Yellen should taper off cautiously

By Xu Hongcai, China Daily, 2014-1-9

The United States Senate on Monday confirmed that Janet Yellen, a key force behind the Federal Reserve's unprecedented and controversial efforts to boost the US economy, will succeed Ben Bernanke as Fed chairman, when his second four-year term expires on Jan 31.Yellen, who is currently the Fed's vice-chair, will be one of the few women heading a central bank and the first to run the Fed in its 100-year history.

Yellen's first task in the world's most powerful financial post will be navigating the central bank's way out of its extraordinary stimulus, beginning with dialing down its bond-buying program.

The Fed cut overnight interest rates to near zero in late 2008 and has quadrupled its balance sheet to more than $4 trillion through a series of massive bond purchase programs meant to push down longer-term borrowing costs, which will promote consumption and investment.

At the last monetary policy meeting last year, the US Federal Open Market Committee announced it would reduce the pace of its monthly massive bond purchases by $10 billion each month, trimming back equally mortgage-backed securities and Treasury bonds, starting January. Such a move signals the Fed is gradually tapering off its quantitative easing on the back of a stronger economic recovery.

Since quantitative easing was just a temporary policy to cope with the global financial crisis, it was only a matter of time before the Fed dropped it. The recent announcement of the reduced bond purchases comes after signs that the US economy is rebounding. The GDP growth rate annualized quarter-on-quarter was 1.1 percent for the first quarter of 2013, 2.5 percent for the second and 4.1percent for the third. Although the core inflation rate has been around 1.7 percent in the past months, approaching the policy limit of 2.5 percent, the Consumer Price Index increased by

just 1.2 percent in November. Moreover, the unemployment rate is around 7 percent, and household consumption, company investment and the real estate market have all shown obvious signs of recovery. The above economic indicators all signal the time is ripe for the Fed to start exiting its quantitative easing policy.

Over the past few months, the Fed has been preparing the market for the change in policy. This time, the Fed also said that in the near future if the inflation rate is far away from the policy goal of between 2.0 to 2.5 percent, it will still keep the federal fund rate between zero to 0.25 percent, showing that the Fed will not raise interest rates in the short term, so as to help consolidate the economic recovery. Furthermore, as such policy change is being initiated as a new hand takes over the helm at the Fed, it indicates the consistency and stability of US monetary policy, which should avoid fluctuations in the global financial markets.

On Oct 31, the Fed reached long-term currency swap agreements with the central banks of Europe, Canada, the United Kingdom, Japan and Switzerland, forming a "monetary union". It seems that the advanced economies are "working together" to exit their quantitative easing policies. Such cooperation is not only good for reducing the negative impacts brought by the policy change, it also consolidates the international currency system dominated by the US dollar.

As the US tapers off its quantitative easing, it will trigger a flow of international capital from the developing countries to advanced economies, such as the US. Some capital has already flowed from emerging countries lately. But China is unlikely to experience capital flight on a large scale, because its stable economic situation is clear to investors, and enormous benefits will be released as China comprehensively deepens reforms. So international capital will still favor China in the long run, but to some extent, the scale will decrease, which can alleviate the appreciation of the renminbi and promote China's exports. So China's central bank has more room for its independent monetary policy. Globally, as the financial liquidity slows down, commodity prices, such as oil, gold and iron ore will fall, reducing China's import costs.

In the short term, as the international capital flow accelerates with more exchange fluctuations, China's central bank should pay close attention to the movement of international short-term capital, strengthen the pertinence and flexibility of its policies, strengthen open market operations and maintain stable and reasonable domestic market liquidity. In other words, a good currency environment for the smooth running of the real economy should be created now. To reduce the impact of international hot money on China's economy, the foreign exchange administration should strengthen supervision and introduce a financial transaction tax, also known as a Tobin tax, to effectively restrain speculative behavior.

Meanwhile, the international community should maintain its heightened alertness toward the financial markets in Asian economies and offer necessary help when it is needed. The renminbi can make up for the US dollar flowing out of emerging economies, and China should seek to speed up the internationalization of its currency and actively contribute to rebalancing the global liquidity.

The US has produced significant spill-over effect to the global economy with its three rounds of quantitative easing. It's now the responsibility of the Yellen-led Fed to ensure the tapering off of quantitative easing will not impact negatively on emerging economies.

The author is a professor in finance and director of Information Department of China Center for International Economic Exchanges.