Central Banks' Tokyo Connection

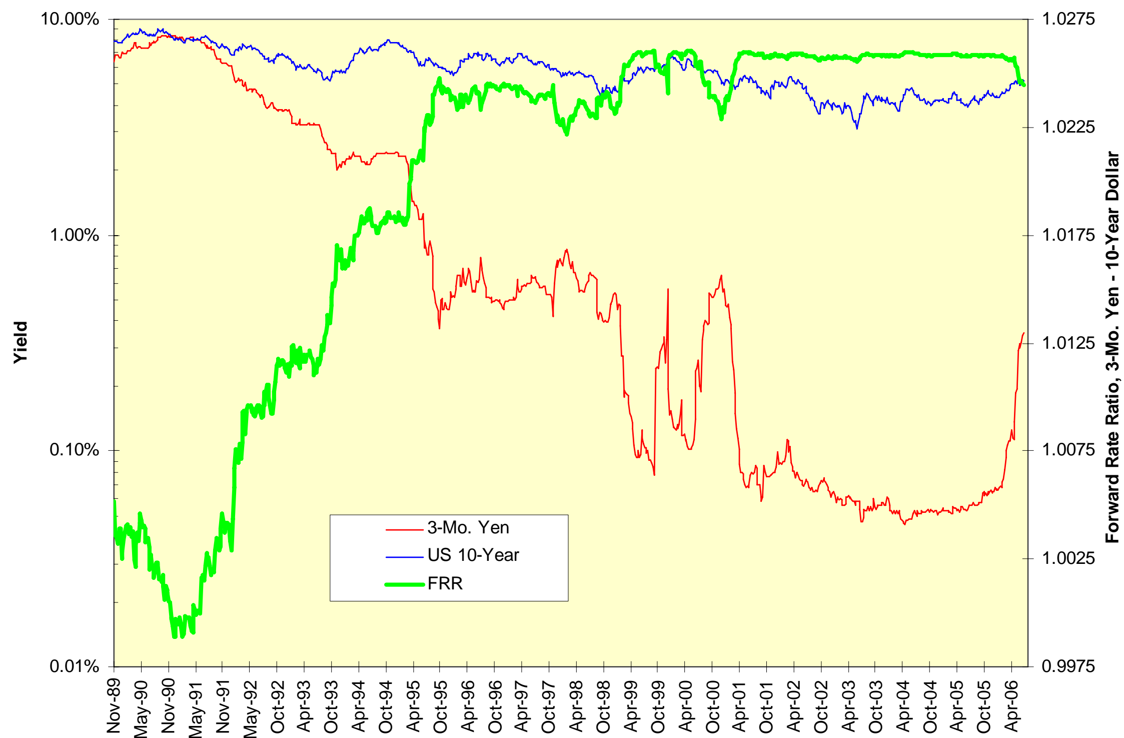
*"You keep playin' where you shouldn't be a playin'
and you keep thinkin' that you´ll never get burnt."* – Nancy Sinatra

Most of us encounter the Heisenberg Uncertainty Principle somewhere in our lives. Its derivation from quantum mechanics comes down to one equation with two unknowns, meaning you cannot know both a particle's location and its velocity exactly. As an aside, the central equation in the foreign exchange market has three unknowns, which helps explain the relative destructive powers of currency traders relative to nuclear physicists.

Central bankers face their own Uncertainty Principle between the money supply and interest rates, which are nothing more than the price of money. One of the lessons of the 1970s for the Federal Reserve was a policy of targeting the federal funds rate could allow the money supply to grow in an inflationary manner. They then switched to targeting the money supply, which led to massive swings in short-term interest rates in the early 1980s under Paul Volcker. Greenspan addressed the problem through simple expedience: He would do whatever he felt necessary to manage some combination of the money supply and interest rates all the while bamboozling the market into believing he had the situation under control.

Quantitative Easing And The Japanese Zero
The Bank of Japan engaged in the both strategies over the past decade. They first lowered short-term interest rates to the extent three-month yen LIBOR was trading below 1.00% in 1995. The yen carry trade, a topic discussed here in April, was born as the rest of the world feasted on cheap yen to finance all manner of things, including the late 1990s global equity market bubble.

