NATIONAL CENTER FOR POLICY ANALYSIS

Exporting U.S. Inflation

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In late 2008, in order to boost the American economy and help mitigate the effects of the Great Recession, the Federal Reserve adopted an expansionary monetary policy, enlarging its balance sheet. The central bank employed various strategies to combat the strong deflationary pressures that surged after the 2008 meltdown.

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First, it slashed interest rates to nearly zero percent and has held them there ever since. It then utilized quantitative easing (QE) to buy financial assets, like government bonds, with the purpose of increasing the liquidity of member banks' reserves and keeping interest rates low.

With quantitative easing, the Fed intended for the "excess" liquidity to push up asset prices, probably hoping that the "wealth effect" of higher asset prices would spur economic activity in the United States.[1] While experts still debate the success of the Fed's approach domestically, the policy has had noticeable international repercussions.

More Dollars Create High Inflation for Others

In the period 2009 to 2012, the abundance of dollars coupled with low U.S. interest rates caused capital to flow overseas into more dynamic markets for investment opportunities.[2] To absorb this flood of investment dollars, other countries had to expand their money supply, thereby creating inflation.

In 2009 and 2010, emerging market asset bubbles began to form due to global carry trades in which investors borrowed capital from low-interest rate countries, particularly the United States.[3] Investors then channeled this capital into higher-yielding investments in those emerging markets, which were less prone to deflation.

Effect on Commodity Prices. By late 2010, capital flows to emerging markets had risen to $825 billion.[4] These inflows fueled emerging economies and drove up the demand for resources and commodity inputs [Figure I]. Energy and food prices were among the most affected. In fact, in March 2011, corn and wheat prices were up 80 percent from the year before. These numbers are important since many residents of developing nations spend more than half of their incomes on food and energy.[5]

Likewise, countries highly dependent on trade had to choose whether to let their currency appreciate versus the U.S. dollar and lose competitiveness, and perhaps endure a recession. Or enlarge their money supply, depreciate their currency and keep their export prices cheap. By contrast, the U.S.

Figure I
Continuous Commodity Index 2004-2013*

Sources: InterContinental Exchange, Quandl.
*The Commodity Reserve Bureau Continuous Commodity Index comprises 17 equally weighted commodity prices.

experienced low inflation because Americans could import inexpensive goods from those same countries.[6]

This situation leads to a chain reaction: if one country depreciates, other trading partners will soon follow to remain competitive. As a result, many trade flows unconnected to the United States are affected since most global transactions are priced in U.S. dollars.

Pegging to the U.S. Dollar Drives Up Prices. Foreign central banks who have pegged their currency to the U.S. dollar have intervened by buying dollars to prevent their currencies from appreciating. Hong Kong is one such case. The Hong Kong Monetary Authority wants to maintain its exchange rate within a tight band but the Fed's creation of U.S. dollars directly impacts the supply of Hong Kong dollars.[7]

When these countries issue base money to buy dollars, domestic interest rates are forced down, generating domestic inflationary pressure.[8] This "imported" inflation causes a surge in property values and equity prices. Primary commodity prices also rise quickly because speculators can easily bid for long positions in organized commodity futures markets when interest rates are low.[9]

