

Kobe Steel Bailout Poisons Capitalism

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Last week, the German and American stockmarket indices hit symbolic highs. Today, Japan is expected to break a 56-year record.

Futures, a de-facto prediction of stockmarket performance before the market opens, were up over the weekend. This morning the actual stockmarket followed suit. By this afternoon, Japan will have managed 15 consecutive daily trading gains. That breaks an all-time record.

Japan is still nowhere near its 1990s stockmarket high. But the run of steady gains is still impressive. And the source of the optimism is obvious.

No, it's not the re-election of Japan's Prime Minister Shinzo Abe. Nor the tentative resignation of the Japanese Emperor Akihito. Politics in Japan doesn't throw up surprises.

Obviously, it's the Japanese central bank that's behind the uninterrupted run. The Bank of Japan (BoJ) continues vast amounts of [quantitative easing](#) (QE). It practically invented the modern version of the policy years ago.

Now that it's credible, with other central banks around the world copying, the Japanese have broadened their own version. They buy a bigger selection of assets than any other major [central bank](#).

If QE is the source of stockmarket bonanzas, you have to wonder why we didn't try all this when stockmarkets were first invented. We could all be immeasurably rich by now. You wouldn't even need to subscribe to our newsletters. Just buy stocks.

Or perhaps we have tried QE over and over again in history. With consistently disastrous results following the short-term benefits each time...

But let's leave that aside today for a different story.

According to Nikkei Asian Review, the Bank of Japan has even been buying [bonds](#) from Japan's third-largest steel producer. That doesn't sound unusual at first. The BoJ is soaking up huge amounts of corporate bonds.

Unfortunately, Kobe Steel is caught in a major scandal. It falsified data in quality tests for the metals it sold. Sounds bad until you discover it's been doing it for more than ten years! That's horrific.

In typical Japanese , it even had a "fraud manual" to ensure continuity between management teams...

Kobe Steel's metal is now sitting in all sorts of Japanese infrastructure and products.

Corporate scandals are nothing new. But what's new is the self-anointed role the BoJ took up. This is the first time the bank bought bonds from a scandal-hit company. The BoJ is now in the business of financially supporting liars. This redefines the concept of "moral hazard" altogether.

Moral hazard is a theory which explains the misbehaviour that leads to financial crises. If bankers know they'll be bailed out by a central bank, they take higher risks. Throw in government bailouts and "too big to fail", and you can see how financial companies of a sufficient size believe they can do whatever they want. The government has their back.

Moral hazard was the original argument made against Walter Bagehot's pitch to classify the [Bank of England](#) as a lender of last resort. Making the lending market safer would actually make it more dangerous because firms would take greater risks. That debate was held about 150 years ago. The criticism sounded clever every seven years or so since. But that's too rare to matter in the political cycle.

Today, the BoJ has enshrined the idea of moral hazard into the corporate bond market. Companies struggling, even for the most immoral reasons, can seek support from the money spigot.

The BoJ bought around 17% of Kobe's total listed bonds. And around 75% of the bonds which are of the quality required by the BoJ under QE rules. Not a bad effort.

Nikkei Asian Review pointed out that the BoJ doesn't openly say which corporate bonds it's buying. But it's not terribly hard to figure out:

Whether the BOJ bought Kobe Steel bonds can be inferred by the average interest rate of corporate bonds accepted. The metric jumped from the prior operation in September, suggesting the steelmaker's bonds likely were included in the purchases.

Knowing that the central bank is purchasing a particular company's bonds is an enormous trading opportunity. Buying the bonds in anticipation of selling them on to the central bank is easy money. But you have to know how to figure it out.

From start to finish, one thing ties all these events together. It took a famous author of a famous fiction book a rather daunting amount of pages to explain the same idea. Something about the essence of capitalism. And how it's poisoned.

How monetary policy poisons capitalism

All of this is straight out of the book *Atlas Shrugged*. Japan is showing how central banks are hollowing out the core of capitalism. Not that there was much left before they started QE.

The story of Kobe Steel could easily be part of Ayn Rand's novel. Kobe might be the politically favoured competitor of the brilliant but hated Rearden Metal.

In the hidden chapter, corrupt Kobe made dodgy products for a decade, with consecutive cover-ups supported by politicians seeking re-election. The government intervened to support the company by buying its bonds in exchange for campaign donations and job stability in an important electorate. Meanwhile, the speculators in the know were served up a bond market trade on a silver platter to profit personally.

You can see how our real world now fits perfectly into Rand's novel. The same consequences play out too.

Why work hard if stocks only go up? Why not falsify data if the central bank has your back? Why spend time on analysis if you can just front run the central bank?

This is a global phenomenon. In Europe, it's in the news too.

The European Central Bank has bought more than 100 billion euro in corporate bonds. A campaign led by the [QE for People](#) group compelled the central bank to begin publishing more information about which bonds it bought. The bank had resisted, saying that the information would allow traders to game the system. But soon it will relent with a report every six months.

The corporate bond market is the central banks' latest victim.

Until next time,

Nick Hubble
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