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Propping Up Yen Is No Sure Thing

STREETWISE |

By James Mackintosh

The joint U.S.-Japan support of the yen is unusual. The way it is being financed is unprecedented, and adds liquidity when the punch bowl of the U.S. economy and markets is already overflowing.

Put simply: America is printing dollars so Japan can buy yen. It's not quite quantitative easing, because the Federal Reserve is lending Japan money in return for temporary ownership of Treasurys in repurchase agreements, rather than outright buying the Treasurys. But like QE it expands the Fed balance sheet and pumps billions of dollars into the economy.

So far the scale is small, but Treasury Secretary Scott Bessent wants the Fed to prop its $60 billion cap

on the emergency facility being used—or abused, given there is no emergency—to lend to Japan, and pledged to do "whatever it takes" to help.

Note

When the Fed is widely thought to be moving toward raising rates, this is exactly the opposite of what it should be doing. Expanding the balance sheet is also the opposite of what Chairman Kevin Warsh has repeatedly said he wants to do.

All that said, is it a bad idea?

Note

Start with the yen, which is seriously weak. In June it dropped to its weakest against a basket of trading partners and adjusted for inflation in data going back to 1970. Japan, which imports most of its energy, is facing a double whammy of higher oil prices and even higher prices in yen terms as the currency plumbed new depths.

Aweak currency doesn't justify intervention on its own. But the yen has also been behaving oddly.

In just over two years the Bank of Japan has raised rates five times, while the Fed has cut rates six times, narrowing the gap between the interest available in the different currencies from 5.6 percentage points to 2.75 points. The gap between 10year U.S. Treasurys and Japanese government bond yields has dropped from a 2023 high above 4 percentage points to below 2 points.

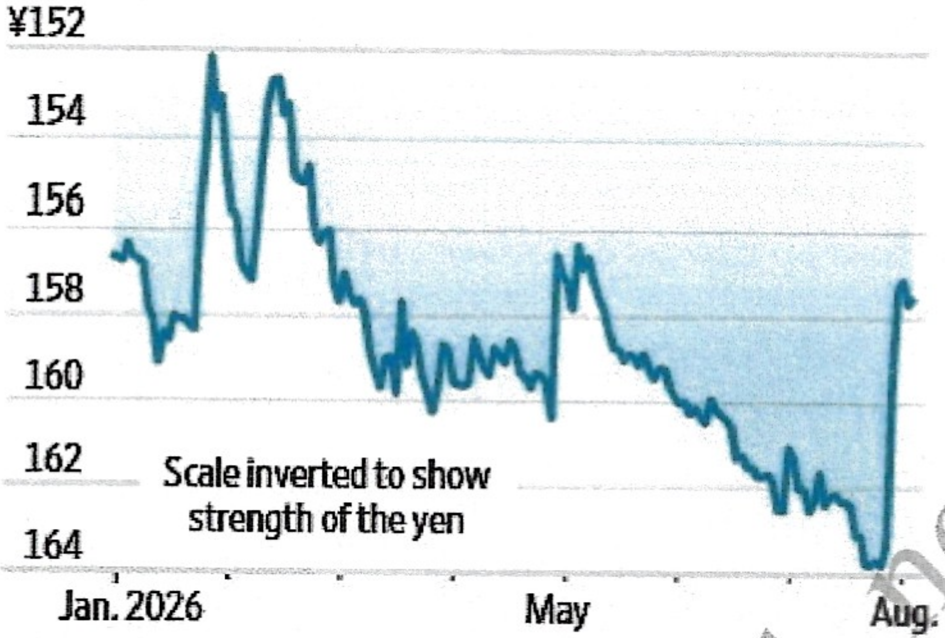
The "carry trade" of selling yen and earning interest on the money in dollars should have become less attractive as policy rates converged, strengthening the currency. But it continued to work because traders shifted to focus on 2-year note yields, where the gap widened a bit this year amid a cautious tone from the BoJ and expectations of Fed rate rises.

Crucially for those putting on the trade, the yen weakened without much volatility, and speculative bets against the yen ramped up to reach far and away their highest in Commodity Futures Trading Commission data back to 2010.

