

CAMRI Global Perspectives

Monthly digest of market research & views

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From QE to Cheap Currency: The Race to the Bottom

By [Brian Fabbri](#)

Visiting Research Fellow, CAMRI & President, FABBRI Global Economics

From Divergence to Convergence

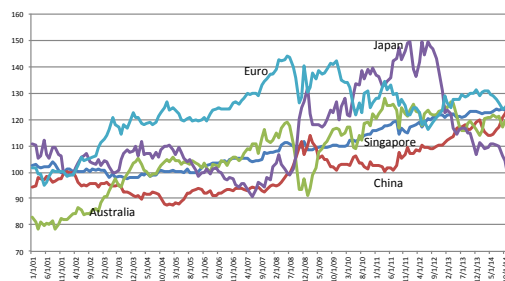
At the start of this year, global policy analysts were focused on predicting potentially divergent policy actions conducted in different parts of the world with dire implications for the global financial markets. Conversely, since the end of last year, all we have witnessed is the convergence of macro policies across developed and emerging economies. In fact, convergence has turned into a competitive race to cheapen host countries foreign exchange values.

Competitive Devaluation

The first to devalue was the Japanese government. The original moves by the Japanese policy makers to ease monetary conditions and cheapen the yen were critical parts of the Abe economic program in 2013. The three-part program was hailed almost universally as a positive step in Japan's long battle with deflation.

However, the global reactions to the second major devaluation of the yen in 2014 were quite different. In the aftermath of the economic slump in Japan during 2014 that was caused inexorably by the inappropriate imposition of a consumption tax, the Abe government doubled down significantly with more monetary creation through unrestrained quantitative easing and the yen plunged again. This time it led to several rounds of competitive devaluation among competing Asian economies.

Trade Weighted Asian and Euro FX

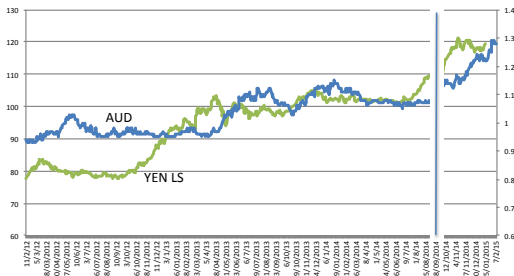


Korea, perhaps the closest and most sensitive economy to currency moves by

Japan, decided to ease monetary policy in the fall of 2014 soon after the Japanese turned up the monetary spigot. Pari-passu their actions weakened the South Korean won, but not by as much as the Japanese yen had depreciated. The South Korean currency had been on a slight appreciating path versus the dollar and the yen until the second great stimulus by Japan.

Not to be outmaneuvered, the Bank of New Zealand sought to maintain competitiveness with the Australians and therefore eased monetary policy sufficiently to allow the New Zealand dollar to depreciate roughly in line and coincidentally with the AUD. We probably won't have to wait long for the Thais to ease monetary policy and adjust their currency lower as well.

Asian Currency Moves After Two Episodes of Japanese Ease

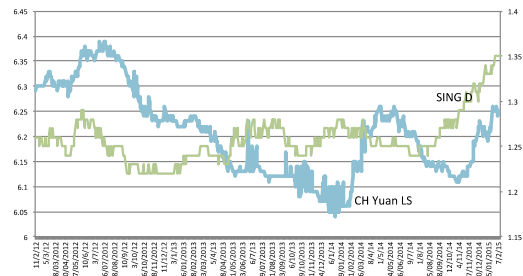


Follow the Leader

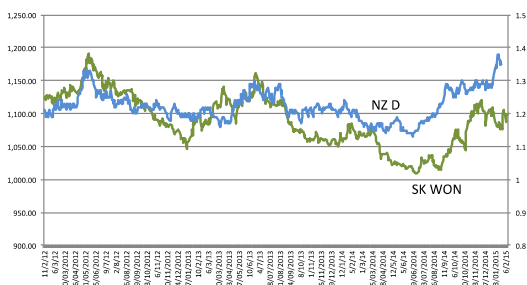
Most of the other large economies in Asia followed suit to some degree. The Bank of Australia eased its policy rates late in 2014 as commodity demand fell and commodity prices plummeted. Consequently, the Australian dollar depreciated significantly versus the USD.

The Singapore dollar began to depreciate around the same time, but the MAS waited a little longer following the Japan's second round before easing their currency's trading bands. It was just 13 days following the shocking Swiss move that the MAS lowered their policy rates.

