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QE3 and Asia: Concerns Over New Monetary Easings

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Synopsis

Quantitative easing in different forms have recently been resorted to by the US Federal Reserve (Fedres), the European Central Bank (ECB) and the Bank of Japan (BoJ) to rescue their respective economies from prolonged recession. Are these efforts effective? What are the implications for Asia's emerging economies?

Commentary

RECENTLY THE central banks of three of the world's largest economies attempted to stimulate their respective economies by adding new liquidities. The US Federal Reserve under Chairman Ben Bernanke, acting on its promise to address the worst US unemployment since the Depression of the Thirties, decided to purchase mortgage-backed securities (MBSs) to the amount of USD 40 billion every month.

This programme will be executed indefinitely until the unemployment rate goes down to a more acceptable level. This is known as quantitative easing three (QE3), following two similar monetary stimulus initiatives since the financial crisis of 2008.

Fed is not alone

This decision was made only a few days after Mario Draghi, the President of the European Central Bank (ECB), announced his version of monetary easing, or what he called outright monetary transactions (OMT). It took the form of a programme to purchase sovereign bonds of eurozone countries in the secondary market with fewer conditionalities. There is now no requirement for triple A-rated bank collateral and the bonds are not treated as senior loan, meaning in the event of bankruptcy, the ECB loan does not get priority for repayment. However, countries have to subscribe to a bailout programme with tough fiscal and structural reform conditions - as in the case of Greece, Ireland and Portugal. Following this, the Bank of Japan (BoJ) too implemented its brand of QE by buying assets held by banks and providing loan to them of about USD 127 billion.

In all these policies, the central banks seem to demonstrate to the public that they are proactively pursuing a policy to salvage their respective economies. In a way the policy has been decided unilaterally by these independent central banks, without being pressured by the respective governments.

Do these policies work?

There is no clear answer as to whether these policies work. Most economists who support QE3 could only claim that it is due to these actions that the respective countries' financial sector, as well as the global financial system, have not worsened. Indeed, every time the policy is announced, the market has responded positively, though only for a short while before doubts return. Only market players seem to welcome the moves of these monetary authorities, and even so, such positive response lasts only briefly.

After the initial euphoria, the market players would resume worrying about the longer-term problems, like whether the sovereigns could repay their debts, when growth would resume, and when the unemployment problem would disappear. In other words, there is scepticism about the long-term impact of these monetary policies and whether they are effective to address the problem of unemployment.

Mario Draghi stated very clearly that OMT cannot be effective without cooperation from the real sector. Monetary policy alone is not enough have an impact on the real sector. And basically monetary policy is no substitute for fiscal policy. The problem lies in weak demand coupled with a fragile financial system. There is also an issue of whether a monetary authority has a clear mandate to address the problem of unemployment that quantitative easing is clearly meant to tackle. In a way the QE seems like a quasi-fiscal policy, which may not be within the mandate of a central bank.

For sure the US Federal Reserve System's mandate does include the objective of achieving full employment of the US economy. However, this is not clearly the case with the ECB whose main function is to maintain stability against inflation and deflation. Most central banks in Asia following the Asian financial crisis of 1997/98 have also become independent with a narrower mandate of merely guarding financial/and economic stability.

Ballooning balance sheets

Another issue involves the ballooning of the balance sheet of these central banks and its implication. In the last four years with QE 1 and 2, the balance sheet of Fedres increased by more than USD2 trillion. There is now the serious possibility of a sovereign default from the Greek crisis. But if ECB loans to banks are not treated as senior loans, there is a grave possibility of a central bank default.

A more serious impact many economists worry about is on price stability or inflation. It does not take a hardcore monetarist to believe that too much liquidity would ultimately result in inflationary pressure. The Japanese economy in the Eighties and the US economy in the Nineties had demonstrated that too much liquidity and prolonged very low interest rates could result in bubbles - properties or stocks which ultimately developed into financial crises.

The worry about the impact of this strategy on inflationary pressures is just as valid as concerns over the quantitative easing executed by the Fedres, ECB and BoJ.

Implications for emerging Asia

For emerging economies in Asia there is still another concern that cannot be ignored. Money is fungible, as students of monetary economics would say. The additional liquidities arising from the QE3 initiatives of these central banks would not necessarily be spent in their own economies. Any extra liquidity obtained by the households, firms or banks would be used first to clear their outstanding obligations, and to improve their balance sheets (deleveraging), before they think about spending, which would then create additional demand, boosting growth and ultimately employment.

But where would these additional funds go? They will flow to where there is more room for profit. In this regard, the emerging economies are the most likely target. In a globalised financial system, it is the emerging economies that would have to deal with these additional liquidities looking for room to unload. This means additional challenge for the monetary authorities of the emerging economies of Asia which are already currently facing increasing risks in general.

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