Currency Competition, Exchange Rate Regimes and Quantitative Easing (3)

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2016 Masters Forum
Chung-Hua Institution for Economic Research
Taipei, 25 August 2016

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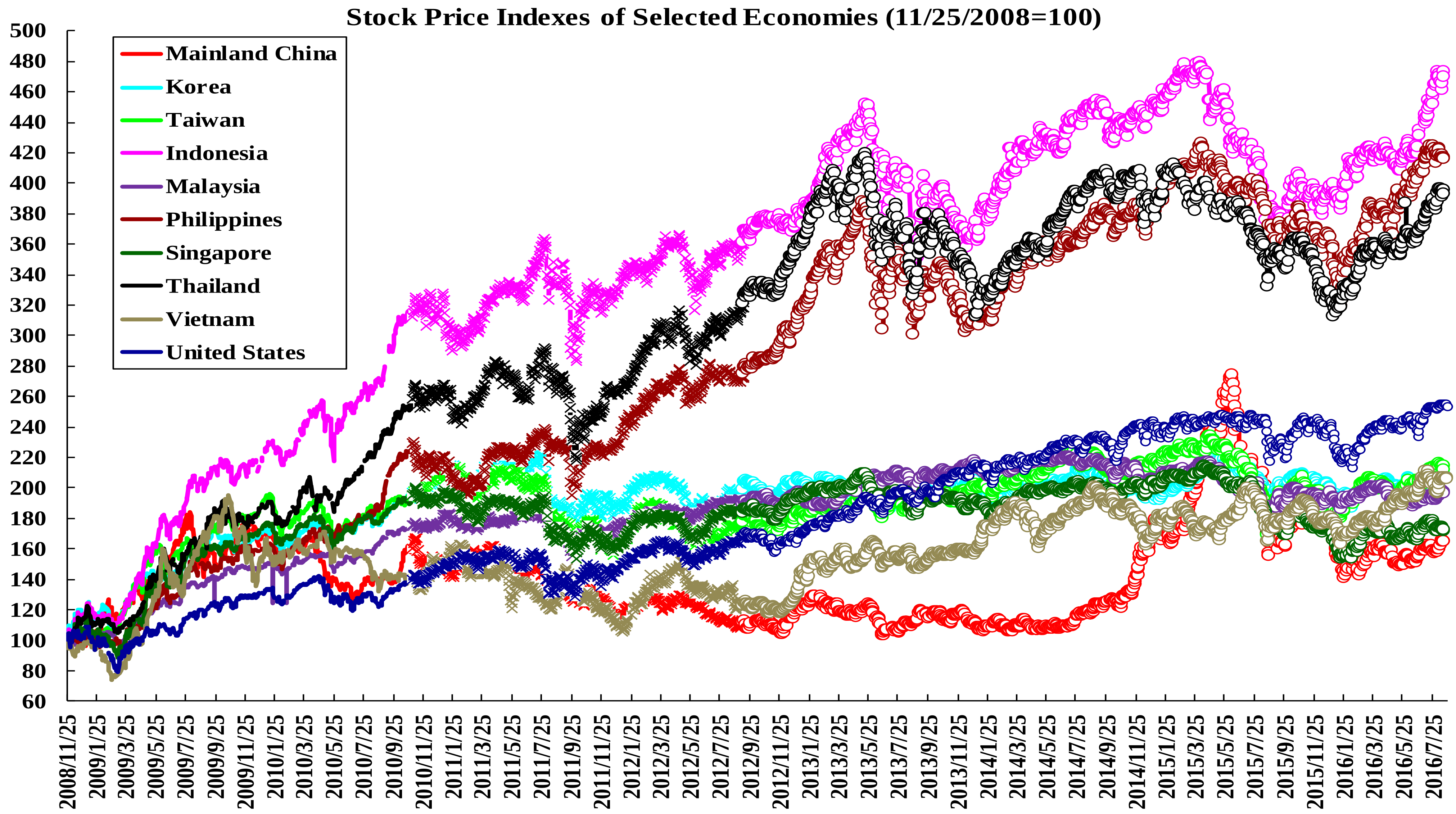
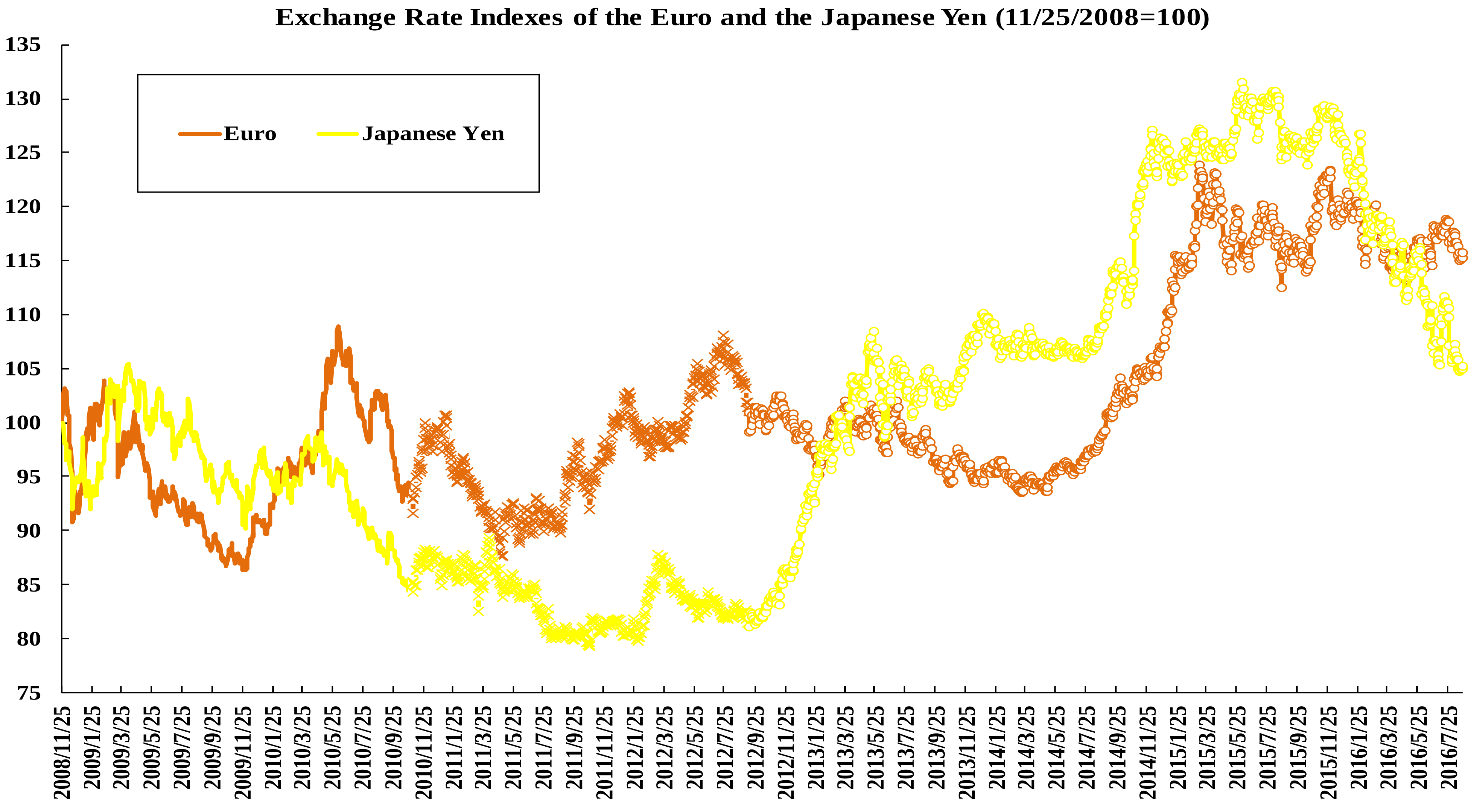
Stock Price Indexes of Selected Economies (11/25/2008=100)



