

The Possible Impacts of Ending Quantitative Easing on Asian Economies

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Introduction:

A Brief History of Quantitative Easing

- ◆ In order to save the U. S. financial system from collapse in the aftermath of the bankruptcy of Lehman Brothers in late 2008, the U.S. Federal Reserve Board (the Fed) undertook a series of “Quantitative Easing” measures, referred to as QE1, QE2 and QE3 respectively, purchasing U.S. Government and agency securities and mortgage-backed securities held by financial institutions.
- ◆ “Quantitative Easing I (QE1)” was initiated by the Fed on 25th November 2008.
- ◆ QE2 was launched by the Fed on 3rd November 2010, followed by “Operation Twist” in September 2011 with the objective of lowering the medium- and long-term interest rates.
- ◆ QE3 was launched by the Fed on 13th September 2012.

Introduction:

A Brief History of Quantitative Easing

- ◆ On 22nd May 2013, the possibility of “tapering” and eventually ending QE3 was publicly disclosed for the first time.
- ◆ On 18th September 2013, the Fed decided to hold off on the “tapering” plan.
- ◆ On 18th December, 2013, the Fed finally decided to begin the “tapering” in January 2014.
- ◆ On 3rd February 2014, Dr. Janet Yellen was sworn in as the Chair of the Fed. Subsequently an announcement was made that the bond purchase programme will finally be terminated in October of 2014, marking the end of “QE”.

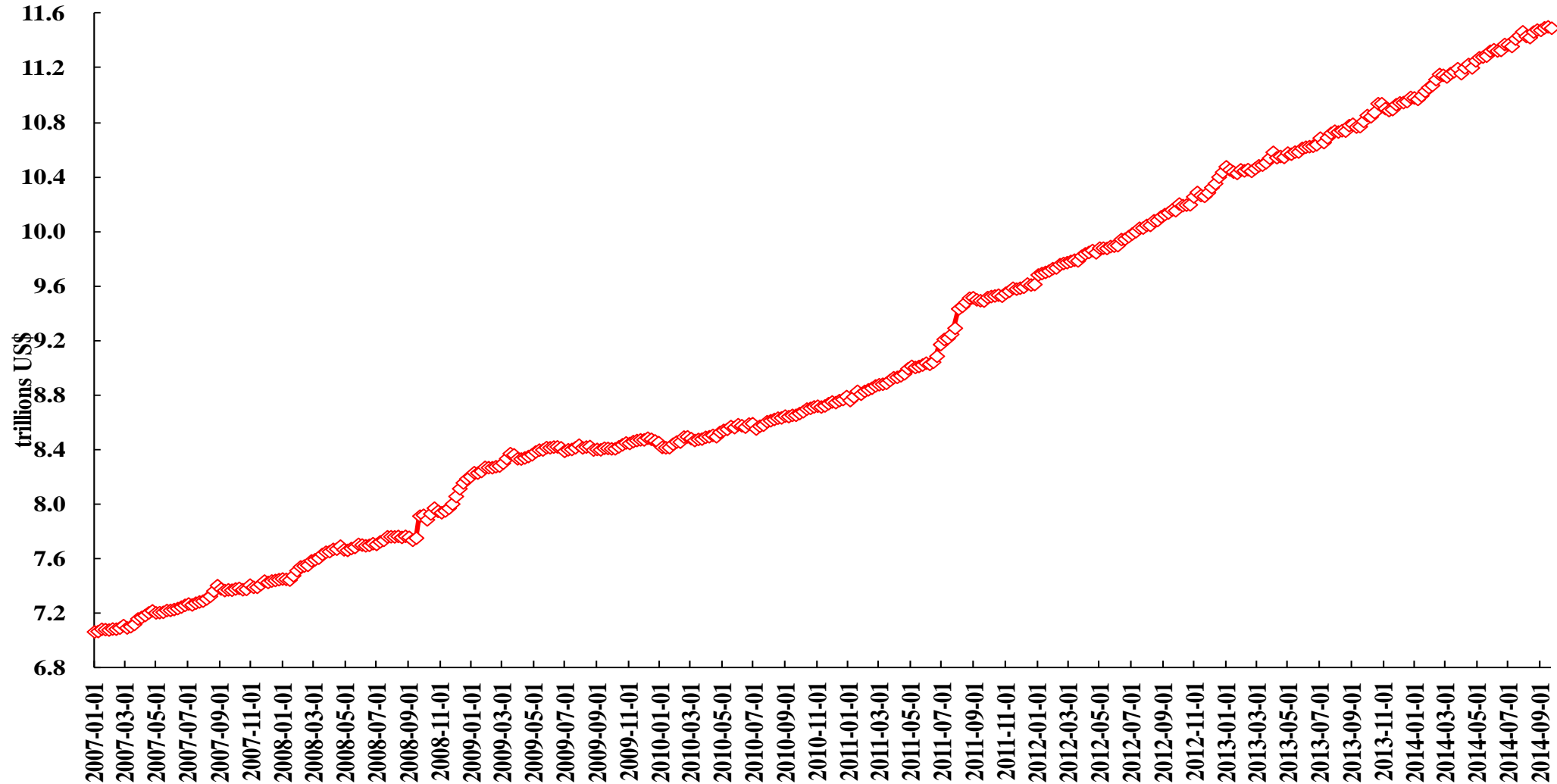
Introduction:

