China-Japan Currency Deal Could Hurt U.S. Treasuries

Both Countries Will Lose Urge to Devalue Competitively

It is a staple in romantic comedies: Two suitors are fighting over the favors of a young lady who pleads, "Stop it! I'm not worth it!" The two combatants exchange a glance with each other, realize she is right and then go off to perform some other mischief.

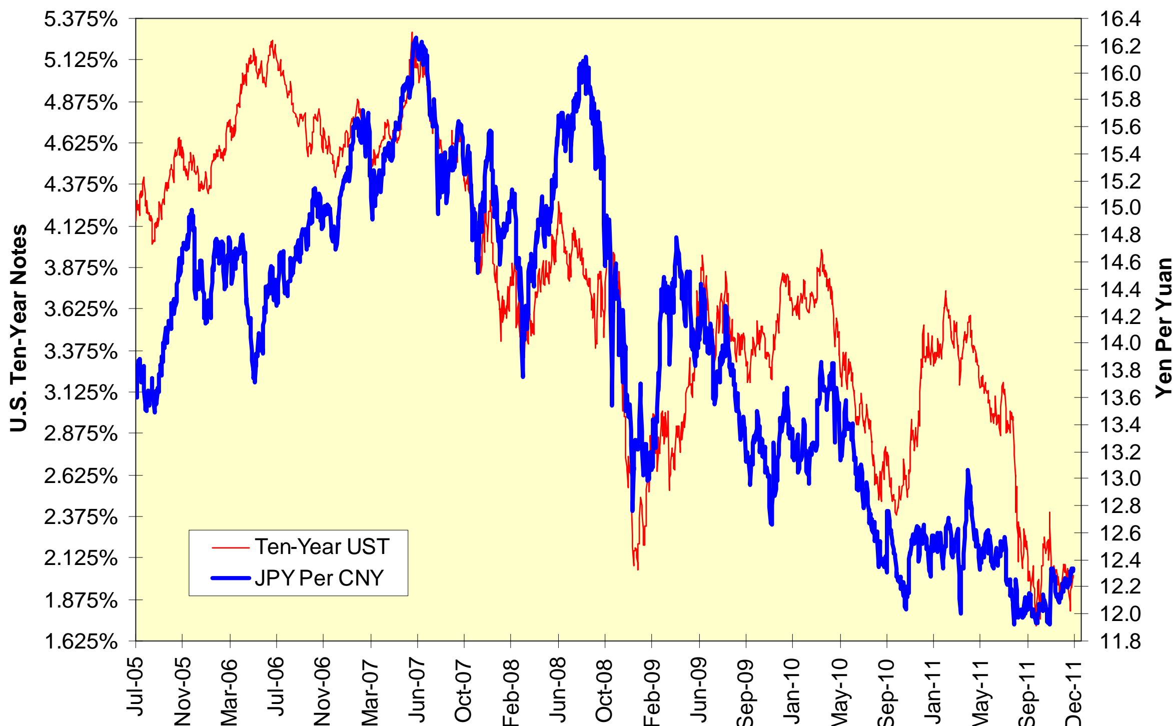
Japan and China have been engaged in a war of competitive devaluation for more than a decade where both have used the tool of massive purchases of U.S. securities to weaken their currencies against both the dollar and against each other. Why Japan has persisted in this fight has mystified me for years as there is no exchange rate where high-cost Japan could gain a price advantage over low-cost China. International economics and trade theory hold Japan should focus on its competitive advantages of high-quality and use its strong yen to build production facilities overseas.

Last week's announcement by the two countries they would trade their currencies directly with each other rather than through the dollar and that Japan would buy Chinese bonds for its foreign exchange reserves signals an end to the era of competitive devaluation. It also eliminates one incentive for both countries to buy massive quantities of U.S. securities in general, Treasuries in particular. If I may be so bold, I think both countries are feeling abused by the American penchant to keep on borrowing as if foreign willingness to keep lending was unlimited. Moreover, how would you like to know you just bought a handful of dollar-denominated assets and Ben Bernanke was inking up the old printing press?