The Effects of Quantitative Easing: "Counter-Q E" by Japan and the Euro Zone

- Japan, which saw its exchange rate rose to 75 Yen/US$ from 100 Yen/US$ as a result of the QEs, greatly hurting its exports, launched its own "Counter-QE" in late 2012. The Japanese "Counter-QE" or "QQE" was quite effective in driving the exchange rate of the Japanese Yen down to the 125 Yen/US$ level.
- The Bank of Japan could have achieved the same result by intervening directly in the foreign exchange market to stabilise the Japanese Yen/U.S. Dollar exchange rate, but there was probably opposition to its direct intervention from the U.S. Government on ideological grounds.
- The Euro did not appreciate too much relative to the US$ except during QE1 because of the sovereign debt and other economic problems within the Euro Zone itself. At the beginning of 2015, the European Central Bank (ECB) is poised to launch its own QE.

Exchange Rate Indexes of the Euro and the Japanese Yen (11/25/2008=100)



The Effects of Quantitative Easing: The Tapering of QE

- "Quantitative Easing" has not been particularly effective in stimulating new gross domestic investment, increasing real GDP or lowering unemployment in the U.S.
- QE3, as expected, not effective in stimulating the U.S. real economy. Thus, tapering and ending QE3 would only be a matter of time.
- That is why tapering began after the December 2013 meeting of the U.S. Federal Open Market Committee and the end came in October 2014.
- The QEs succeeded in stabilising the U.S. financial sector in the aftermath of the global financial crises, but failed until recently to return the U.S. real economy to a path of sustainable growth.

