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Global Governance of Public Goods:
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Sessions summaries

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The AEEF is organised with the financial support of the Asia-Europe Foundation (ASEF) which promotes understanding, strengthens relationships and facilitates cooperation among the people, institutions and organisations of Asia and Europe.

SESSION 3 - MONETARY POLICY, GROWTH AND EXCHANGE RATES

*Chair: **Zsolt Darvas**, Senior Fellow, Bruegel*

Chong en Bai, Chair, Department of Economics and Associate Dean, School of Economics and Management, Tsinghua University

Interest rates in China have been growing steadily since 2009. Labor costs have been growing faster than GDP. As a result, corporate profits have been negatively affected. In the first 8 months of 2015, profits were 8% lower than last year's. In China there is a policy support sector - such as the construction sector, market sector,

If we divide investment in three types: machinery, residential and non-residential. In the first 8 month of this year, infrastructure investment increased 20%, whilst overall investment increased only 10%. The market interest rate is too high, which causes capital inflows and pressures the renminbi to appreciate.

Chinese trade surplus has decreased, going from 9% of the GDP in previous years to 2% last year. Household consumption and income have increased only a bit. This means that there is no way the Chinese economy's growth can be fully supported by household consumption at the moment.

The government has started to reform the structure of investment in China. In this context, the ability to finance infrastructure investment has been constraint since 2014 when the budget law was signed. As a matter of the fact, tax revenue has not increased and government investment is limited. Consequently, activity slows down, and accommodative expansionary monetary policy appears as an option in order to avoid deflation pressure.

Michel Houdebine, Chief economist, French Treasury

Improving global financial safety nets and macro-prudential policies

We identify a 3-layer approach with ideas coming from G20 Ministers' communiqués and which aims to provide the best conditions for growth and monetary policy action: multilateral global financial safety nets; national macro-prudential policies; fiscal policy and structural reforms.

*"As markets react to various policy transitions and country circumstances, asset prices and exchange rates adjust. **This might sometimes lead to excessive volatility that can be damaging to growth.** While many economies are prepared for this, **our primary response is to further strengthen and refine our domestic macroeconomic, structural and financial policy frameworks. Exchange rate flexibility can also facilitate the adjustment of our economies.** (…) We will consistently communicate our actions to each other and to the public, and continue to cooperate on managing spillovers to other countries, and **to ensure the continued effectiveness of global safety nets." (February 2014)***

*"Monetary policies will continue to support economic activity consistent with central banks' mandates, but **monetary policy alone cannot lead to balanced growth.**" **(September 2015)***

A lot of instruments were designed at global (IMF), regional (agreements) and national (macro-prudential tools, FX reserves) levels, for improving global safety nets and the international financial system. Nevertheless, we realize they are not properly coordinated nor calibrated. In fact, better monitoring and coordination would avoid situations of insufficient or excessive coverage.

Combining fiscal policy and structural reforms with monetary policy

The question we should address is the following: how to combine structural reforms with fiscal and monetary policies?

Evidence suggests that the effectiveness of reforms depends on the macroeconomic environment, which can be presented in 3 scenarios:

- Normal conditions: even in these conditions, short-term impact of reforms is not well known, especially on demand.
- Weak demand
- Weak demand and constrained macroeconomic policies (ZLB/public deleveraging)

We are currently on the last case – weak demand and constrained macroeconomic policies. Even though there is no clear-cut result, it seems that this scenario is the most complex to lead reforms. In practice, we should therefore pay attention to: the packaging of reforms and its sequencing by starting with the ones that less hamper demand.

Traditionally, we can identify two helpful channels when leading reforms. The first is to implement other growth-friend policies (including monetary policy) to go along with the on going structural reforms. The second is to anticipate future wealth coming from reforms in order to favor wealth effects.

In the current situation policy makers often ask two questions:

1) How to chose the packing of reforms given the monetary policy situation?

We observe that structural reforms (i.e. French competitiveness improvement reform) tend to have disinflationary impacts but with a one-off effect on prices. With effective communication, it is possible to disentangle transitory and underlying components of inflation, thus implementing structural reforms that do not affect inflation expectations.

2) How to find the best pace for reforms: gradual or frontloaded?

