac{\partial^2 v}{\partial s^2} + rs\frac{\partial v}{\partial s} - rV\right] \times \beta = 0$

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Or

$$\beta \times \left[\frac{\partial v}{\partial t} + \frac{1}{2}\partial^2 S^2 \frac{\partial^2 v}{\partial S^2} + rs\frac{\partial v}{\partial s} - rV\right] \times \alpha = 0$$

Cumulative distribution function probability for normally distributed variables

$$\alpha = N(x) = \frac{1}{2}\left[\frac{1}{\sqrt{2\pi}}\int_{-\infty}^{x} e^{-z^2/2} dZ\right] \beta \ (Short\ Put\ Option)$$

The chances of probability rise and fall are each half

$$\beta = N(x) = \frac{1}{2}\left[\frac{1}{\sqrt{2\pi}}\int_{\infty}^{x} e^{z^2/2} dZ\right] \alpha (Long\ Call\ Option)$$

The chances of probability

Modify B-S Model Approach

$$\frac{1}{2}\left[\frac{\partial v}{\partial t} + \frac{1}{2}\partial^2 S^2 \frac{\partial^2 v}{\partial S^2} + rS\frac{\partial v}{\partial S} - rV\right] \alpha = 0$$

probability

B-S Model

α male share hold probability distribution

As for the increases in exchange rates, refer to the fluctuations in the value of one currency in relation to another. When the exchange rate increases, it typically indicates that the domestic currency is weakening against foreign currencies. This scenario presents a significant opportunity for institutional investors who hold exchange rate warrants—financial instruments that give them the right, but not the obligation, to exchange currency at a predetermined rate.

As exchange rates rise, institutional investors are likely to exercise these warrants to capitalize

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on favorable exchange conditions. By doing so, they can convert their holdings at the more advantageous rates, potentially leading to substantial gains.

Moreover, the exercise of these warrants often leads to increased demand for the underlying securities associated with them. As institutional investors exercise their warrants and acquire these securities, it can create upward pressure on their prices. Over the long term, this chain reaction can contribute to a robust increase in the overall price of the securities tied to the exchange rate warrants.

Thus, the interplay between exchange rate fluctuations and the behavior of institutional investors plays a critical role in shaping the market dynamics of related securities, resulting in a potential long-term rise in their prices.

For now, we'll refer to this type of short position, which involves long-holding and short-selling, as a gray foreign exchange market operation. This "passive operation" is designed to address the risk-averse strategies of policymakers, which we call "gray area operation" (either long hold short sell or short hold long sell).

Institutional investors do not solely focus on generating profits from the black market; instead, a portion of these investors engages in passive risk trading strategies. This method is utilized to effectively hedge against the potential risks and uncertainties that may arise from the ever-changing central bank policies and interventions in the financial markets. Such trading practices demonstrate a sophisticated understanding of market dynamics and the necessity for risk management in an increasingly complex economic environment.

Returning to the Bank of Japan's bilateral operations, its distinct advantage lies in its capacity to issue supplementary currency and its sovereign authority to undertake extensive currency issuance. This preeminent power, wherein the Bank can expand its monetary base at will, provides it with a unique leverage over economic liquidity and the financial markets. Unlike traditional institutional investors, the Bank of Japan possesses unparalleled authority that enables it to influence monetary policy directly. Such extensive control allows for strategic interventions aimed at stabilizing the economy, managing interest rates, and directing capital flows, thereby rendering it a pivotal player in both domestic and global financial landscapes.

In 1986, Japan entered into the Plaza Accord, an international agreement designed to artificially elevate the valuation of the Japanese yen against major currencies. This landmark accord involved the participation of the Group of Seven (G7) nations, which collaborated to manipulate foreign exchange markets with the intention of fostering a significant appreciation of the yen. The strategic objectives included correcting trade imbalances and promoting a fairer competitive landscape for Japanese exports. Consequently, the yen experienced a substantial appreciation,

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surging from an exchange rate of 286 yen per US dollar in 1986 to approximately 80 yen per dollar by 1995, reflecting a transformative shift in Japan's economic landscape and its international trade dynamics.

Some people might wonder why Japan signed the Plaza Accord. But even if they hadn't, the G7 would still have bought up a lot of yen to boost its value, causing major problems for Japan's exports and manufacturing. This would have hurt the country's main source of success: its manufacturing industry and ability to earn foreign exchange through exports. So, the Japanese government felt like they had no choice but to sign the agreement. At the same time, some individuals in the government and business circles saw the yen's appreciation as an opportunity to invest heavily overseas. Everyone had their own take on the situation. In the end, this could be seen as the first currency war, with the big winners being the interest groups led by the US.

