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Recent turbulences suggest the limit of the world economy's capacity
～Worries about currency wars and secular stagnation theory～

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One thing has become apparent in turbulences and their convergence in the global financial market since the start of the year. It is the belief that the world economy will not be able to endure the four interest rate hikes by the US, even for aggregate 1%, despite the continued monetary easing for about 8 years since the previous crisis.

The US Fed confirmed the market view that there would be only 2 rate hikes this year, prompting the depreciation of the dollar, which helped the resource prices hit the bottom. The US stock prices have been renewing the highs since the start of the year, while the oil prices edging up to around $40 per barrel. However, this development has been an adverse wind to Japan and Europe that pushes up the yen and the euro, forcing the Bank of Japan and the ECB to take additional easing measures with the BOJ introducing negative interest rate and the ECB further expanding the negative interest rates and others measures. Yet the negative interests have produced rather an adverse effect before they get desired results.

Of course there is already a speculation that as the recovery of the US economy becomes clearer, the original outlook on rate hikes will revive, pushing the yen and the dollar back on the trend of higher dollar and lower yen. If that should happen, however, it may raise concerns about interest rate hikes and higher dollar, pushing the asset prices down again. Intentionally or unintentionally, the monetary authorities in Japan, Europe and the US appear to be groping for their degree of monetary easing to avoid the appreciation of their own currencies. Of course the oil producing countries are relying on a lower dollar. What has become clear is a fragile reality that no country may be able to achieve a sustainable growth without relying on the depreciation of its currency.

Mr. Rajan, the Governor of the Reserve Bank of India, sharply criticizes such situation[1]. In the first, Mr. Rajan questions whether such monetary easing as quantitative easing and negative interest rates really has strengthened the demand and the growth at all. Then he stresses the

[1] http://www.project-syndicate.org/commentary/new-monetary-policy-rules-needed-by-raghuram-rajan-2016-03

larger adverse effect with less benefit of it, noting that “monetary policy works by influencing public expectations. If an ever more aggressive policy convinces the public that calamity is around the corner, households may save rather than spend. That tendency will be even greater if the public senses that the consequences (distorted asset prices, high government debt, etc.) eventually must be reversed.”

He then explains about the external spillover effect of easy monetary policies beyond domestic impacts. Given the distortions of bond prices (unusually low interest rates) stemming from unconventional quantitative easing, institutional investors like pension funds and life insurance companies have no other choice to invest in foreign bonds. As a result, there arises a risk that triggers an excessive fall of a currency, he points out. Therefore, he urges, in order to prevent the risk of currency wars, some rules that require central banks of each country to carry out their international responsibility are needed.

A similar argument has been made by Marvyn King, former Governor of the Bank of England, in his recent book titled *The End of Alchemy: Money, Banking and The Future of The Global Economy.* Based on the tendency countries are seeking to devalue their currencies, he warns that competitive devaluation is a zero-sum game that countries scramble for demand from others. Japan seems to be one of the countries that get a yellow card on this game.

What is common to both arguments is a caution to the current situation where countries are delaying the writing-off of debts accumulated before the Lehman crisis and letting the bubbles increase again by completely depending on monetary easing which should essentially be used as a short-term policy measure. On the other hand, Professor Lawrence Summers of Harvard University emphasizes the possibility that the world economy is experiencing a secular stagnation again, and argues that the countries should cooperate to increase investment ratios by taking fiscal expansion.[2] He is also concerned with the currency wars triggered by excessive monetary easing.

With a prediction emerging that a Japanese type stagnation will prevail in the world, will it be sufficient for us just to wait for the recovery of demand with continued monetary easing? It may be the time that we should directly address the structural and essential problems of the stagnation.

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The Age of Secular Stagnation (Foreign Affairs March/April 2016)

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