The Monetary Stimulus *Illusion*

The record in China, Japan, and even the United States is one of disappointment if not failure.

By Tadashi Nakamae

Perhaps economic policymakers, including Federal Reserve Chair Janet Yellen and the Bank for International Settlements, should take a closer look at Japan, China, and yes, the United States, when debating the limits of monetary stimulus and the dangerous nature of financial bubbles. The discussion is happening too late to be anything more than an intellectual exercise.

Since its inception in 2008, easy monetary policy has created very few positive effects for the real economy—and has created considerable (and in some cases unforeseen) negative effects as well. The BIS warns of financial bubbles. Quantitative easing has already created asset price bubbles in the United States and elsewhere, and an investment bubble (this includes capital expenditure and real estate) in China and other emerging markets.

Meanwhile, this policy has failed to have a positive impact on the real economy partly because central banks have adopted very aggressive monetary easing at a macro level while restricting banks from increasing the size of their balance sheets at a micro level (macro-prudential policy). As a result, easy money has flowed into asset markets through shadow banks and overseas through carry trades.

China has been the main recipient of this bounty. Yet unlike global asset market bubbles, China's expanding bubble is less well understood. China's economy has grown at a rapid clip this century. Industrial production, based on the value of the dollar in 2005, increased five-fold from $800 billion in 2000 to $4 trillion in 2013. China averaged an annual growth rate of 33 percent during this period while global

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production grew 3.1 percent and the United States barely grew at all (averaging 0.5 percent). Not surprisingly, China's share of global production increased from 4.5 percent to 22 percent between 2000 and 2013.

Take cement production. In 2013, China produced 2.4 billion metric tonnes of cement, 60 percent of the 4 billion metric tonnes produced globally that year. The scale of China's cement production is astonishing. Over the past two years, it has produced more than 4.2 billion metric tonnes of cement, more than the United States produced in the twentieth century. China matched a century's worth of infrastructure (plus capital expenditure) in just two years. But China cannot continue to produce cement at this pace. It will probably take several decades of adjustment for this to reach a rate that is sustainable, creating deflationary consequences for the global economy.

China exports deflation. Its GDP growth rate has fallen to 7.3 percent after peaking at 12.1 percent in the first quarter of 2011 (when aggressive stimulus measures were in place). As its economy stalled, it led industrial commodity prices, energy prices, and shipping freight rates to decline.

The ultra-easy monetary policies that fueled China's bubble have magnified the deflationary effects of China's economic slowdown. This is because China financed most of its recent fleeting recovery with imported foreign capital. For example, cheap money created by American and Japanese quantitative easing policies was placed in offshore centers, notably Hong Kong, and sent to China in the form of carry trades. These funds were first converted to Hong Kong dollars, which are pegged to the U.S. dollar, and then invested in renminbi-denominated high-yield investment products. According to Hong Kong banking statistics, international claims and liabilities of Hong Kong banks were HK$9.5 trillion and HK$7.2 trillion respectively, resulting in HK$2.3 trillion of net foreign claims as of June 2014. In the beginning of 2010, net claims by Hong Kong banks *vis-à-vis* China were zero; today they total HK$2.6 trillion, indicating that most of their lending was to China.

The end of quantitative easing would reverse the trend of money flowing into China and hasten its economic decline. The collapse of China's investment bubble is likely to have myriad adverse effects worldwide. International commodity and energy prices are already falling. Industrial products will also face downward pressure as China seeks to export its excess supply as domestic demand wanes. And companies, such as those in the mining industry, which assumed that China's economy would continue to grow and invested accordingly, are facing excess supply and over-capacity problems too. Considering all these deflationary pressures on the global economy, it is ridiculous for central banks to aim for a 2 percent inflation target.

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The Risk for China

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Japan provides a good example of how inflation-targeting and quantitative easing policies can backfire. The Bank of Japan, prodded by advocates of so-called Abenomics, implemented an ultra-easy monetary policy to weaken the yen and bolster exports. But even though the yen depreciated over 20 percent from ¥78 to ¥105 versus the dollar between October 2012 and September 2014 and Japan's exports increased nominally, real exports continued to decline because Japanese companies had moved so many factories overseas.

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Domestic carmakers have shifted two-thirds of global production abroad, thus blunting the effects of a weaker yen. And even as Japan's exports remain fragile, a weaker yen has increased the value of imports and exacerbated the trade deficit.

Instead of boosting the economy, a weaker yen has pushed up the prices of energy, food, and other consumer staples. The rising cost of basic commodities is a triple blow, reducing the purchasing power of consumers and raising costs for employers, which leaves them with even less room to raise wages. Thus deflationary pressure from China has resulted in negative real income growth for Japanese households and created another consumption-led recession.

Japan's aggressive monetary policy also sought to shore up the stock market. This, in turn, was supposed to create a so-called "wealth effect" and stimulate consumption. However, according to a survey by the Bank of Japan, only 15 percent of households held equities in 2012. Thus, only a fraction of households would have profited from a stock market rally. Instead, a rising stock market (though it has fallen back quite a bit over the since the end of September) merely increased the inequality levels for wealth and income in Japan.

Across the Pacific, ultra-easy monetary policy has led to a drop in the United States' potential growth rate. Over the past five years, labor participation rates have fallen steeply and the labor force has almost stopped growing. Productivity growth has also slowed, resulting in a lower potential growth rate (the combination of productivity growth and labor force growth). The potential growth rate, which was 4 percent in 2000, is now less than 2 percent.

Productivity has declined because zero-percent interest rates are propping up companies that would have failed if they had to pay interest on their loans, leading the market to become inefficient. Take an industry that has only room (given the overall level of demand) for seven companies, but instead has ten (with several surviving only because interest rates are so low). If three companies fold—an unfortunate but natural consequence of operating in a market economy—productivity and profitability at the surviving seven companies will increase by roughly 40 percent.

Zero interest rates prevent the economy from allocating resources efficiently. Market efficiency and labor productivity would improve if laid-off workers in the above scenario were retrained and rehired by industries with greater potential for demand. In Japan, these new industries are agriculture and predominantly service industries such as healthcare and old-age care, which are currently riddled with red tape. Structural reforms (long promised by but so far not forthcoming from the Abe administration) in regulations and financing would open these industries to potential demand. However, interest rates would have to rise as well. Without higher interest rates, financial markets cannot execute the basic function of allocating money.

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Zero interest rates also hurt savers. Twenty years ago, when deposit rates were around 5 percent, consumers had ¥50 trillion of interest income (the equivalent of 20 percent of Japan's total household consumption). But as interest rates fell to zero, this income disappeared as did the consumption it generated.

These are only some of the drawbacks of Japan's twenty-year ultra-easy monetary policy. The Federal Reserve should take heed. If it delays plans to raise to interest rates after halting its program of asset purchases, the United States can expect to face even more of the problems that Japan is suffering. ◆