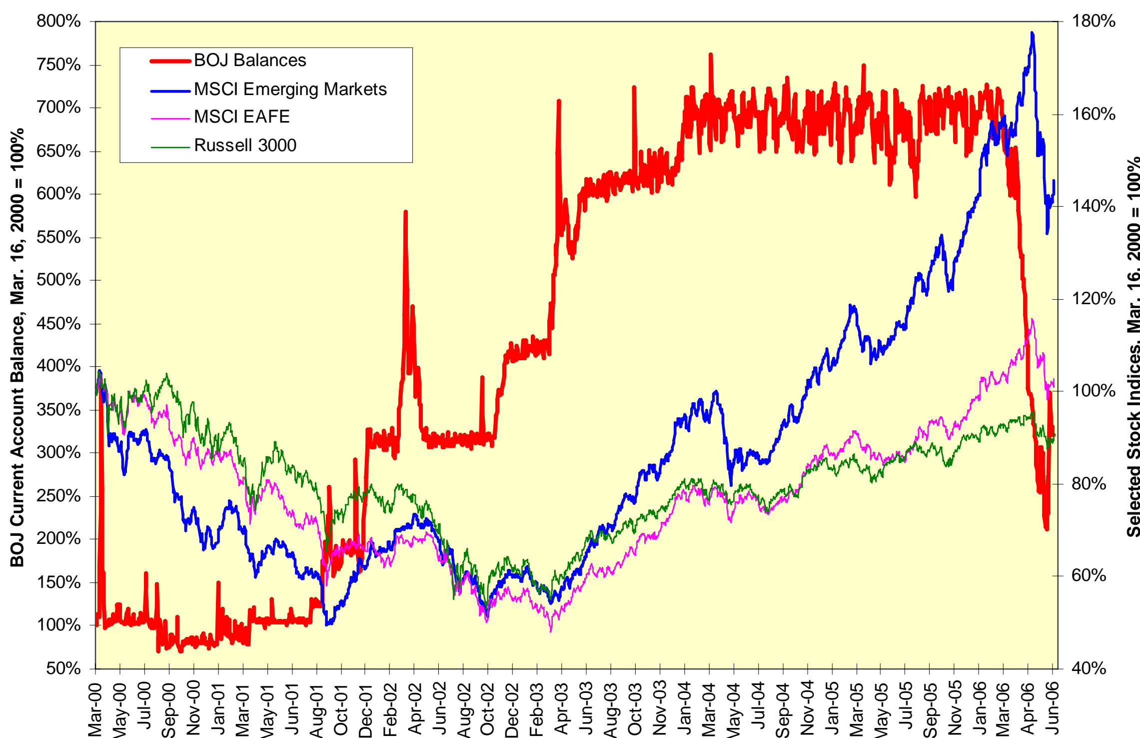
The scale and pace of Japan's rate cuts are difficult to comprehend. If we plot both them and U.S. ten-year note yields on a logarithmic scale to depict them in percentage-change terms, the history of the U.S. ten-year note looks downright boring. Focus on how rapidly short-term yen rates have jumped during the last two months and the implications for the yen carry trade for investors borrowing short-term in Japan to lend long-term in the U.S.



The drive higher in yen rates was precipitated by a clumsily executed effort by the Bank of Japan to end its five year-old policy of quantitative easing. Even as But Japan continued to languish as even near-zero nominal interest rates were constrictive in a deflationary environment. The Japanese had two alternatives, either go to negative interest rates (penalties on savings) or quantitative easing, injecting more money into the system regardless of whether there were domestic borrowers. They chose the latter course, with full knowledge aforethought this money would be borrowed outside of Japan.

We can chart the course of quantitative easing by measuring the current account balances held at the Bank of Japan. They increased dramatically between 2001 and 2004 and then hovered there until the start of the year. Then the fun began. Even though the BOJ hinted as early as last November 16th and again on February 3rd of this year that quantitative easing was going to end, Wall Street tends to be populated by people who believe they can exit a burning building faster than the next guy.

Between February 10th and June 12th, the BOJ's current account balance shrunk by ¥21.56 trillion. At an average yen/dollar rate of 115.432 over this period, the BOJ withdrew $187.776 billion. As the U.S. GDP is 12.1688 times as large as the Japanese GDP, this would be the equivalent of the Federal Reserve withdrawing $2.2285 trillion out of the U.S. banking system over a four-month period. By way of comparison, the St. Louis Federal Reserve's zero-maturity money measure, MZM, is $6.9363 trillion.

