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Fed to Bail Out Bank of Japan

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Though details are yet to emerge, it appears that the Federal Reserve has reached an agreement with the Bank of Japan to initiate a currency swap to shore up the faltering yen.

Currency-swap lines have become in recent years a standard tool to maintain financial stability. The Federal Reserve, in effect, loans dollars to certain other central banks for a fixed term of up to three months in exchange for the local currency. At the end of the term, the foreign central bank repays the dollars with interest.

These swaps are designed to discourage foreign governments from selling off U.S. Treasuries to prop up their own currencies. In the case of Japan, the yen has been in steep decline for months, stoking fears that Japan, the largest foreign holder of U.S. government debt, might attempt to defend the yen by selling U.S. Treasuries and obtaining U.S. dollars (a move that would allow Japan to print fewer yen).

In a global financial climate in which the market for U.S. Treasuries on the part of foreign governments has declined sharply over the past couple of decades, a Japanese fire sale of U.S. government debt holdings could be catastrophic for the dollar as well as the yen. This latest move to shore up the yen may be just a minor bump in the road — or it could betoken the end of Japan's three decades of monetary folly, whereby the Asian nation has become one of the world's most indebted, with a debt-to-GDP ratio well above 200 percent for years.