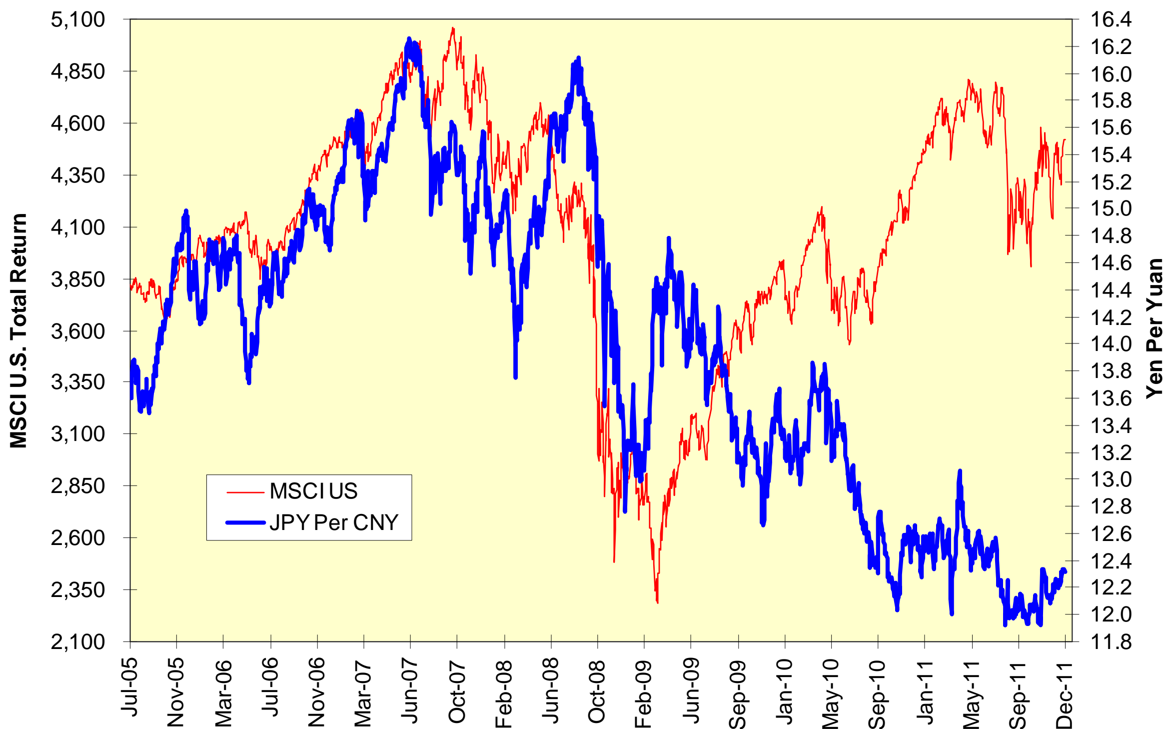
The Treasury Connection

What has been the relationship between the yen/yuan cross-rate and U.S. Treasury yields since China first moved toward revaluation in July 2005? Between March 2007 and March 2009, the connection was very direct; each time the yen weakened on the cross-rate, Treasury yields rose and vice-versa. After QE1 began and especially after the dollar became cheaper to borrow than the yen starting in August 2009, the connection weakened. The QE2 era saw low Treasury yields in the face of a weaker yen as the Federal Reserve supplanted the two Asian exporters as the largest holder of Treasuries.

The Yen-Yuan Rate And U.S. Notes



The Stock Market Connection
Something similar happened in the case of U.S. equities as measured by the MSCI-Barra total return index. Once the dollar became cheaper to borrow than the yen in August 2009, stocks disconnected from the cross-rate and then took off during the QE2 era.



While U.S. stock prices were higher with a weaker yen on the cross-rate prior to the 2008 financial crisis, there is no reason to believe this relationship was causal. What seemed to have happened was the financial crisis ended the yen carry trade. This pushed the yen higher on the cross-rate and induced a huge U.S. monetary response that pushed stock prices higher after March 2009.

The link between the cross-rate and Treasuries does appear more causal, however. If neither country maintains its Treasury purchases, U.S. yields are going to move higher unless the Federal Reserve offsets their move with a QE3 move of equal or greater magnitude. This would be money-printing on a Biblical scale and would trigger fears of higher inflation to come. Either way, we may be looking at 2% ten-year Treasury yields in the rearview mirror very quickly.