Quantitative Easing Revisited

By

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In November 2010, the U.S. Federal Reserve unleashed a second round of a type of monetary stimulus known as quantitative easing (QE). The Federal Reserve (central bank) declared that it would buy $600 billion in long-term Treasury bonds in an attempt to push down long-term interest rates. Immediately after the move, the rest of the world accused the United States of deliberately attempting to depreciate the dollar and flood the world markets with hot money and footloose capital.

Arguably many emerging-market countries have been accused of using a mix of similar interventions and capital controls to keep their own currencies from appreciating. There are only winners and losers in an interventionist approach: in order for one country's currency to depreciate, another country's currency must appreciate.

According to former IMF Economist, Raghuram Rajan, and the author of “Fault Lines: How Hidden Fractures Still Threaten the World Economy”. Most countries through currency manipulation; are nurturing domestic economic policy strategies that have allowed them to thrive in the past. For developed countries such as the United States, this has meant an emphasis on consumption; strategies in East Asia and other emerging markets, on the other hand, have emphasized exports.

In conjunction, these strategies have precipitated significant trade imbalances globally. In the long run, prolonged trade imbalances usually lead to financial and political instability, a recipe for disaster in other words. Should the domestic policy strategy of the concerned nations remain unchanged, these imbalances will likely exacerbate and threaten Global economic stability.

When a central bank cuts interest rates, the country's currency weakens as capital leaves for greener pastures (better returns). Nevertheless, lower interest rates also increases domestic demand, as households and firms spend more. In a nutshell, what monetary easing does is it creates overall demand.

By allowing its currency to remain undervalued, a nation can enlarge its market share and production by essentially usurping demand from other states. The circumstances under which the Federal Reserve embarked on the second round of quantitative easing made the move suspect. With short-term U.S. interest rates already near zero, and with large firms able to borrow at very low rates. It is alleged QE would make dollar

[1] The views and opinions expressed herein are those of the author and do not necessarily reflect the views of MIER.

bonds unattractive, because long-term bond yields would diminish when taking into account of higher inflation. In the long run, capital would flee the United States, lower the value of the dollar, and expand U.S. exports at the expense of other nations.

Initially, as expected after the Feds announced of their QE moves, U.S. long-term interest rates dropped and the dollar weakened. Ironically though, worries about government debt in the eurozone economies soon led the dollar to rebound!

Prior to the Recession in 2008, consumer credit, especially for housing, was greatly enhanced. Some of this inducement was political; politicians, both from Democrats and Republicans looked to homeownership to placate the masses whose incomes had not grown as much as promised. Thanks to successive deregulation since the 80s, a financial sector left to its own devices and running out of control also found incentive to loan more. Financed mainly with debt, U.S. consumption increased from about 67 per cent of GDP in the late 1990s to about 70 per cent by 2007.

Did we Malaysians take the cue too? Similar to other emerging economies, households in Malaysia typically borrow to purchase residential properties and transportation vehicles. On March 8, 2011 Prime Minister Datuk Seri Najib Razak officially launched My First Home Scheme. However, it must be emphasized here that the scheme is not the same as “the Ownership Society’ launched by the then US President George W Bush in 2004. The folly of the American scheme was that it actually emphasized on asset appreciation coupled with “innovative” financial derivatives without actually looking into its long-term sustainability!

It is hoped that our home ownership is based on a growing real economy and not that built on a credit-fuelled bubble. For it is clear that a person purchasing a house must be able to pay the monthly installments diligently in the long run and this translates into employment with income not stagnating. Thus far our Central Bank seems to have taken this into consideration, when introducing the tighter 70% loan-to-value (LTV) ratio requirement for property purchases as a measure to prevent speculative home-buying tendencies.

The pundits in Washington DC though, they wish to shift growth in spending from industrial countries to emerging markets, simply because developed countries, are saddled by high levels of household and government debt. They are hoping that emerging markets will shoulder the “burden” of expanding global consumption and investment.

In the final analysis, what is clear though, consumption in poorer countries, such as Brazil, China, and India, as well as in Africa and the Middle East, is actually lower than average consumption levels in richer nations and so are their average physical capital and infrastructure –houses, roads, ports etc. There is an opportunity for growth here, and so when the powers that be try to shift consumption abroad, Malaysians could jump in the bandwagon by meeting their demand with our supply!