Central Banks Proved A Negative

One of the highest compliments readers have paid me over the years is some variation of, "I cannot tell what your politics are." Just as I will switch from being bullish or bearish on any given market as the conditions warrant and be right on occasion, this "mask" of trying to keep my biases to myself hopefully diverts attention to what I am writing rather than to me.

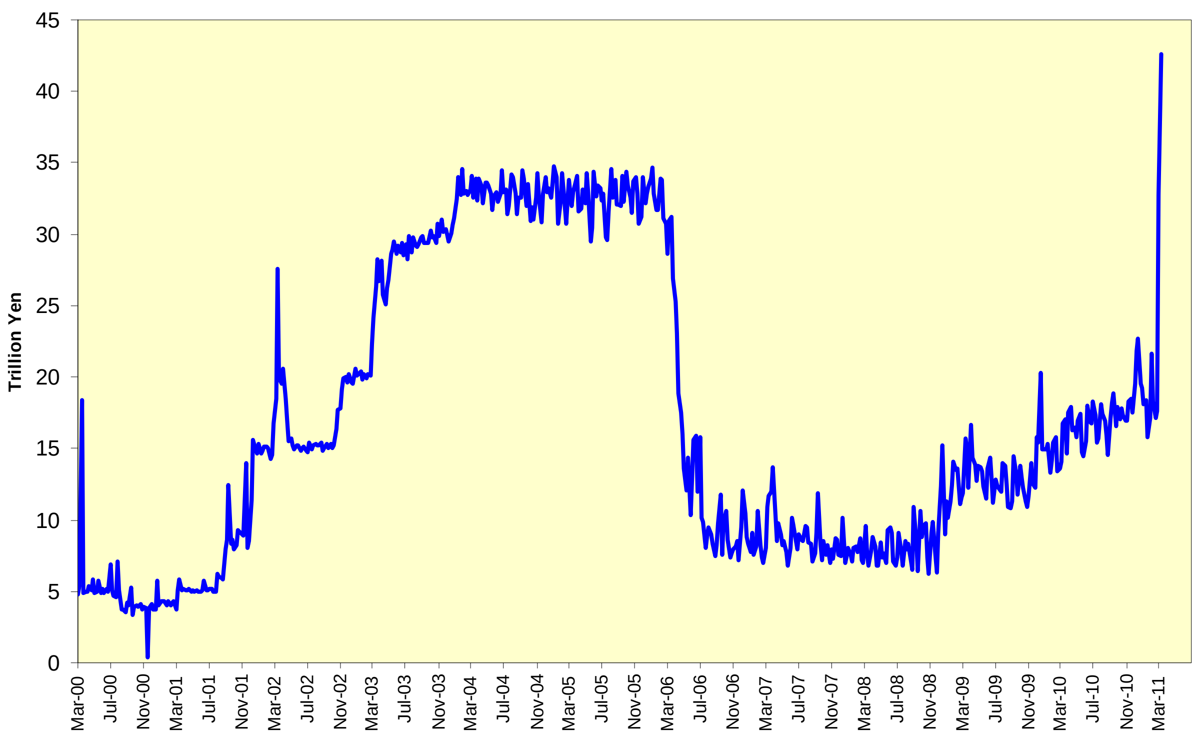
Even so, I have seldom hidden my opinion on central banks: As monetary policy is incapable of producing deterministic outcomes, a too-fancy way of saying if you turn the steering wheel clockwise the car should move to the right, it should not be used for policy stabilization. Please see the bubble-and-bust cycles of our lifetimes as evidence.

However, I now will issue a man-bites-dog statement in praise of the joint G-7 interventions against the surging yen two weeks ago. The set of disasters visited upon Japan raised the very real possibility of a surge in the demand for cash; recall Alan Greenspan's decision to have an extra $50 billion in cash printed in front of Y2K more than a decade ago as insurance against a bank technology failure. The resulting withdrawal of bank deposits would have led to a contraction in the Japanese money supply. This deflationary impulse in deflationary Japan would have propelled real short-term interest rates higher.

Those higher short-term rates would have made the yen more expensive to borrow, raised the real debt load on Japan's already over-indebted government and led to a panic to repatriate yen before they got even more expensive. If we combine this little death-spiral with the presence of a large number of barrier options, akin to a buy-stop, for the yen just above their all-time high near 80, we could have had the makings of a runaway freight train.

The only way to break the panic was to supply sufficient yen to the market to remove the deflationary threats of bank withdrawals and a surging yen. This was done, and in a size almost inconceivable to those of us who do not sling about trillions of anything.

Bank of Japan's Current Account Balance



The situation now is notable for what did not happen: We did not see a surging yen, a surge in Japan's real short-term interest rates and panicky liquidation of Japanese-owned assets overseas. The central banks acted swiftly, forcefully and decisively to forestall that panic, in the best tradition of 19th century sage Walter Bagehot who advised the Bank of England to lend freely at a penalty rate against good collateral at a time of crisis.

The real trick now will be to keep these yen from being borrowed outside of Japan in a re-ignition of the yen carry trade. That happened after the 1995 Kobe earthquake and led to the creation of the late 1990s global financial bubble.