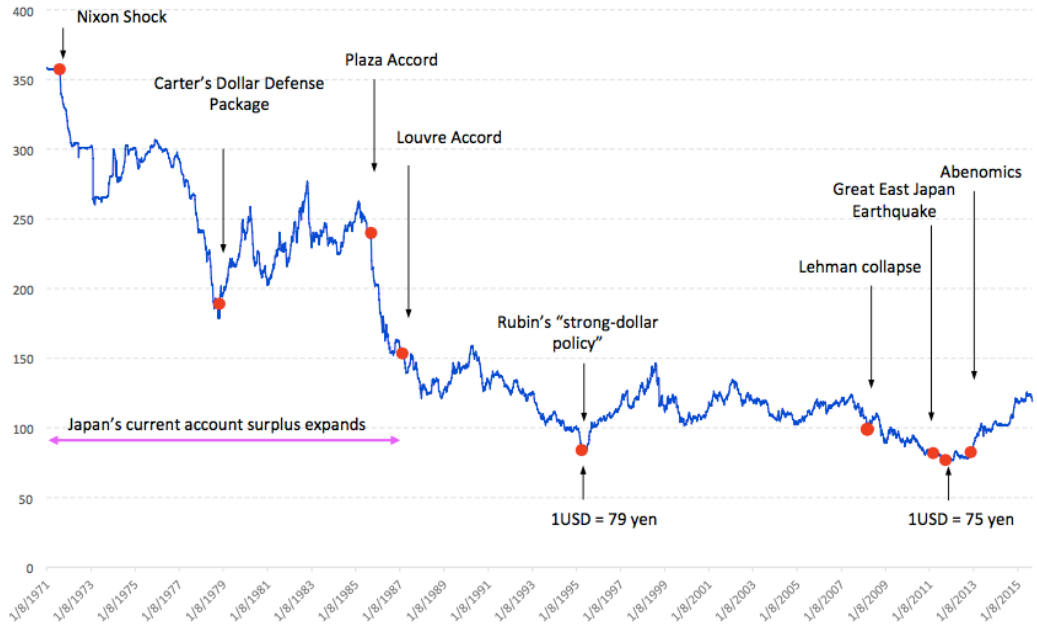
Following the need to well anchor expectations, frontloading a bundle of reforms is supposed to be beneficial for wealth effects. The conclusion seems less clear regarding precautionary effects, which could be related to uncertainty (or even fear). This is specially the case when a lot of reforms are implemented at the same time or if they are not well announced. Here also, communication is the key.

One could finally ask: in the short run, how can policy-makers and central bankers deliver the best policy-mix? It is clear that accommodative monetary policy would help fiscal consolidation (in particular in the case of deflationary pressures coming from spending cuts).

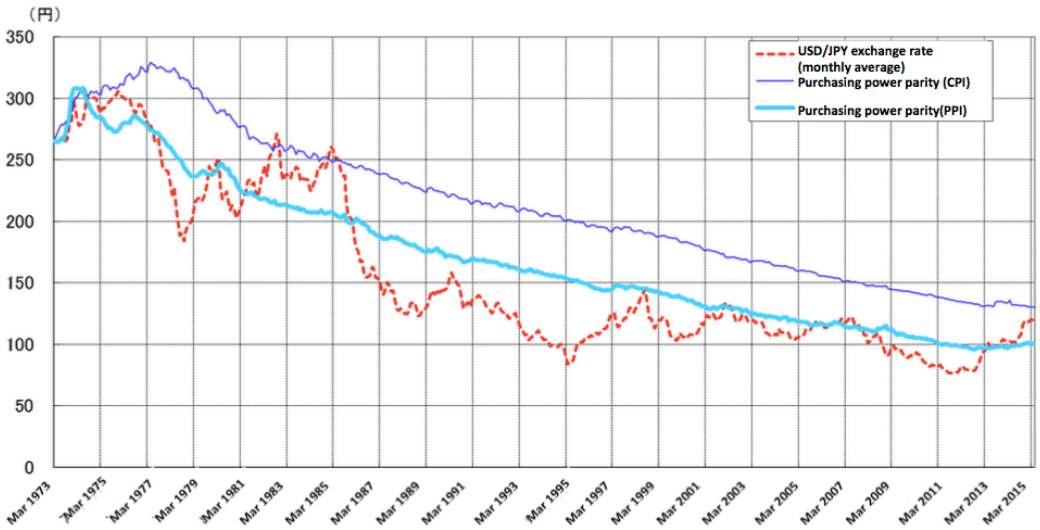
Kiyoto Ido, Vice Chairman IIES and former Executive Director Bank of Japan

Trends in the USD/JPY Exchange Rate & QQE of BOJ

Over the last four decades the exchange rate USD/JPY has been showing a downward trend as the JPY appreciates against the USD. In fact, from the early 70's until the late 80's, the Japanese current account has expanded, hence appreciating Japan's currency. After the 90's this appreciation trend becomes steadier with the USD/JPY oscillating between 150 and 75. The following graph illustrates the USD/JPY exchange rate evolution and indicates major historical events that affected its course.

