Currency war warnings follow US Fed's "quantitative easing"

Nick Beams
24 September 2012

There are growing fears that the US Federal Reserve's policy of "quantitative easing"—the process by which tens of billions of dollars are pumped into financial markets every month—is sparking international tensions over currency values.

One of the consequences of the Fed's actions is to push down the value of the US dollar, thus worsening the competitive position of other major countries in international markets.

Following the latest decision, in which the Fed gave an indefinite commitment to purchase mortgage-backed securities to the tune of $40 billion per month, the Brazilian finance minister, Guido Mantega, repeated his earlier warnings of a currency war.

Interviewed by the *Financial Times* last Thursday, Mantega said the US move was "protectionist" and could have drastic consequences for the rest of the world. "It has to be understood that there are consequences," he told the newspaper. The Fed's latest move would have only marginal benefits, he said. There was already plenty of liquidity in the economy but it was not going into production. The real purpose of the measures was to depress the value of the dollar and boost US exports, he added.

Mantega pointed to last week's decision by the Bank of Japan (BoJ) to intervene in financial markets with its own version of quantitative easing as another sign of global tensions. "That's a currency war," he said.

In a move clearly aimed at pushing down the value of the yen and lifting Japanese exports, the BoJ decided to add $128 billion to its program of asset purchases. It cited the effects of "financial and foreign exchange market developments" as one of the reasons for its actions.

Further evidence of the impact of global financial turmoil is revealed by Japanese trade figures for last month. These show that exports to Western Europe were down by 28 percent compared to a year ago, with exports to China falling for the third month in a row.

China is also concerned about the impact of the Fed's actions. The head of the country's central bank, Zhou Xiaochuan, publicly released criticisms he made last April of the "quantitative easing" program. He said the continued injections of cheap credit were not working and more targeted measures should be developed to get money where it was needed.

China has two concerns about the fall in the value of the American dollar. It tends to push up the value of the yuan, which impacts on Chinese export markets, and reduces the value of the more than $1.2 trillion of US treasury bonds that Beijing holds.

The US Fed's rationale for its actions is that the injection of liquidity will lower interest rates and encourage investment, resulting in the creation of more jobs and a lowering of unemployment. But a recent Duke University survey of the chief finance officers of 887 large companies found that a lowering of interest rates would have virtually no impact on their decisions.

According to the Duke University analysts: "CFOs believe that ... monetary action would not be particularly effective. Ninety-one percent of firms say they would not change their investment plans even if interest rates dropped by 1 percent, and 84 percent said they would not change investment plans if interest rates dropped by 2 percent."

In other words, so far as the real economy is concerned, the Fed's actions are equivalent to pushing on a string. Indeed this is recognised within leading financial circles.

Addressing the Harvard Club of New York last Wednesday, Richard Fisher, a non-voting member of the Federal Open Market Committee, which decided on the latest policy, said the Fed was sailing deep into uncharted waters. In a frank admission, he stated: "The truth ... is that nobody on the committee, nor on our staffs at the Board of Governors and the 12 Banks, really knows what is holding back the economy. Nobody knows what will work to get the economy back on course. And nobody—in fact, no central bank anywhere on the planet—has the experience of successfully navigating a return home from the place in which we now find ourselves. No central bank—not, at least, the Federal Reserve—has ever been on this cruise before."

Former Fed chairman Paul Volcker has added his voice to those who insist that further quantitative easing will do nothing to boost the economies of the US and Europe. Speaking at a conference in Scotland over the weekend, he said: "There is so much liquidity in the market that adding more is not going to change the economy."

The growing sense that the world economy is heading down again was reinforced by the latest forecasts from the World Trade Organisation. It predicted that the world economy would grow only 2.5 percent this year, down from its previous estimate of 3.7 percent.

While the Fed's measures have almost no impact on investment and jobs, they do give a boost to financial markets. Since the collapse of September 2008, the Fed has followed a clear agenda. The banks and finance houses, whose speculative activities, some of them of an outright criminal character, triggered the crisis, have been given endless supplies of ultra cheap money. Profits are being made through the elevation of the price of financial assets resulting from the injection of more money from the Fed.

However, the stagnation and outright recession in the real economy means that this process cannot continue indefinitely and the house of cards must collapse. The interventions by the world's three major central banks—the US Fed, the European Central Bank and the Bank of Japan—means that rather than being able to provide further bailout money, they will themselves be dragged into the maelstrom.