Currency Moves by Asian Competitors



Currency Moves by Asian Competitors

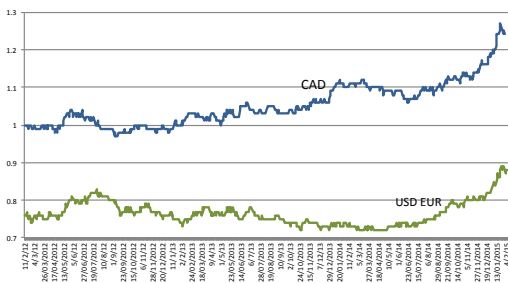


Even the Chinese decided to halt the two - year slow but steady appreciation of the yuan in the fall of 2014. They began a controlled depreciation slightly later than the other countries that had reacted more swiftly to the threat of becoming uncompetitive. The Chinese lowered official rates in December and followed that move in January when they eased reserve requirements on banks to encourage more

lending. It was the latest economic evidence that began confirming that economic growth in China was slowing more than the leadership had expected, and this prompted their second move.

Monetary creation by the world’s central banks is not enough to boost global demand and arrest the decline in prices. Governments need to boost demand by complementing their monetary ease with fiscal ease: increase infrastructure spending and create new jobs or lower tax rates.

Western Currencies React the Same



In the Name of Deflation

The justification for most of the easing moves by central banks across the world has been the deceleration of inflation and the threat of deflation. The sudden surprising decline in oil prices, and the shocks to other prices that the 60% fall in crude oil prices had set in motion, raised the specter of deflation in many countries and their respective price indexes began to confirm this fear. Consequently, central banks tried their old remedy and created more money to chase the available goods.

Improving the Terms of Trade is Good But Not the Only Result of Lowering Official Rates

Moreover, global competitiveness is important for economic growth, but trade accounts for only 10% to 15% of most countries’ GDP. Consequently, producing faster economic growth through improving a country’s global competitiveness has only limited value. However, in today’s modern world of interconnectedness attempting to control international capital flows through monetary policy is critically more important than improving trade terms.

Currency Manipulation is of Limited Value

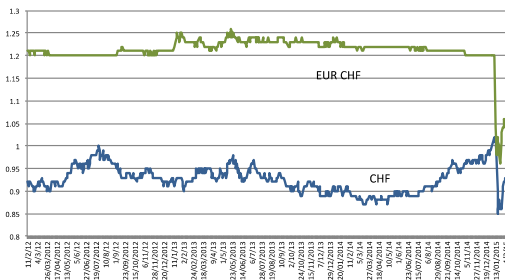
The problem with this global round of tit-for-tat policy easing and subsequent currency devaluation is that nearly every major country (and most minor countries) did it and therefore no country will benefit.

The Swiss were primarily worried about capital flows even though they are a small open economy more dependent upon foreign trade than many of the others. For years their foreign exchange policy was to closely align the Swiss franc with the EUR. As the EUR weakened over the past 6 months the Swiss had to buy more and more Euro bonds that yielded less interest than similar assets in Switzerland and they had to stockpile a depreciating asset. The Swiss also realized that their currency was weakening along with the EUR. In an astonishingly quick and unexpected move, the Swiss changed

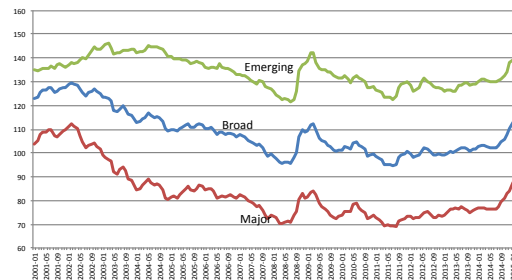
the peg, removed the cap on its currency's trading band, and the CHF soared initially.

thus creating larger asset bubbles and income inequalities.

The CHF Appreciated Until it Didn't



US Trade Weighted dollar



The Limits of Monetary Policy

The global competition to lower interest rates and to create more liquid assets through quantitative easing is sending interest rates around the globe to astonishingly low levels, and in some cases into negative territory, hence reducing incentives to hold fixed income securities. The immediate consequence is to raise the demand for riskier equity securities, especially in strong currency markets, and in relatively safe haven real estate markets. Most of the world's international institutions have warned governments about the risks of creating financial asset bubbles and the lose-lose situation from entering a currency war.

In addition, as these riskier assets become overvalued their rising wealth effect exaggerates the growing income and wealth disparity in these countries. Moreover, excess liquidity created by large economies can and often does overwhelm small open economies like Switzerland and Singapore,

The USD has Appreciated Most

What could prove to be the biggest risk to global growth this year is if there is a major stumble in US economic growth. As of now, the principal currency to bear the weight of concerted currency devaluation is the US dollar. On a trade-weighted basis against all currency pairs, it has appreciated by 10.8% in the past year, while against its biggest trade partners it has appreciated by 15.7%.

