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Central banks stash cash for unwind shock

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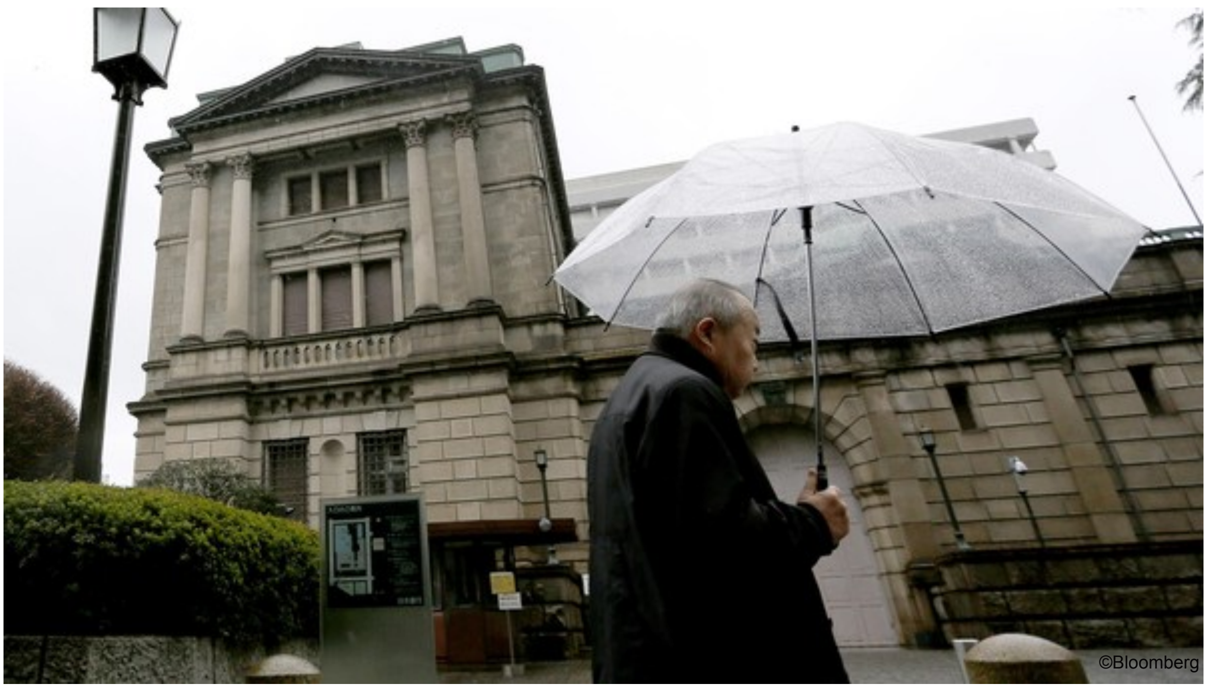
BoJ has allocated 25% of its QE profits to higher reserves



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It should be no surprise that in the Alice in Wonderland world of central banks these days — when preserving the value of the currency no longer matters much — among the biggest beneficiaries of monetary policies are governments and central banks themselves, at least for the moment.

The Bank of Japan, for example, has just reported that its net profits surged 28 per cent in the year to March to more than Y2tn. That performance owed less to canny investment management, however, than to the dramatic expansion of the BoJ's balance sheet as a result of its quantitative easing, and to translation gains on foreign investments as the yen continued to weaken — largely because of the BoJ's own loose monetary policy.

The Japanese central bank balance sheet was up 34 per cent

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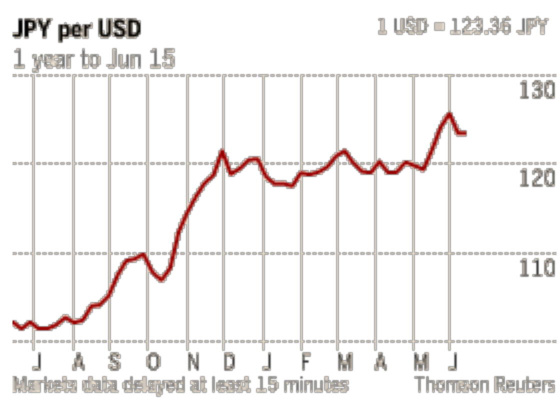
for the period. And while the value of its holdings of Japanese government bonds rose almost 43 per cent, the return on those holdings "has fallen persistently, despite the lengthening maturity", notes Masaaki Kanno, head of economic research in Tokyo for JPMorgan and a former BoJ official.

That is because the Bank's JGB yields declined to 0.521 per cent in the second half of the fiscal year (also largely because of buying by the BoJ and other government-linked institutions).

The BoJ has shares, although they do not trade in the market. But if they did, this still does not mean the BoJ is a screaming buy. The biggest surprise in the report was the BoJ's decision to allocate 25 per cent of its profits to increased reserves, as Mr Kanno notes.

This is both to brace itself for a rise in volatility and to prepare for its eventual exit from the current policy. In other words, the BoJ understands better than most investors how artificial the value of financial assets has become. (It is required by law to only set aside 5 per cent of its profits to reserves.)

This is the dilemma of all developed market central banks that have engaged in unconventional monetary policies. Since their actions have driven up the value of financial assets, it is hard to imagine that their exit will not reverse the surge in value given that economic fundamentals have not improved much, though the principal mandate of central banks is not to produce massive profits anyhow.



Central bank money has sloshed into financial markets far more than into the real economy and has driven down the value of currencies. Now some analysts are predicting that the yen may slide from about Y123 to the dollar to Y140. In real terms, the yen is at historic lows, according to data from Morgan Stanley, with the aim being to stimulate exports by underpricing competitors.

To some officials in emerging Asia, this means developed markets are declaring war on the exports of emerging markets by driving their own currencies down, since exports in a world where trade is more or less flat is essentially a zero sum game.

Some Chinese officials are quietly saying that if the dollar keeps going up and the yen (and euro) down, they may be forced to devalue. That, of course, would lead to another major round of volatility in both the foreign exchange market and financial markets.

At the same time, China is offering swap lines to other emerging market players to help them deal with volatile capital flows stemming from developed world QE. China has signed such agreements with a total of 33 governments, of which 25 or 26 are in emerging markets.

By contrast, in the autumn of 2013, when many emerging market governments thought (mistakenly) that unconventional monetary policy in the US was coming to an end, they approached the US for central bank swap lines — and all were turned down, according to both officials and academics. That made governments in emerging markets conclude that China is a more reliable friend than the US, says Eswar Prasad of Cornell University and the Brookings Institution.

Today, US officials speak about how any future interest rate rises will happen in slow increments over a long period of time. They say the markets have fully discounted such rate rises.

In fact though, monetary tightening scares alone can move markets so dramatically that central banks may have to swiftly reverse course. But still, when these policies finally unwind, even 25 per cent reserves may not be enough to cushion the blow.

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