Monetary Policy leading to Currency Wars and Asset Bubbles

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On Jan. 27, 2010, President Obama fired the first volley of Currency War III in his State of the Union speech. He announced the National Export Initiative. Its aim — to double U.S. exports in five years.

Currency wars are one of the most destructive and have feared outcomes in international economics. At best, they offer the sorry spectacle of countries' stealing growth from their trading partners. At worst, they degenerate into sequential bouts of inflating assets prices, recession, retaliation, and sometimes actual violence. Currency wars revolve around the themes of inflation, deflation, and debt in the international monetary system. These themes are the intentional policy of a country devaluing its currency against that of other countries to import inflation, expand exports, and increase nominal economic growth. If left unchecked, these currency wars could lead to a crisis worse than the panic of 2008.

Currency wars have happened twice before in the last century alone-and they always ended badly. Currency War I was the period from 1921 to 1936. That period began with massive war reparations and debts and included the famous beggar-thy-neighbor currency devaluations, which were sequential devaluations by France, England, and the United States. Currency War II lasted from 1967 to 1987, with the centerpiece of that war being US President Richard Nixon taking the United States off the gold standard on 15 August 1971. That period also included inflation, recession, and oil shocks. Time and again, paper currencies have collapsed, assets have been frozen, gold has been confiscated, and capital controls have been imposed. Today, the world is in the midst of Currency War III. Recent headlines about the debasement of the dollar, bailouts in Greece and Ireland, and Chinese currency devaluation are all indicators of the growing conflict. And the next crash is overdue.

Currency War III began in 2010. The world economic system is not always in a currency war, but when it is, it can go on for 5, 10, or 15 years. Once a currency war starts, it does not end just anywhere; there are successive rounds of depreciation until there is some extreme intervention, which can be either the collapse of the system or a real war, as in the case of World War II. Currency War III was started by the United States in 2010, specifically during President Barack Obama's State of the Union Address in January 2010, which seemed to be informed by the G–20 Summit in Pittsburgh in 2009.

In the years since the financial crisis, the central banks of most advanced countries have been trying to restore growth by pumping money into their economies and buying up government debt and other assets, a process known as quantitative easing. The scale of the interventions has been eye-popping: The balance sheet of the US Federal Reserve Bank has ballooned from around $700 billion at the outset of the financial crisis to peak at more than $4 trillion. So far, this massive "money printing" has not led to inflation because bank lending has not grown proportionately. The European Central Bank said that it would focus on buying covered bonds, a form of corporate debt. It signaled that its initial purchases would be worth about €60 billion in May 2009. In a dramatic change of policy, on 22 January 2015 Mario Draghi, President of the European Central Bank, announced an 'expanded asset purchase programme where €60 billion per month of euro-area bonds from central governments, agencies and European institutions would be bought. Beginning in March 2015, the stimulus was planned to last until September 2016 at the earliest with a total QE of at least €1.1 trillion. Mario Draghi announced the programme would continue: 'until we see a continued adjustment in the path of inflation', referring to the ECB's need to combat the growing threat of deflation across the eurozone in early 2015. The ECB's

balance sheet has almost doubled since 2010. In early October 2010, the Bank of Japan announced that it would examine the purchase of ¥5 trillion (US$60 billion) in assets. This was an attempt to push down the value of the yen against the US dollar to stimulate the domestic economy by making Japanese exports cheaper; On 4 August 2011 the BOJ announced a unilateral move to increase the commercial bank current account balance from ¥40 trillion (US$504 billion) to a total of ¥50 trillion (US$630 billion). In October 2011, the Bank expanded its asset purchase program by ¥5 trillion ($66bn) to a total of ¥55 trillion.On 4 April 2013, the Bank of Japan announced that it would expand its asset purchase program by 60 to 70 trillion Yen a year. The Bank hopes to bring Japan from deflation to inflation, aiming for 2% inflation.

The same inclination continued with the Bank of England, beginning in March 2009, BoE purchased around £165 billion in assets as of September 2009 and around £175 billion in assets by the end of October 2009. At its meeting in November 2009, the Monetary Policy Committee (MPC) voted to increase total asset purchases to £200 billion. Most of the assets purchased have been UK government securities (gilts); the Bank has also purchased smaller quantities of high-quality private-sector assets. In December 2010, MPC member Adam Posen called for a £50 billion expansion of the Bank's quantitative easing programme. In October 2011, the Bank of England announced that it would undertake another round of QE, creating an additional £75 billion. In February 2012 it announced an additional £50 billion. In July 2012 it announced another £50 billion, bringing the total amount to £375 billion.