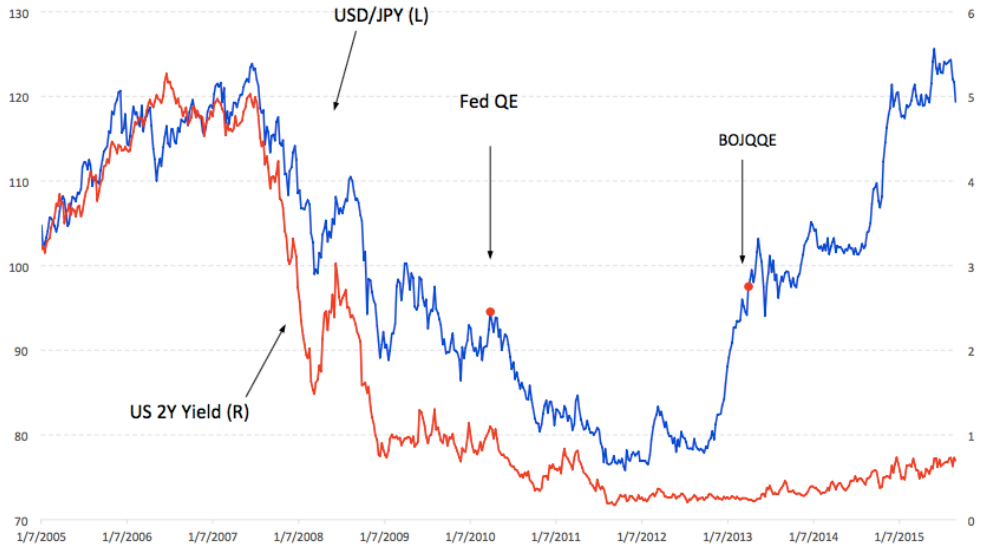


Furthermore, we observe that the USD/JPY is usually beyond the PPP CPI and the PPP PPI, suggesting the currency is somewhat undervalued.

