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All eyes on Japan

Japan's support of the dollar may have ended, which could push U.S. rates higher; stay tuned.

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By Mark Gongloff, CNN/Money staff writer

NEW YORK (CNN/Money) - A Herculean effort by Japan to support the U.S. dollar is apparently over, at least for now, but there seems to be little risk of a sudden plunge in the greenback or a jump in U.S. interest rates, analysts said Wednesday.

Since the start of the year, the Japanese central bank has pumped some $144 billion into U.S. Treasury bonds, after buying $193 billion of Treasurys last year.

By buying bonds, the Bank of Japan hopes to keep demand for dollars strong, thus weakening the yen, which would tend to help the Japanese exporters that are key to cementing yet another fragile recovery in the world's No. 2 economy.

The purchases by the central bank have also helped keep U.S. interest rates super low, since as bond prices rise, their yields decline.

But the bank's aggressive campaign has apparently ended in recent weeks, according to traders and news reports, and the yen has rallied furiously as a result.

Wednesday morning the dollar sank below 105 yen, a key psychological level, and briefly touched 103.90 yen, its lowest in four years.

Though some say Japan's central bank is simply cooling its heels at the end of Japanese fiscal year, and is ready to jump back into the market to weaken the yen, there are also signs that the Japanese economy is finally coming out of its long slump.

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An economic recovery could draw investors to Japan, increasing demand for Japanese stocks, for example, and decreasing investors' appetite for Treasury bonds, the dollar and other U.S. assets. In that way, the market would work against future central bank efforts to prop up the dollar.

While that would seem to raise the risk of a sudden dollar decline and a sharp rise in U.S. interest rates, threatening the health of the U.S. economy, most analysts aren't worried.

For one thing, Japan has no interest in helping such a disaster occur, since a slowdown in the U.S. economy would only hurt its own ability to export goods to the States.

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"The Japanese would argue that they never really intended to bend the trend of the dollar; they were just trying to make sure the dollar depreciated gradually, in an orderly fashion," said Sung Won Sohn, chief economist at Wells Fargo & Co. "I suspect that's still their game plan."

What's more, it's not a sure thing that even a dramatic end to Japan's intervention would push U.S. interest rates much higher. Fed Chairman Alan Greenspan has said recently that less intervention by the Japanese wouldn't be the end of the world, and most economists agree with him.

"This whole question of the impact on interest rates is really complicated, but a lot of smart people at the Fed and elsewhere have said it's not really a big issue -- it's only suppressing long-term interest rates at the margin," said Lara Rhame, a senior economist and foreign exchange analyst with Brown Brothers Harriman who is a former Fed economist.

Lehman Brothers senior economist Drew Matus, in a research note to clients last week, noted that most Japanese buying has been in short-term Treasury bonds, which may have crowded other investors out, pushing them into longer-term notes. A slowdown in Japanese buying might only make room for other investors to quickly step in and take up the slack.

Though Matus warned that an abrupt Japanese pullback might cause a "sharp reaction" in the market, the reaction this week has actually been dulled by confusion about the Bank of Japan's intentions and by the large amount of money the bank has in cash reserves, which will be put to work at some point, possibly in U.S. Treasury markets.

Traders may end up scratching their heads, sorting out the possibilities, rather than selling off U.S. Treasury bonds, Matus suggested Wednesday, meaning the transition to less-vigorous Japanese intervention will not be so jarring.

"The longer this news drips into the market, the lesser the impact will be because people will become accustomed to the idea," Matus said.

And there's no guarantee Japan's economy is finally on the mend -- it's seen many false springs in the past decade or so. Another slowdown could help sink the yen and support the dollar.

Morgan Stanley chief global economist Stephen Roach, in a note to clients last week, warned that Japan depends too much on exports to China and business spending, with little help from Japanese consumers.

"Without the consumer, revival remains all too dependent on tenuous support from China and [business investment]," Roach wrote. ■

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