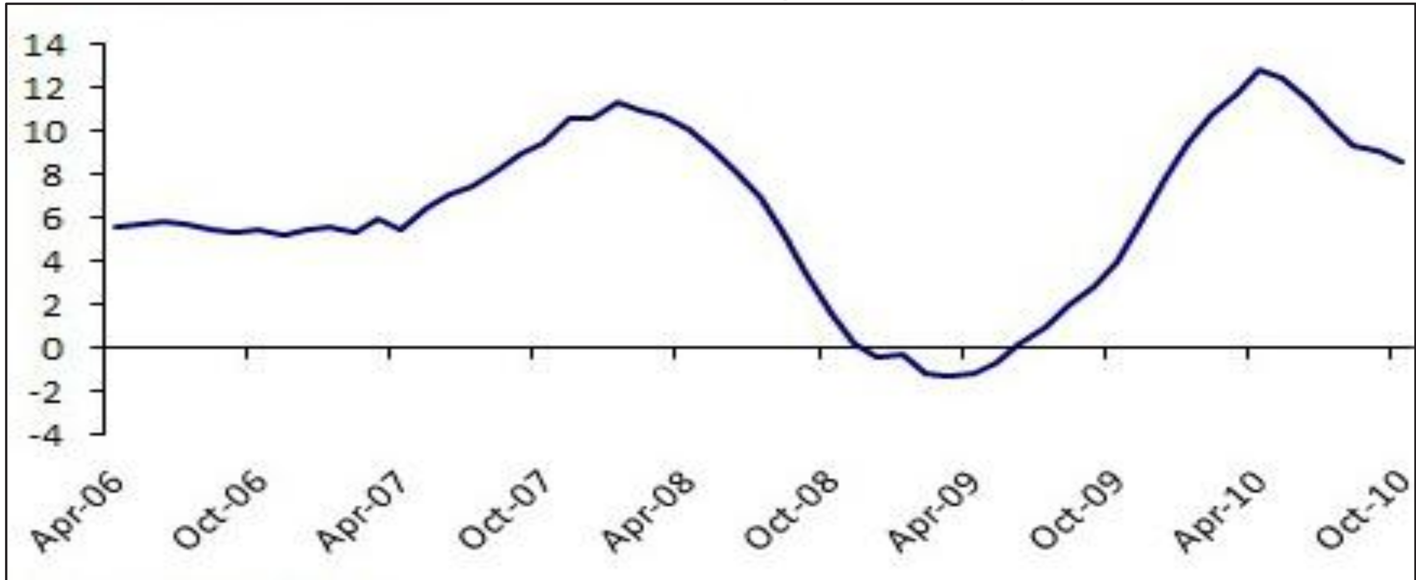
These conditions have occurred a few times before. The world saw an upswing in the dollar prices of primary commodities in 1971 to 1973 when the U.S. abandoned the gold standard. A commodity price spike also occurred during the shock of 2003 to 2004, when the federal-funds rate was reduced to an unprecedented low of 1 percent, followed by a falling dollar.[10]

For the United States, general price inflation comes with long and variable lags, showing up much later than in peripheral economies. For example, in 2010, consumer price indexes increased more than 5 percent in major emerging markets such as China, Brazil and Indonesia, while the U.S. consumer price index rose only 1.2 percent.[11]

International Repercussions of Federal Reserve Policy

Some countries affected by the Fed's loose domestic policy perceived it as a "selfish" action. They argued that the Fed did not consider the role the U.S. dollar plays as a reserve currency and how oversupply would impact other economies. Some observers went as a far as to claim that the U.S. deliberately exported its inflation in order to

Figure II
House Price Annual Percent Change in 70 Major Chinese Cities



Source: Carnegie Endowment. Available at http://carnegieendowment.org/2010/11/24/inflation-replaces-growth-as-china-s-top-priority.

make its exports more competitive and overcome its own economic crisis.

The truth, however, is that no matter how much excess supply the Fed creates, it cannot affect another country's inflation unless that country is willing to increase its own money supply to prevent its currency from appreciating.[12]

Inflation in China. One of the best known cases is China, where its central bank chose to peg the yuan to the dollar, thus letting the Federal Reserve control its monetary policy. And yet, the Fed's monetary policy was not appropriate for China, which was experiencing accelerating inflation.[13] Had the Chinese currency been allowed to float freely in the foreign exchange markets, it is likely that inflation would have subsided, but so would growth in their exports and GDP, and probably their employment levels.[14]

China, to a certain extent, mitigated the amount of inflation from an oversupply of dollars by accumulating and investing a large percentage of its capital abroad, including U.S. Treasuries.[15] Nevertheless, the oversupply of dollars and its own stimulus led to a sharp increase in economic activity that included the construction of massive infrastructure projects, opulent government buildings and a housing property bubble, as shown in Figure II.[16] Additionally, negative real interest rates, plus limited investment options, encouraged many Chinese buyers to purchase real estate to protect their savings from inflation.