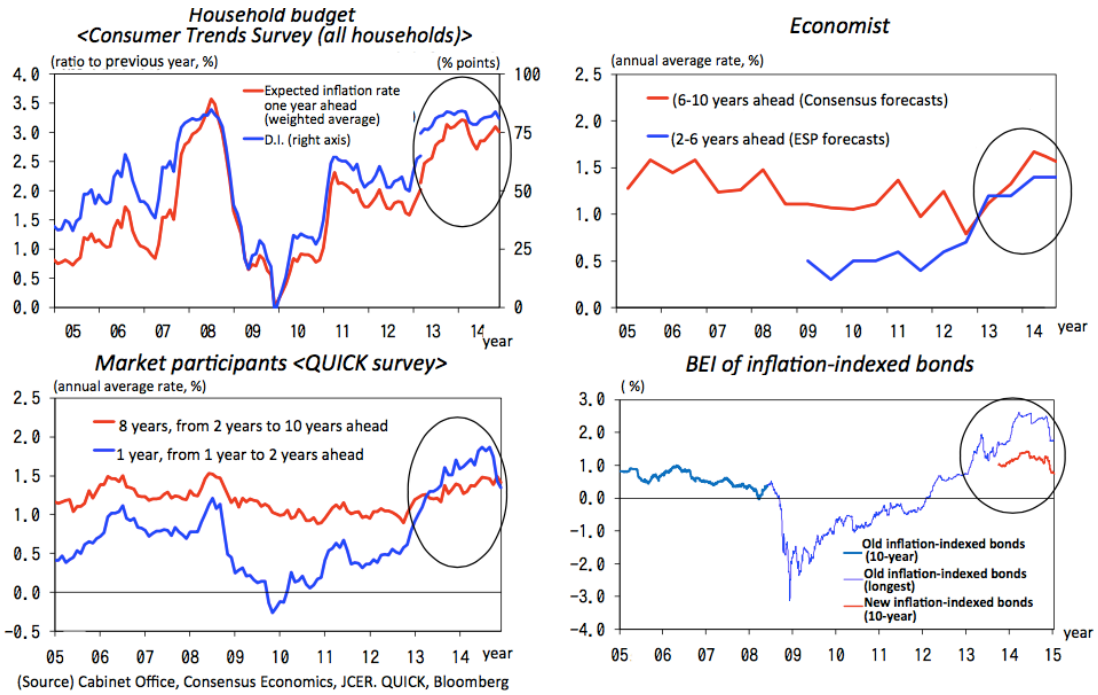


(Source) Consumer Price Index (CPI): Ministry of Internal Affairs and Communications of Japan; US Department of Labor; Producer Price Index (PPI): Bank of Japan, US Department of Labor; USD/JPY exchange rate: Bank of Japan
(Notes) Based on monthly average exchange rate for March 1973 (265.3 yen per US dollar)

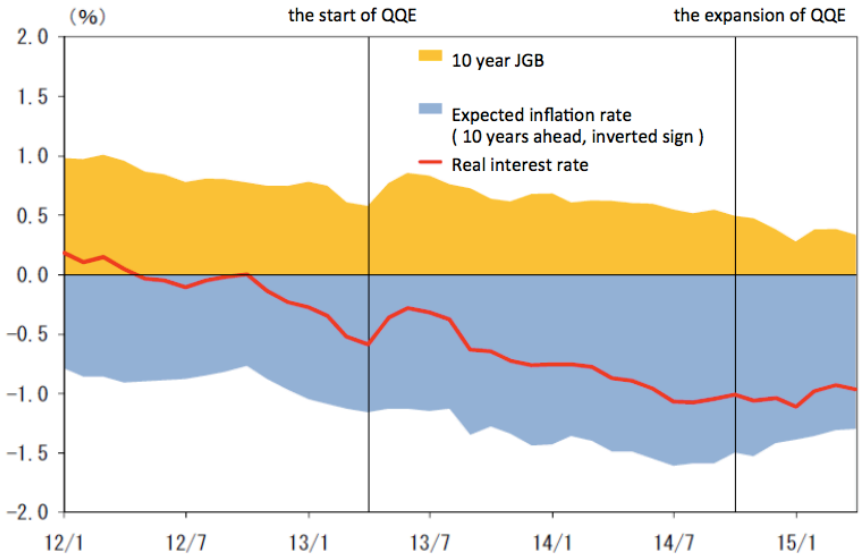
Until the Fed QE, as the graph below shows, the US two-year treasury notes yield and the USD/JPY exchange rate tended to commove.



The US and Japanese monetary easing lower real interest rates through different mechanisms. In fact, the US quantitative easing pressures down the nominal interest rate, whilst the Japanese quantitative and qualitative monetary easing (QQE) exerts upward pressures on the expected inflation rate. The graphs below compare different surveys on the expected inflation rate for the Japanese economy. In fact, expected inflation rate has been increasing after the expansion of the QQE.



(Source) Cabinet Office, Consensus Economics, JCER. QUICK, Bloomberg



Finally, the table below gives us an overall comprehension on the effects of the QQE for the Japanese economy.

(Changes in financial economic variables from 2013/1Q to 2014/4Q)

	Macroeconomic model-based estimates		Performance
	[Estimate 1]	[Estimate 2]	
Real interest rate	- 0.8% Points	- 0.8% points	(Up to -1% points)
Equity Indices (TOPIX)	+18%	+40%	+40%
Currency exchange rate (dollar/yen)	+8%	+25%	+24%
Supply-demand gap	+1.1% points	+3.0% points	+2.0% points
CPI, (YOY) (less fresh food)	+0.6% points	+1.0% points	+1.0% points
Employee wages	+2 Tril. yen	+5 Tril. yen	+6 Tril. yen
Corporate income	+4 Tril. yen	+9 Tril. yen	+12 Tril. yen