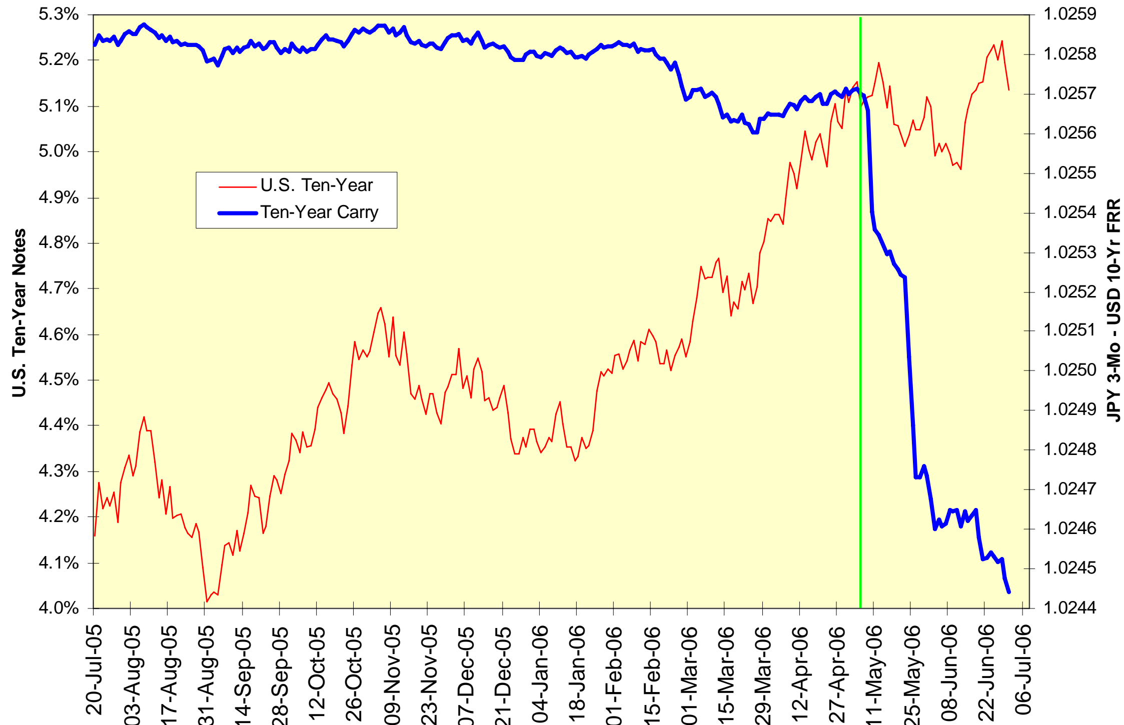


Let's go out on a limb and say such a move would be noticed both in the U.S. and elsewhere. It should not come as a surprise this move by the BOJ was greeted by selloffs in the MSCI Emerging Markets and Europe, Australasia and Far East indices and in the Russell 3000. By June 13th, the BOJ realized the enormity of its overshoot and re-injected the equivalent of ¥7.5 trillion back into the system. The world's bourses rebounded accordingly. Scrap all the focus on the Federal Reserve and the next move in the federal funds rate; focus instead on the oafish attempts by the Bank of Japan to manage the supply of money.

Flatter Still

When we consider how smartly financial markets rebounded following last week's FOMC meeting, we might think an easier Federal Reserve has joined a chastened Bank of Japan in opting for the risk of higher inflation as opposed to the risk of global recession. The 10-year average rate of consumer inflation implied in the TIPS market rose from 2.5669% on Tuesday to 2.0621% on Friday, and the price of gold bullion jumped from $570.05 to $615.85 over the same period. Judging from the markets' reactions, investors are happy to assume the risk of inflation in return for an end to the fear the central banks will raise rates and restrict credit excessively.

But we are not out of the woods just yet. The carry from 3-month yen LIBOR to ten-year U.S. Treasuries as measured by the forward rate ratio between the two continues to move downward toward 1.00. This ratio is the rate at which we can lock in dollar lending from yen borrowing for 9.75 years starting three months from now divided by the ten-year Treasury rate itself. At some point, Japanese investors will be faced with little interest rate return for assuming the currency risk of a stronger yen.



If central banks cannot predict the outcome of any of their actions, a topic addressed here last November, and if they cannot manage both the supply and the price of money simultaneously, we will be faced with the inevitability of a policy error. Either the bankers please us market hypocrites who cry about inflation but cheer when the fight against it is dropped, or we face a recession and a credit crunch. The betting here is we will accept higher inflation.

In the long-term, this is the less desirable path from central banks who deliberately are out of the political system so they can focus on long-term price stability. In the short-term, markets love easy money and will succumb to the illusion all will be well.

Is a perfect outcome between higher inflation and slower growth possible? Yes, but that is not the way to bet. As another pioneering physicist, Ernest Rutherford, remarked after experiments positing the existence of an atomic nucleus, “It was almost as incredible as if you fired a 15-inch shell at a piece of tissue paper and it came back and hit you.” Do that, and they will call you a Maestro.