Bubbling Brazil. Brazil experienced an enormous bubble in the period from 2004 to 2012, with a brief hiatus in 2008-2009. During this period, its exports rose 500 percent. In fact, Brazil's soaring exports of soybeans, iron ore and other industrial materials to China would not have happened without the massive credit available to emerging economies.[17]

As foreign money flooded in, investors put a large portion in the stock market. After the 2009 global lows, the IBOVESPA (the Brazilian stock index) doubled in value. However, it began to decline slowly in 2011, experiencing a more abrupt decline of 20 percent since 2013 [Figure III].[18] It is important to note that a great percentage of the market capitalization of the country's stock market is in companies with government

Figure III
Brazil Stock Market (BOVESPA)

Source: "Sao Paulo Stock Exchange," Trading Economics. Available at http://www.tradingeconomics.com/brazil/stock-market.

participation, which have been mired in corruption and inefficiency. At the same time, domestic consumer debt increased eight-fold and the cost of living rose higher than some European nations. Banks became engaged in a lending spree, driving up demand for automobiles, home appliances and housing.[19] The rise in consumer spending has even benefited the economies of Florida and New York City, where Brazilians travel to satisfy their craving for luxury goods shopping.[20]

This type of growth only happens under conditions typical of unsustainable bubble economies. President Dilma Rousseff of Brazil, an economist, used to denounce the large pool of speculative capital seeking returns in emerging market assets. She called it a "liquidity tsunami" due to its ability to cause inflation, overheating and asset bubbles.[21]

Effects on Mexico. In contrast to China and Brazil, Mexico didn't experience an asset-price appreciation of the same magnitude. Although the country experienced a property bubble that pushed prices to record levels and saw the introduction of real estate investment trusts (REITs) to the Mexican stock exchange for the very first time, the focus was mostly on commercial real estate. The more modest housing boom took place mainly in greater Mexico City. Weaker links between homebuilders and the financial sector meant that the risks for the overall economy were not as serious.[22]

In 2010, Mexico's central bank chief, Agustin Carstens, stated that Mexico was already expecting global investors with "excess" liquidity to search for better returns in assets such as Mexican bonds. Past abrupt capital inflows and outflows have had adverse effects on the Mexican economy. Carstens mentioned the central bank was planning to enact capital controls to try to contain appreciation of its currency; but ultimately it did not pursue this measure.[23]

Other Central Banks Follow the Fed

In spite of the volatility affecting international markets, Fed officials have defended their actions, stating that their aim is to encourage spending and induce moderate inflation. In their view, slowly rising prices will turn into falling prices, which will usher in a deflationary phase like the one Japan went through in the 1990s when prices fell and growth stagnated.[24] But they miss the fact that globalization and increasing competition have put downward pressure on consumer

prices. As a matter of fact, the United States is now "exporting" deflation.

The European Central Bank and the banks of Japan and China have adopted the Fed's approach by implementing their own low-interest or QE programs.[25] As the United States comes closer to normalizing its monetary policies, the low-cost funding currencies are now flowing toward the United States, causing further volatility in emerging markets.[26]

Furthermore, a Morgan Stanley analysis of two hundred years of data found that until recently none of the major central banks had set short-term interest rates at zero for such a prolonged period.[27] By exclusively targeting consumer prices, major central banks have chosen to ignore the effects of surplus liquidity on asset price inflation. They have also created an environment in which easy money dictates investment decisions, driving a synchronized bubble in housing and financial assets.

The Consequences of Exporting Inflation

Gerald O'Driscoll of the Cato Institute says that keeping nominal interest rates very low has ensured that real (inflation-adjusted) interest rates are negative.[28] The Fed's primary objective was to fight deflation and stimulate the American economy. Instead, it enticed economic agents to invest in riskier assets. Indeed, financial institutions augmented their use of derivatives and leverage to expand their returns.[29]

Price increases in primary commodities and a weakening dollar were indications that the Fed was pursuing a very loose monetary policy. When the central bank for the world's reserve currency generates "excess" liquidity, those excesses have unintended consequences.[30] The policy contributed to asset price inflation and massive investments in financial instruments of all sorts, both in local and global markets, in what is known as a search for yield.[31]

The Fed's policies also opened the door to capital-flow reversals — capital suddenly leaving a country. The economic distortions created by these unsustainable policies have produced a very sluggish and vulnerable post-recession recovery, and created a workforce approaching full employment, but with the lowest labor participation rate since 1977.[32] Real estate prices are also near their bubble peak and stock market prices are "quite high," in the words of Janet Yellen.[33]

Finally, this easy monetary policy has meant a massive transfer from middle-class savers to favored investors and speculators. Banks were able to make more profits relending this free money while savers got nothing. The policy benefits the wealthy. This is why the current Fed's policy is the equivalent of a regressive income-transfer policy.[34]

Conclusion

In the period immediately after the financial crisis the Fed ignored inflationary warning signs on the dollar standard's periphery and made both the U.S. and global economies much less stable.[35]

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Notes

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