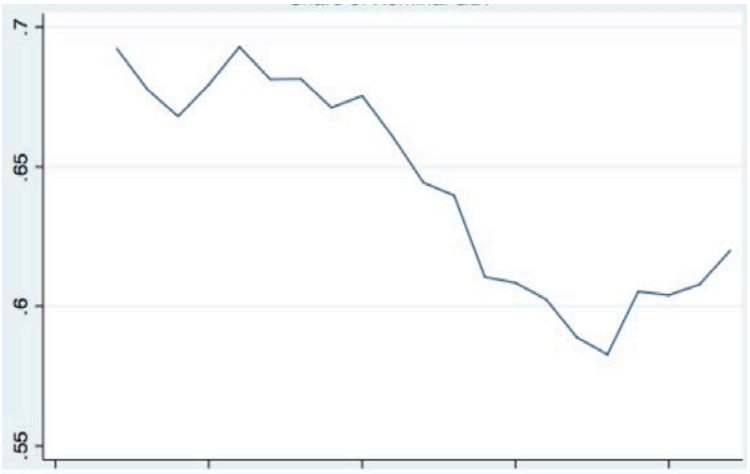
Keyu Jin, Lecturer in Economics, London School of Economics

In response to the financial crisis, the Chinese authorities have adopted an aggressive stimulus package. Since November 2014 the Chinese Central bank has already cut interest rates four times and is expected to cut interest rates further. Additionally, China has had an active fiscal policy and credit expansion in the last few years as a way to counter the slowing external demand from the rest of the world. It is important to analyze the effectiveness of these policies.

In China, credit is often directed to large companies and state-owned enterprises, which are inert to changes in the interest rate. Small and medium sized companies, however, are severely capital constrained being sensitive to higher borrowing cost. This financial market distortion combined with a lethargic business environment creates a deep disconnection between credit in the financial system and how it is channeled into the real economy. Consequently, loose monetary policy may not work that well in China, and may be doing the opposite of what is supposed to do – that is, to lower the effective cost of capital to firms, and to raise producer price inflation.

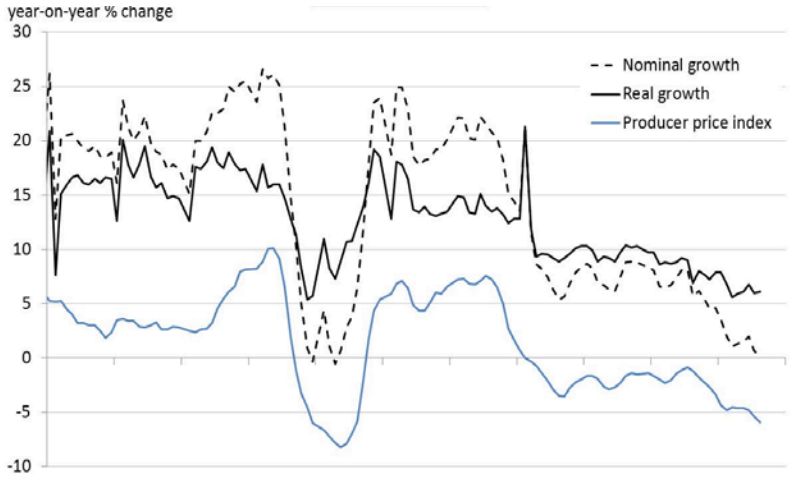
Two aspects of the Chinese economy make it somewhat different from others in their responses to monetary policy shocks. The first is related to the Chinese households. In the past few years, inflation expectations have been catching up. In response to expected inflation, rather than raising current consumption, the Chinese households are saving more to protect against expected decline in their purchasing power.