The Effects of Quantitative Easing: The Limits of Monetary Policy (QE)

- The experiences of the quantitative easing policies undertaken by the U.S. Federal Reserve Board, the Bank of Japan, the European Central Bank (ECB) and other central banks since late 2008 confirm what should have been well known—that monetary policy alone cannot turn a depressed economy around. Low interest rates cannot overcome the effects of negative expectations about the future. If expectations about the future of the economy are poor, then firms will not invest and households will not consume no matter how low the interest rates are, even if they are negative. Moreover, such expectations can be self-fulfilling.
- The U.S., Japan and many of the European countries have been stuck in a classic "liquidity trap". As the saying goes: "One can pull on a string, but not push on a string". Monetary policy or quantitative easing is powerless when faced with a low level of confidence about the future of the economy.

The Effects of Quantitative Easing: The Limits of Monetary Policy (QE)

- Both Japan and the Euro Zone undertook their respective quantitative easings not so much to lower their rates of interest as they were already low enough but to devalue their respective currencies vis-a-vis the U.S. Dollar. They are "implicit" currency manipulators. However, manipulating the exchange rates this way has the consequence of creating asset price bubbles as a side-effect and exiting can potentially be a problem, which is currently being faced by the U.S. Federal Reserve Board.
- In addition, zero or negative interest rates create asset price bubbles, which will eventually burst, with damaging consequences. They also have serious negative effects on the income and wealth distribution and impose hardships on the net savers of the economy--the middle and lower classes, especially the retired elderly.
- What is needed in all these economies is some real economic stimulus from real aggregate demand expansion. However, ideological considerations prevent these economies from undertaking more aggressive actions.

The Effects of Quantitative Easing: The Limits of Monetary Policy (QE)

- The Bank of Japan would have been better off by simply intervening directly in the foreign exchange market to lower the Yen/US$ exchange rate. Then at least it would not have caused an asset price bubble in Japan, lowering interest rates to negative levels and hurting the aged and the retired. However, it was constrained from doing so because of opposition from the U.S. on purely ideological grounds—direct intervention is anathema whereas indirect manipulation, via quantitative easing, is fine.
- While the lowered Yen exchange rate did increase Japanese exports on the margin, the low Japanese interest rate did not lead to any significant increase in domestic real investment.
- The European Central Bank was no more successful with its quantitative easing in stimulating additional real investment within the Euro Zone.

The Effects of Quantitative Easing: The Limits of Monetary Policy (QE)

- In retrospect, the U.S. QEs could have been much more effective in increasing real aggregate demand if instead of purchasing the federal government securities (Treasury and Agency securities), the U.S. Federal Reserve Board had offered to purchase the securities of individual states with the proviso that the all the proceeds must be used for either building new basic infrastructure or for repairing existing basic infrastructure within the respective states. This will inject significant aggregate demand in each of the states. The money would not have been wasted as U.S. basic infrastructure had become antiquated and under-maintained and ready for renewal over the years.
- The same could have been done by the Bank of Japan and the European Central Bank—to purchase local (in the case of the ECB, national) government securities to finance new or renovated basic infrastructure. It is still not too late for them to do so.

The Effects of Quantitative Easing: The Limits of Monetary Policy (QE)

- The truth is that easy monetary policy has not worked to revive the economies, and should have never been expected to work by itself alone.
- What is needed in every economy is an increase in real aggregate demand sufficient to change expectations about the future.
- As there is excess capacity almost everywhere, the social cost of an economic stimulus is small, especially compared to the lost output and employment.
- The World can really use a "simultaneous coordinated real economic stimulus" by all the major economies such as the U.S., China, Japan and the Euro Zone.

Concluding Remarks

- The international monetary order is in need of restructuring. However, adding the Renminbi as another potential international reserve currency does not really solve the problem.
- A more promising idea is to encourage and facilitate more economies to use their own currencies for invoicing, clearing and settlement of their international transactions. This can be done through a multilateral settlement mechanism similar to what the Bank for International Settlements did for the Western European economies in the 1950s. It may work within East Asia.
- A return to a Bretton-Woods-like system, with its relatively stable exchange rates, but without the use of gold, and instead relying on "Special Drawing Rights (SDRs)" or a few key currencies to play the role of gold, is a possibility worth exploring.
- It will mean that the world economy will not be so dependent and reliant on the currency of a single country.

Concluding Remarks

- Another possible way for reducing relative exchange rate volatility is exchange rate coordination among economies with close economic relationships (e.g., the "European currency snake" before the introduction of the Euro) on an entirely voluntary basis.
- For example, there can be an implicit understanding to maintain relative real parities among a group of economies, say, amongst East Asian economies, on an entirely voluntary basis. This would also facilitate the adjustment of exchange rates among East Asian economies with respect to other major currencies such as the Euro and the US$ as no East Asian economy would be relatively advantaged or disadvantaged.

Concluding Remarks

- QEs are not enough. And simply ending it may lead to a significant fall in asset prices. What is needed is a change in the expectations about the future. This can only be done with a real economic stimulus, coordinated among the major economies, to increase aggregate demand.