

Stability in the Time of QE

Cliff Tan
Bank of Tokyo-Mitsubishi UFJ

IIMA Global Symposium
4 March 2015

The title of this talk, of course, borrows from Gabriel Garcia Marquez's famous novel, *Love in the Time of Cholera*. Love and stability seem benign enough, both worthy objectives in normal times, but QE has been inserted in place of "cholera," suggesting it's crossed the minds of EM (including Asian EM) whether QE is really cure or disease?

To begin, and speaking as a markets practitioner, this year's #1 Global Theme – policy divergence – could just as well be politespeak for: Global central banking is about as uncoordinated as we can remember in 30 years.

Our Assertion #1 (or Fact #1, because we don't think there is much dispute after recent years): The United States Federal Reserve conducts monetary policy with only the US economy in mind. We remember when New York Fed President Dudley paid a visit to Hong Kong in April 2011 and we stood up to ask a question we guessed was on the minds of many in the room that day: Does the US Fed think much about effects of its policies on other countries around the world? Dudley – who used to be one of us - and his answer were clear: No. With its twin mandates, the Fed looks only at those and nothing else: So there were no concerns for capital outflows from the US (inflows into EM and stronger EM currencies), if they help the US economy. Any concerns the US might have today about a "strong dollar" follow the same logic: Concerns about capital reflows (EM outflows) exist only if they hurt the US economy. E.g., the Taper Tantrum was mainly a concern for the Fed only if it affected US housing.

This is beginning to nudge us toward a recent debate between former US Federal Reserve Chairman Bernanke and RBI Governor Rajan. We had not been aware until looking up this event on the Internet that there is now an actual search term associated with this interchange (which took place at the Brookings Institution in April 2014, shortly after Bernanke retired) – the Bernanke-Rajan Face

Off! If you actually watched the interchange, you will have seen the question-and-response was quite polite, friendly even, but of course the Bernanke-Rajan Lovefest doesn't quite have the same ring to it.

In the exchange Bernanke said a couple of things that caught our ears. The first: “ ... *unconventional policies are **demand augmenting**, they increase demand in the economy, whereas exchange rate interventions like the tariffs of the 1930s are demand diverting.*” [Our emphasis.]

All well and good, but then how do you explain disinflation that's crept into the world, especially this year but also a trend stretching back several? This seems to me the weak underbelly of global central banking today. If QEs are demand-augmenting what explains an onset of disinflation? For us for many years it has made no sense for the US Federal Reserve to assert with confidence (and correctly) that don't worry, QEs won't lead to runaway inflation; but for the Bank of Japan (and now the ECB) to assert with just as much assurance that QQE/QE will certainly produce inflation. Do we all live on the same planet?

This is a big mystery to us, but not just us; we also suspect it's a mystery to the central banks as well. The profession has made some advances in recent years about the way micro prices diffuse through the macroeconomy, and with point-of-sale information now available there is also the promise of Big Data to throw hopefully more light (and not just more data) onto the problem. But for the bigger issue of inflation the models we work with don't seem that much more advanced than models we were using in the late 1970s. For whatever reason, near the zero bound global central banks seem to have problems generating inflation when they need it, which was not a problem contemplated when inflation targeting was becoming established as the central orthodoxy 15 years ago. To put it in monetarist terms, we seem to have had a large exogenous shift up in the hoarding (money demand) function, so that agents around the world are happy to hold those trillions and trillions of units of high-powered money central banks have created. Why? We don't know.

Nor, we believe, do global central banks. But to add the latest twist of irony, in an age of forward guidance CBs feel the need to sound more confident on this score than perhaps they are. A few years ago at the Hoover Institution's annual conference on monetary policy we stood up to ask Don Kohn, then Federal Reserve Vice Chairman, how confident he was in the Fed's own models to

predict inflation? We asked because the Fed's models were predicting deflation risks in the early 2000s – something Bernanke as Governor highlighted in his speeches at the time – which never materialized. Kohn, who came up through staff ranks, answered in a way that reminded us of the old Fed: Guarded but honest and transparent about the limitations of the models. Contrast this with another event in Hong Kong we attended in 2012, when Chicago Fed President Evans visited. We tried to ask why it seemed QEs were not working (as implied by the need to have to successively unveil more QEs). He got visibly angry and waved (figuratively) a sheaf of academic papers at us to assert that, don't be ridiculous, of course QE worked (he also forbade us from asking any more questions).

Being confident about the unknown is a good recipe for future surprises and volatility. Our critique is we feel global central banks are in a way flying blind, but too constrained by forward guidance to be able to admit it (or to at least have a healthy discussion about it).

The other thing Bernanke said at Brookings that caught our ears was, *"If you have a different empirical assessment than I do, that in fact, emerging markets would be better off if they hadn't been used, then you would have a different view."* So what's good for the US is good for EM. Ditto Japan. Ditto Europe.

Are we the only ones here to whom that sounds a little neo-imperialist?

The onset of QE initially led to some EM searches for alternatives to the USD-standard, perhaps most notably in PBOC Governor Zhou's revisit to the SDR and then-Finance Minister Mantega's invocation of currency wars. The proliferation of QEs across industrial countries has perhaps brought the old topic of searching for stable money back to the forefront of developing country finance ministries. Most of the discussion from industrial country sources we've seen basically says there's no alternative to the dollar, but that hardly seems to us a sufficient long-term answer for EM.

The development of the offshore CNH market is a response to the inability of Governor Zhou to advance the SDR discussion much, so it's ironic China is currently experiencing exchange market pressures through this mechanism which it itself set up. More recently we believe China has begun to

manage its currency with a view to tempering the effects on its REER of both USD strength and also the disinflation (sometimes outright deflation) that's set in among some major trading partners [present slide]. When a REER moves 5% in a month we are sympathetic to this response. We'll talk more about China in the panel discussion.

Our humble suggestion as a markets practitioner at the end of this talk is perhaps the G20 should discuss QE externalities more seriously – and to think about more coordinated fiscal stimulus and less uncoordinated monetary stimulus – because it really is beginning to look like a beggars banquet out there.