What allowed the United States to win the currency war wasn't some extraordinary strategy, but the fact that it has the power to print money globally, including the right to issue the world's currency. As the world's dominant currency, the U.S. dollar benefits from its unlimited supply. Meanwhile, Japan is stuck with a passive price situation. Although the yen's high premium helps Japan, it also hurts its export, manufacturing, and foreign exchange earnings. This reduces Japan's competitiveness as a global factory and hurts its relative advantage. Looking at the long-term, the yen's appreciation will likely damage export profits and harm Japan's domestic economy.

Japan has successfully navigated out of a prolonged period of deflation and is now witnessing a robust economic upswing characterized by heightened prosperity. This resurgence is reflected in the performance of the Japanese stock market, which has attained unprecedented heights, surging past the 40,000-point threshold. One of the pivotal factors influencing this landscape is the depreciation of the yen, which has empowered the Bank of Japan by amplifying its monetary maneuverability. The weakened yen has resulted in a notable uptick in tourism and hotel services, as it renders Japan a more attractive destination for foreign visitors, consequently augmenting foreign exchange earnings significantly.

Moreover, the depreciation of the yen has bestowed upon Japanese manufacturers a considerable export dividend, enhancing their competitive edge in the global marketplace. This increase in profitability among exporters has acted as a catalyst for the ongoing bull market, driving stock valuations to soaring levels, which is undeniably a favorable economic development.

Statistical analysis indicates a significant shift in the global utilization of the yen; historically, the currency accounted for merely 6 to 7 percent of total global reserves. However, in recent years, this figure has experienced a pronounced surge, climbing sharply to approximately 10 percent.

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This incremental rise of 3 to 4 percentage points is profoundly impactful as it bolsters the Bank of Japan's foreign exchange reserves, propelling them to unprecedented highs and positioning Japan closer to the upper echelons of global currency reserves, closely trailing China.

Future Trends for the Yen

This study forecasts that if the yen continues to depreciate (as per the black-white foreign exchange rate model), the Bank of Japan's foreign exchange reserves are likely to reclaim the top global spot, surpassing other nations to become the largest in the world soon. The article even predicts a significant decline in the yen's value, estimating a drop from the current 5 yen to 1 RMB, reaching a discount of over 50% at 2.5 yen to 1 RMB. Consequently, the number of people investing in real estate or traveling to Japan will likely increase substantially, and its export volume, alongside with foreign exchange reserves, will also experience a marked rise to the world-leading position.

The depreciation of the Japanese yen brings forth several significant economic disadvantages, most notably the phenomenon of imported inflation. This occurs when the cost of foreign goods and commodities rises due to the weakening of the local currency, leading to an increase in the prices of imported products. Consequently, this escalation in costs diminishes the real purchasing power of consumers, resulting in a contraction of real income for citizens.

Furthermore, the gross domestic product (GDP) of Japan, when expressed in US dollars, is anticipated to experience a downturn as a direct consequence of the yen's depreciation. This devaluation not only affects domestic economic stability but also alters Japan’s international economic standing. In light of these developments, there exists a plausible scenario where emerging economies, particularly Brazil and India, might outpace Japan in terms of economic growth and GDP performance during this period. Such a shift could signify a significant realignment in regional economic dynamics and warrant a scrutiny of Japan’s economic policies and strategies moving forward.

In addition, the gross domestic product (GDP) expressed in US dollars is expected to decrease due to the yen's decline. As a result, there is a chance that emerging nations such as Brazil and India could exceed it during this time.

Conclusion

This study characterizes a significant advancement in economic modeling by introducing an innovative black-white exchange rate model aimed specifically at predicting the future trajectory of the Japanese yen. A fundamental aspect of this model is its capacity to forecast the yen's future movements through the application of a black-white mechanism, integrating insights from

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strategic purchasing games associated with currency exchange dynamics. This methodology not only enhances the accuracy of predictions but also introduces a novel approach to understanding the interplay between market forces and exchange rate fluctuations. The implications of this research extend beyond theoretical contributions; it offers substantial insights for both economic strategists and investment professionals, facilitating informed decision-making in capital markets. Furthermore, the findings are expected to enrich the academic discourse, providing a robust framework for future studies in exchange rate economics and related fields.

