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The global implications of QE2

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The financial markets have now become convinced that another large round of US **quantitative easing** is on the cards, with predictions focusing on a maximum liquidity injection of $1,000bn over about 12 months – enough to increase the Fed's balance sheet by 40 per cent and to finance the bulk of the US budget deficit next year.

No wonder the dollar has been falling, gold prices surging and US equities rising in recent weeks.

What about the global effects of another round of quantitative easing from the Fed?

The Bank of Japan and the Bank of England seem likely to follow suit, but the European Central Bank is currently not minded to do so. Whether the ECB can maintain that position indefinitely in the face of a rising euro seems doubtful, but eurozone monetary easing will almost certainly lag that seen in other countries.

Despite this, monetary policy in the developed economies will be eased markedly in coming weeks, and this will pose some severe problems for the major emerging economies, which do not want or need, any form of monetary easing at the moment.

Past experience strongly suggests that the emerging world will be unable to declare monetary independence from the liquidity injection likely in the developed world.

Already, the scale of capital flows into the Asian and Latin American blocs has been exceeding that seen at the peak of the last cycle in 2006/07, with Asian inflows about 60 per cent above that level. Recent **research at the International Monetary Fund** has shown conclusively that G4 monetary easing has in the past transferred itself almost completely to the emerging economies, whether or not their own economic circumstances warranted such a move.

In fact, since 1995, the stance of monetary policy in Asia has been almost entirely determined by the monetary stance of the G4 – the US, eurozone, Japan and China – led by the Fed.

There are some legitimate questions about whether these linkages will remain in place now that G4 monetary policy is taking the form of liquidity injections, rather than reductions in short-term interest rates.

One possibility is that US central bank bond purchases will simply result in higher holdings of liquid reserve assets by the US banking sector, with little tendency to transfer any of this dollar liquidity into foreign currencies. That would repeat the behaviour that confronted the Bank of Japan's programme of QE in the last decade, when the provision of yen liquidity simply got stuck in the Japanese banking system.

But it seems much more likely in the current climate that the increase in the supply of dollar liquidity will cause the dollar to fall, and that has usually been the main channel through which monetary easing has been transmitted to the emerging countries in the past.

The long-term economic consequences of this may not be desirable, but the shorter term impact on markets cannot be ignored.

The IMF research quoted earlier shows that equity prices in Asia and Latin America generally rise when excess liquidity is transferred from the G4 to the emerging economies. But the extent of this is determined in part by the foreign exchange policy of the different emerging economies.

A majority of economies in Asia (following the lead of China and now Japan), and many in Latin America, are likely to increase their foreign exchange intervention by selling their domestic currencies in exchange for dollars. Even though some or all of this will be sterilised by selling short-dated bills to the domestic monetary sector, it will still increase the liquidity of the domestic financial sector, and eventually this leaks into equity prices. Countries like China, India, Korea, Taiwan, Brazil and Mexico may well go down this path, which would be favourable for domestic asset prices on a six to12 month view.

Some other emerging economies, including Malaysia, Thailand, Chile and Colombia may take a different view, allowing more upside in their currencies, and doing slightly less intervention in the foreign exchange markets. The equity markets in these countries may see less upside, but there could still be plenty of scope for currency gains for macro traders.

So far the consequences on emerging currencies and emerging equities (relative to developed markets) of the Fed's shift towards more QE have been fairly limited.

Some investors have been concerned that a sharp US slowdown may prevent a surge in emerging equities. But there are signs that capital inflows to the emerging world could reach unprecedented proportions in coming months. A combination of slow, but positive, growth in the US, along with more QE, could prove extremely positive for many emerging equity markets. It is a theme to follow.

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