Well what can be presumed is that the objectives of central banks with their cheap monetary policy are two fold

1. The idea is that if banks have more money to lend, lower rates will work their way into the economy and stimulate consumption and production.

2. The traditional and fastest way to increase nominal economic growth is to pursue export oriented growth by cheapening the domestic currency vis-à-vis foreign currency

Nevertheless, some worry that there will be big effects as the economy normalizes; others worry that “QE” has distorted the prices of stocks and other assets, creating a giant bubble waiting to pop, perhaps leading to another deep recession.

Monetary policy changes can have a significant impact on every asset class. Monetary policy refers to the strategies employed by a nation’s central bank with regard to the amount of money circulating in the economy, and what that money is worth. While the ultimate objective of monetary policy is to achieve long-term economic growth, central banks may have different stated goals toward this end. Monetary policy as such can be restrictive (tight), accommodative (loose) or neutral (somewhere in between). When the economy is growing too fast and inflation is moving significantly higher, the central bank may take steps to cool the economy by raising short-term interest rates, which constitutes restrictive or tight monetary policy. Conversely, when the economy is sluggish, the central bank will adopt an accommodative policy by lowering short-term interest rates to stimulate growth and get the economy back on track. The impact of monetary policy on investments is thus direct as well as indirect. Monetary policy affects not only economic growth but also the primary asset classes across the board – equities, bonds, gold, cash, real estate, commodities and currencies.

From the calendar year 2008; with the credit crunch and financial meltdown occurring in autumn of 2008 that delivered a massive blow to the consumption and the accompanying demand. In response central banks in the rich world slashed their benchmark interest rates to boost consumption. By early 2009 many were close to zero, approaching what economists call the "zero lower bound". Even so, growth remained elusive.

The accommodative monetary policy lead to an increase in the stock market prices because of the belief that the policy generates increased economic activity i.e. the boom phase of economic activity which is associated with strong output, employment, consumption and investment. The result was that movements in stock prices could influence aggregate consumption through the wealth channel

In the occasion where there is substantial economic weakness (as in the cases recorded recession in major developed countries and the EM's) cheaper money looks for better returns; which for obvious reason are not coming from a weak economic activity. So the money diverts itself into different asset classes such as equities, bonds, cash, real estate, commodities and currencies. And exactly this did start happening. On January 8 2010 the Dow Jones Industrial Average index read 10,618 points (source google finance) over a period of five years from 2010 – 2015, the Dow Jones Industrial Average index rose to 18,086 shooting up with a whopping return of 70.33% annualizing to a CAGR 11.25% per annum. While during the same period the US GDP was growing at a cautious or a sluggish pace of 1.59% per year. During the same period i.e. from the start of 2010 to 2015 Japanese Nikkei delivered an 84% jump with a CAGR of almost 13% while their GDP contracted at an CAGR of -3.49% from $ 5.9 trillion to $ 4.6 trillion. An ailing Chinese economy whose GDP growth rate slipped from 12% p.a. to 6% p.a., the Shanghai Composite Index delivered a handsome return of 112% with a CAGR of almost 16% year p.a. FTSE delivered a return of 35% over a period of five years with a CAGR of a little over 5% while the GDP was stagnant at close to 2%.

Well after all these years of easy monetary policy the hints of recession still loom on the heads of all the major economies. But what the monetary policy has done is fueled on more asset bubble which has started to burst since mid of 2015 and bursting in a pretty ugly manner as well. Since June 2015 when the initial weakness in Chinese economy started surfacing, the bubble in the stock market started bursting; Shanghai Composite Index has fallen 40%, the Nikkei has fallen a little over 20%, the FTSE with -14%, the Hang Seng a tad below -29% and Dow Jones Industrial average has fallen 9%. And the amount of wealth wiped off over the world runs in trillions of dollar

In all monetary policy risks becoming ineffective in a world where growth is sluggish, economies are deeply interconnected and interest rates are already near zero. What these monetary policies are leaving behind are the legacies of ugly bubbles getting created only left to burst one day.

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