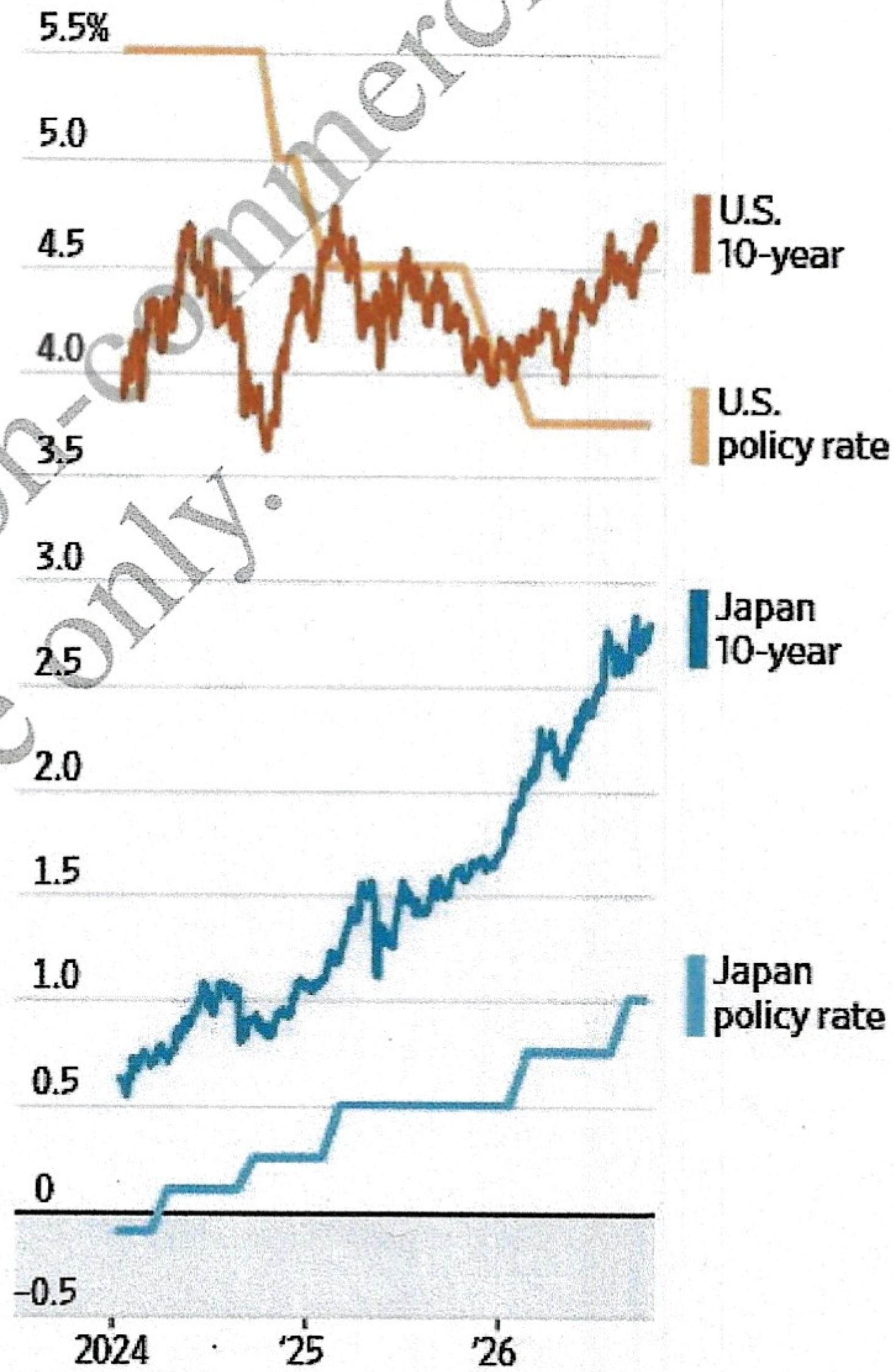
The real measure of effectiveness is whether the intervention forces the market to reconnect the yen's level against the dollar to the interest- rate gap between the U.S. and Japan. The surest way is for the BOJ to be clear that more rate rises are imminent.

Intervening now makes some sense, but the way it is being done should make us worry both that the Treasury is concerned about a hidden problem in government debt, and that the Fed is being roped in to ease monetary conditions when it should be moving to tighten them.

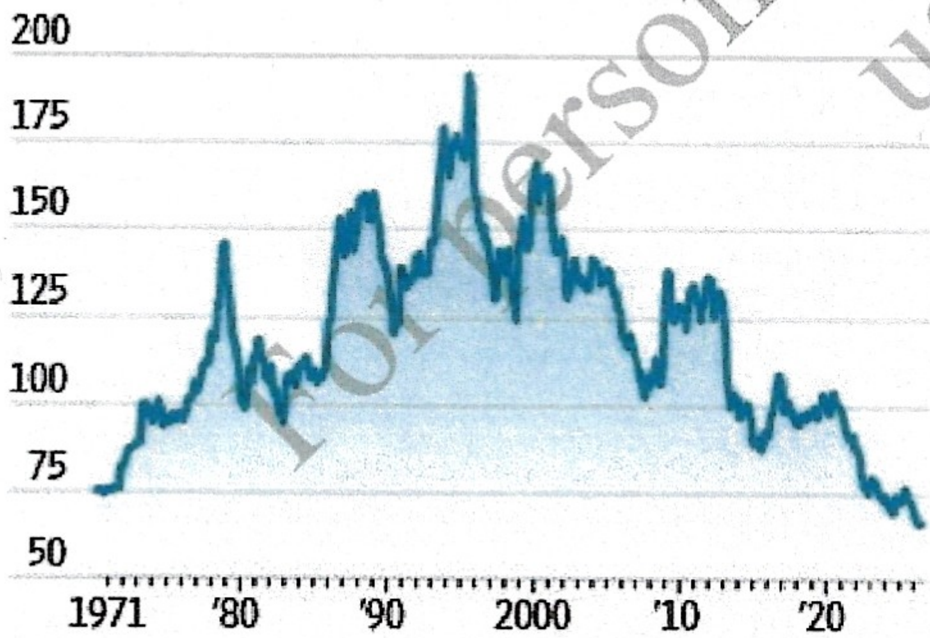
How many Japanese yen $1 buys



Long bond yields and central bank rates†



Japan inflation-adjusted, trade-weighted exchange rate index*



*Monthly data through June †Central bank target rates are monthly; upper bound of Fed target range shown
Sources: Tullett Prebon (forex); LSEG (index, bond yields)