The Effects of Quantitative Easing

- ◆ With QE1, the U.S. money supply was increased quickly and the short-term interest rate was also driven quickly to almost zero, and it has stayed there since.
- ◆ However the long-term interest rate remained relatively high until the introduction of “Operation Twist” under QE2.
- ◆ QE3 was quite effective in keeping the long-term interest rate low, until the possibility of “tapering” was disclosed to the market in May 2013, which led to a jump in the long-term interest rate in the U.S.
- ◆ Successive QEs have also led to large increases in the U.S. money supply (M2).

U.S. Money Supply (M2), trillions US\$, 01/01/2007-09/22/2014

M2 Money Stock, trillions US\$, 01/01/2007-09/22/2014



The Past Impacts of Quantitative Easing on Asian Economies

- ◆ First, we examine the actual impacts of successive QEs on the exchange rates, interest rates and asset prices of the East Asian economies since the beginning of QE1 on 25th November 2008.
- ◆ If and when the QEs are finally ended, these past impacts on the exchange rates, interest rates and asset prices may be wholly or partly reversed. The magnitudes and directions of these past impacts can therefore provide some guidance on the possible potential impacts of the ending of QE.
- ◆ We can also learn from the actual experience of the movements of the exchange rates, interest rates and asset prices after the disclosure of the possibility of “tapering” to the market on 22nd May 2013. These movements were driven by market expectations of what might happen when QE would finally be ended, even though, as it turned out, “tapering” did not actually begin until January 2014.

The Past Impacts of Quantitative Easing on Asian Economies

- ◆ It is also important to understand that the ending of the bond purchases by the Fed does not necessarily imply a contraction of the U.S. money supply. It simply means that new bond purchases by the Fed will no longer be a source of increase of the money supply.
- ◆ It is unlikely that the Fed will begin to sell the bonds it currently holds. Such bond sales will definitely decrease the money supply.
- ◆ The most likely scenario is that the Fed will hold its bonds until maturity but will not purchase new bonds with the proceeds from the returns of the principals of the maturing bonds. This will also decrease the money supply but in a relatively slow and gradual manner.

The Past Impacts of Quantitative Easing on Asian Economies

- ◆ The excess liquidity released through the successive QEs (QE1, QE2 and QE3) and the extremely low interest rates in the U.S. have led to a massive exodus of short-term capital from the U.S. to the rest of the World, seeking higher yields.
- ◆ This massive liquidity drove up the exchange rates of most other currencies relative to the U.S. Dollar, except for the Vietnamese Dong (thus effectively devaluing the U.S. Dollar), and lowered interest rates almost everywhere, which in turn fueled a rise in asset prices (real estate and common stock) worldwide.