Share of nominal GDP

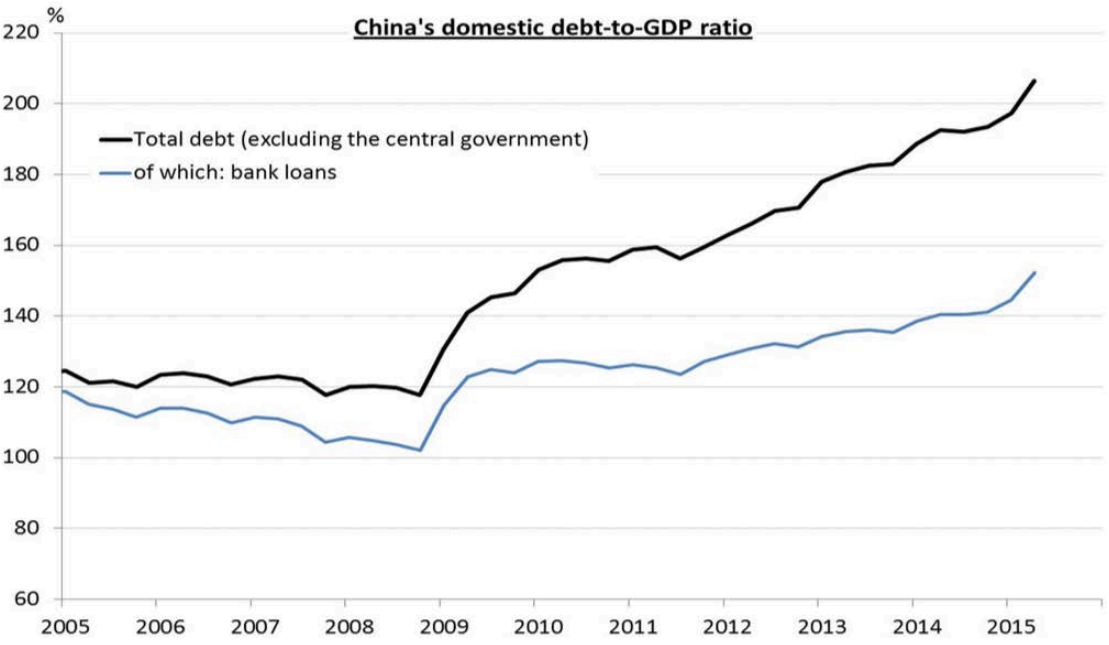


They are also concerned about old-age resources, as they have fewer children to provide support with China's strict fertility policies. Wealth accumulation and the search for high rates of return have thus become a primary goal. With long periods of financial repression, where the real return on deposits have been near zero, Chinese households are shifting their saving out of bank deposit into equity markets and trust funds.

So the result of an easy monetary environment is not to raise product price inflation but higher and higher equity and property prices. In fact, producer prices have been slipping continuously for more than three years on end. The producer price index (PPI) after a 41 months straight fall has reached its lowest level since October 2009. Falling producer prices harm corporate profits, which further exerts pressure on Chinese firms.



Additionally, capital has flown towards financial markets rather than the goods market, and consumer inflation has also remained at 1.6 percent. Thus, the assumption that expansionary monetary policy can induce higher consumption by Chinese households reflects an oversight that inflation expectations are catching up in China. In fact, domestic debt levels have steadily increased since 2009.



The second factor relates to the dynamism of Chinese firms. The original aim of the stimulus was to lower the effective cost of capital for private enterprises – small and medium sized companies that need the capital. But in fact, the opposite may be occurring – with the effective cost of capital rising rather than declining. First, the search for yield in the economy, as well as the gradual withdrawal of deposits from the banking system by the Chinese households, has exerted upward pressure on financing costs. Second, large enterprises with sizeable collaterals can obtain bank loans but meet difficulty in finding good investment opportunities, and therefore channel credit through the shadow banking system to lend to small and medium sized firms at high interest rates. And because the firms are facing increasing profitability problems with the sluggish economic environment combined with producer deflation, default risk is on the rise.

The easy monetary environment may mean that much of the credit is bottled inside the financial sector: banks are not eager to lend with the accumulation of bad loans and because companies are perceived to be risky in the current economic environment. In order to preserve shareholder value, they have channeled much of the funds to the equity markets and trust funds. Very little of the credit actually flows to the real economy.

The distorted financial market has created a vicious loop. As private firms face severe financing constraints, borrowing at high interest rates and often short-term, they are perceived to be even more risky by banks – which slap on an additional risk premium and in turn raise their borrowing costs further. The consequence is that rather than lowering the effective cost of capital for the small and medium sized firms that would benefit the most from funds, the opposite is effectively happening.

The disconnection between the financial sector and the real economy significantly hampers credit flows and much of the intended objectives of monetary policy. Chinese enterprises, in an increasingly difficult business environment, are turning to investing in the financial markets as a primary activity rather than focusing on their core business. But the lack of economic fundamentals underlying a high equity market valuation supported by leverage is unsustainable and cannot be a reliable source of profit – neither for Chinese firms nor for the households.

The vicious cycles and key distortions are at the heart of the problem. And it is not something that a stimulus-driven environment can do much to help, not least because it may not have the benefits it intends to deliver, but especially because it may be doing just the opposite. Structural reforms are ultimately the necessary preconditions to make monetary policy more potent at a time when China needs it most.