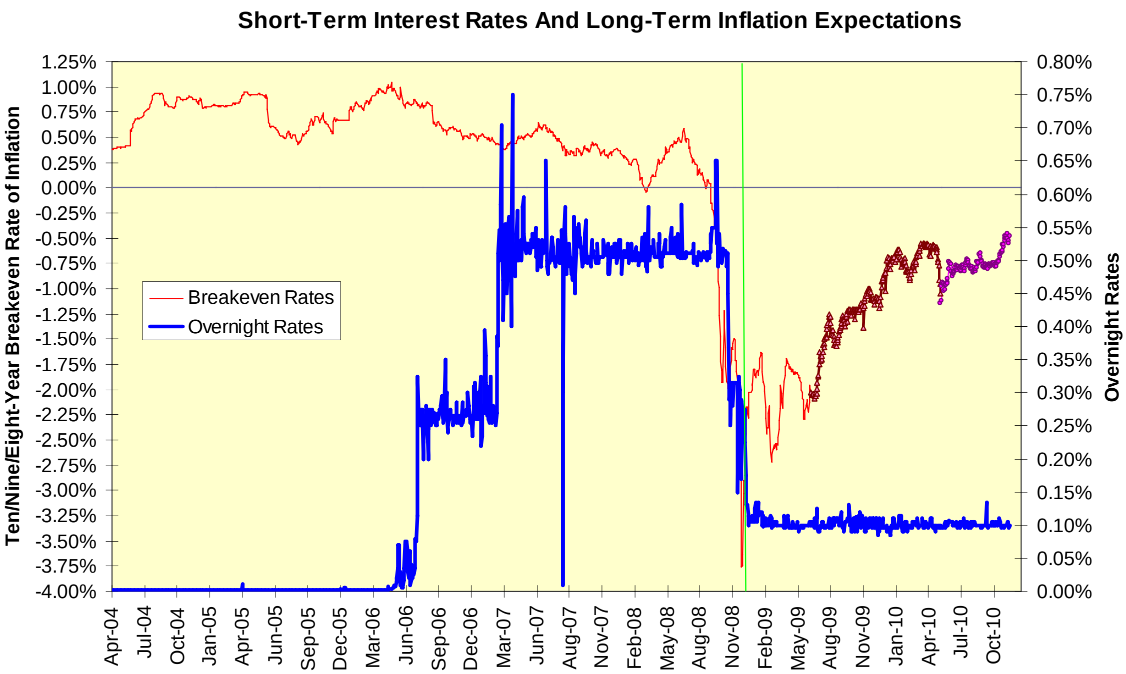
Japan Failed At Deflation Management

To paraphrase Yogi Berra, you can find a lot just by looking. For example, you can find inflation-linked bonds (ILB) in Japan, a country that has spent most of the last twelve years with negative year-over-year changes in its CPI. This is exciting: Anyone can sell you insurance in an adverse trend, but it takes a genius to sell you insurance in a favorable trend.

This might be a laboratory curiosity were it not for the Federal Reserve's commitment to battle the evil forces of deflation, its justification on even-numbered days for its campaign of money-printing. If you do not like that reason, come back on the odd-numbered days for messages on how money-printing will solve unemployment, low investment and – my personal favorite – how it will create those financial bubbles we have come to know and love while they are inflating.

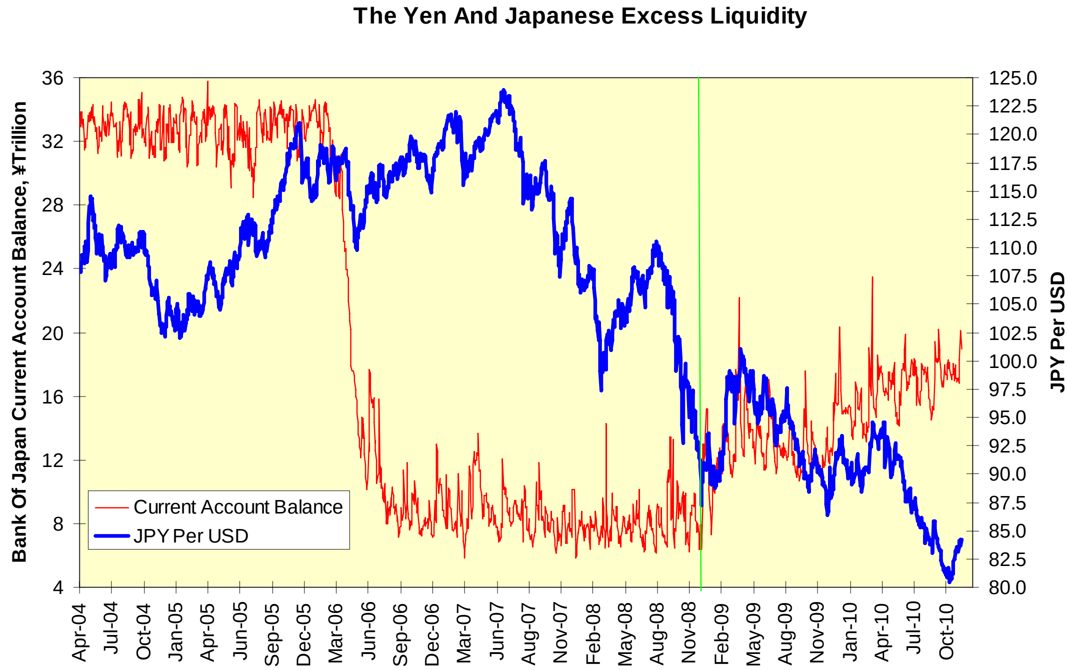
Breaking Even

The difficulty in selling long-term ILB in a country with actual and not imagined deflation means various generic ILB indices sort of disappear when you are not looking, which is most of the time. The chart below splices together breakeven rates of inflation implied by ten-, nine- and now eight-year ILB; these are marked in thin red, hatched red and magenta lines. Please note how two years after Japan's version of QE2 (not to be confused with WTF4) in December 2008, marked with a green line how these breakeven rates are still struggling to get as high as zero. Overnight interest rates, which had been virtually zero through the first half of 2006, are now at a relatively lofty 10 basis points.



Piles Of Money

As our own monetary geniuses – just ask them, they will tell you – have discovered over the past month, printing money does not always have the desired effect in the currency markets. If we look at the Bank of Japan's current account balance, the amount of excess reserves on their balance sheet, we see how they plunged during the BOJ's abortive attempt in 2006 to raise short-term interest rates. They began climbing again after December 2008, but the yen continued to strengthen against the dollar until – and this is ironic – the U.S. restarted its monetary pump in November. Not only did printing money fail to break deflationary expectations, it failed to keep the yen from rising. All conspiracy theories regarding China's yen purchases are account for in this last statement.



Let's conclude by paraphrasing Ronald Reagan: Is Japan better off now than it was twenty-one years ago? Twelve years ago, when it adopted its zero interest rate policy? Ten years ago when it adopted QE1? Two years ago when it adopted QE2? The answers, in case you are wondering, are no, no, no and no again.

It will be no different here.