Because the US economy is predicted to grow the most vigorously of all the developed economies in 2015, it can afford the added headwinds of a stronger currency. However, the most recent US economic data from the end of 2014 and into the first two months of 2015 suggest that the faith in a US-led global economic recovery may be waning. Manufacturing data has been depressed, and it would be this sector of the US economy that would be most sensitive to lost global competitiveness. Ironically, the recent appreciation of the dollar may

become an impediment to future US economic growth rather than an affirmation of economic success.

Invigorating Stalling Economies

Governments need to reexamine their approach to deflationary threats and open their policy toolbox and discover that they have more tools than simply currency manipulation. Most struggling economies suffer from rigid regulations and outdated or inadequate infrastructure. It's time for politics of the past to step aside and promote growth for the future.

Consequently, there are at least two solutions for governments to undertake instead of, or in conjunction with monetary easing.

- The first is to reform outdated and strangling labor or capital regulations.
- The second is to scrap fiscal restraint and open the fiscal spigot by using available funds or borrowed funds and invest in infrastructure. It creates employment, stimulates economic growth, raises demand for resources, and encourages second round business investments.

Both of these solutions increase demand and most likely prices. And these efforts can turn the global macro policy game into a win-win situation.

For more information, please contact

camri@nus.edu.sg

KEY INDICATORS TABLE (AS OF 24 FEBRUARY 2015)								
INDEX	LEVEL (LC)	%1MO (LC)	%1MO (USD)	%1YR (LC)	%1YR (USD)	INDEX	LEVEL	%1YR
S&P500	2115.48	3.34%	3.34%	16.85%	16.85%	3MO LIBOR	0.26	11.63
FTSE	6949.63	2.10%	5.11%	5.11%	-2.38%	10YR UST	1.98	-27.69
NIKKEI	18603.48	6.24%	5.29%	27.53%	9.97%	10YR BUND	0.38	-77.70
HANG SENG	24750.07	-0.37%	-0.44%	14.92%	14.95%	10YR SPG	1.39	-61.06
STI	3437.61	0.87%	-0.13%	14.14%	6.19%	10YR SGS	2.31	-9.29
EUR	1.13	1.21%		-17.44%		US ISM	53.50	3.30
YEN	118.97	1.02%		16.06%		EU PMI	51.10	-5.60
CMCI	1146.87	4.35%		-22.95%		JP TANKAN	5.00	-37.50
Oil	49.28	8.09%		-52.07%		CHINA IP	7.90	-18.60

Source: Bloomberg

APPENDIX

GLOSSARY OF KEY TERMS (Source: Bloomberg, with tickers in parenthesis. In US\$ where applicable)

S&P500: capitalization-weighted index of the prices of 500 US large-cap stocks (SPX)

FTSE: capitalization-weighted index of the prices of the 100 largest LSE-listed stocks (UKX)

NIKKEI: capitalization-weighted index of the largest 225 stocks of the Tokyo Stock Exchange (NKY)

HANG SENG: capitalization-weighted index of companies from the Hong Kong Stock Exchange (HSI)

STI: cap-weighted index of the top 30 companies listed on the Singapore Exchange (FSSTI)

EUR: USD/EUR exchange rate: 1 EUR = xx USD (EUR)

YEN: YEN/USD exchange rate: 1 USD = xx YEN (JPY)

CMCI: Constant Maturity Commodity Index (CMCIPI)

Oil: West Texas Intermediate prices, \$ per barrel (CLK1)

3MO LIBOR: interbank lending rate for 3-month US dollar loans (US0003M)

10YR UST: 10-year US Treasury yield (IYC8 – Sovereigns)

10YR BUND: 10-year German government bond yield (IYC8 – Sovereigns)

10YR SPG: 10-year Spanish government bond yield, proxy for EU funding problems (IYC8 – Sovereigns)

10YR SGS: 10-year Singapore government bond yield (IYC8 – Sovereigns)

US ISM: US business survey of more than 300 manufacturing firms by the Institute of Supply Management that monitors employment, production inventories, new orders, etc. (NAPMPMI)

EU PMI: Purchasing Managers' index for the 17-country EU region (PMITMEZ)

JP TANKAN: Bank of Japan business survey on the outlook of Japanese capital expenditures, employment and the overall economy, quarterly index (JNTGALLI)

CHINA IP: China's Industrial Production index, with 1-month lag (CHVAIOY)

LC: Local Currency

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