The Past Impacts of Quantitative Easing on Asian Economies

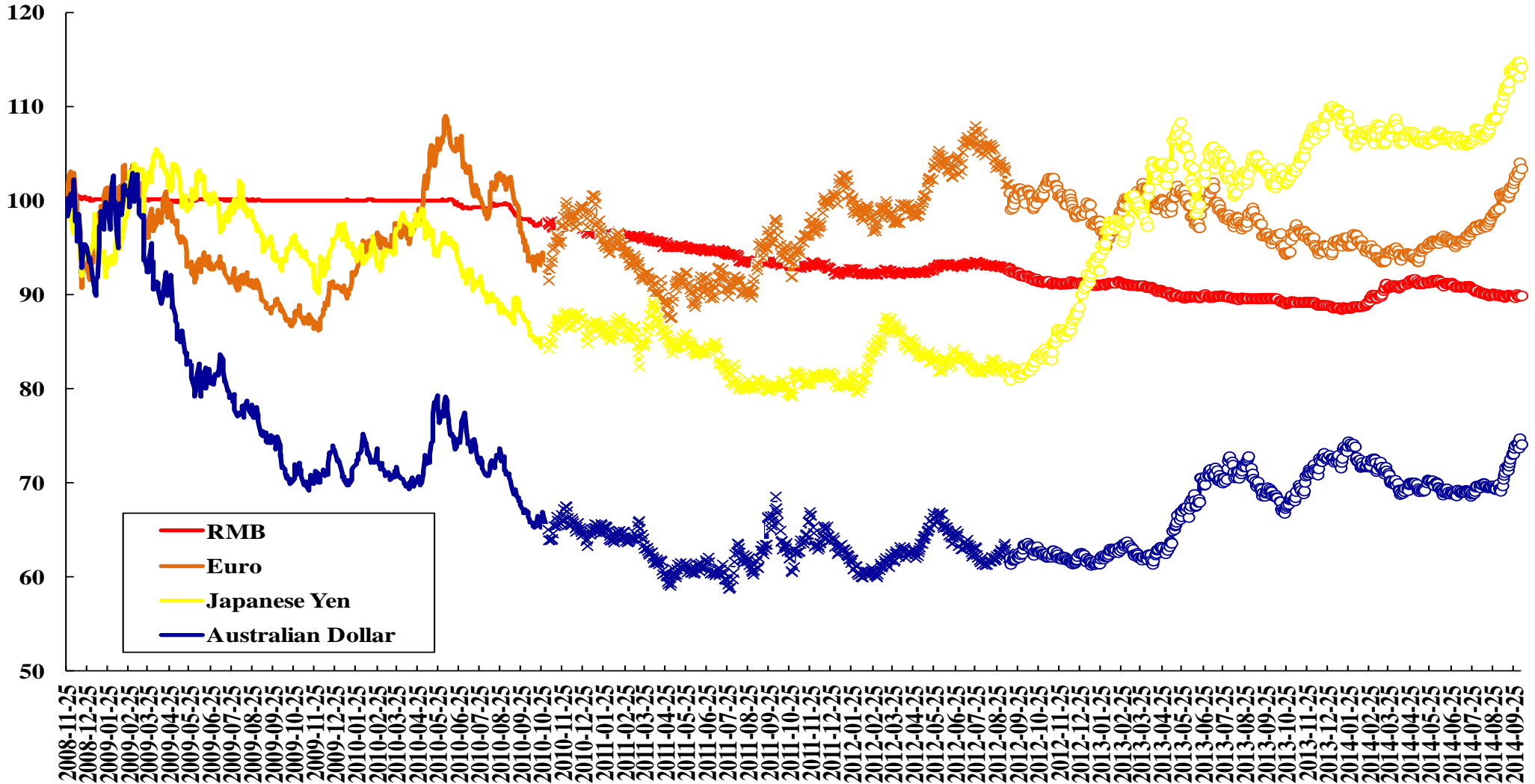
- ◆ Japan, as part of its Abenomics initiatives, countered with its own QE in December 2012, and reversed the appreciation of the Japanese Yen vis-a-vis the U.S.\$ since the beginning of QE1.
- ◆ These trends of rising exchange rates, falling interest rates and soaring asset prices in the Asian economies were partially and temporarily reversed with the public disclosure of the possibility of “tapering” on 22nd May 2013 through its effects on market expectations.
- ◆ However, with the repeated assurances by the Fed that the U.S. interest rate will remain low for a considerable period of time, these stock indexes resumed their climb in early 2014, in tandem with the U.S. stock price index.

The Past Impacts of Quantitative Easing on Asian Economies: Exchange Rates

- ◆ In the following chart, we examine the exchange rates of the Australian Dollar, the Chinese Yuan, and the Japanese Yen vis-a-vis the U.S.\$, with the Euro/US\$ exchange rate as a backdrop.
- ◆ It is clear that upon the launch of QE1, the Australian Dollar and the Japanese Yen (and also the Euro) appreciated significantly.
- ◆ The Renminbi, which stopped appreciating in late 2008 in response to the global financial crisis, resumed its upward movement in mid-2010.
- ◆ The expectation of possible “tapering”, which was first publicly disclosed on 22nd May 2013, caused a partial reversal of the appreciation of the Australian Dollar and the Chinese Yuan.
- ◆ Thanks to Chinese capital control, the exchange rate of the Chinese Yuan was not significantly affected by the QEs.

Exchange Rate Indexes of Selected Economies (11/25/2008=100)

Exchange Rate Indexes of Selected Economies (11/25/2008=100)

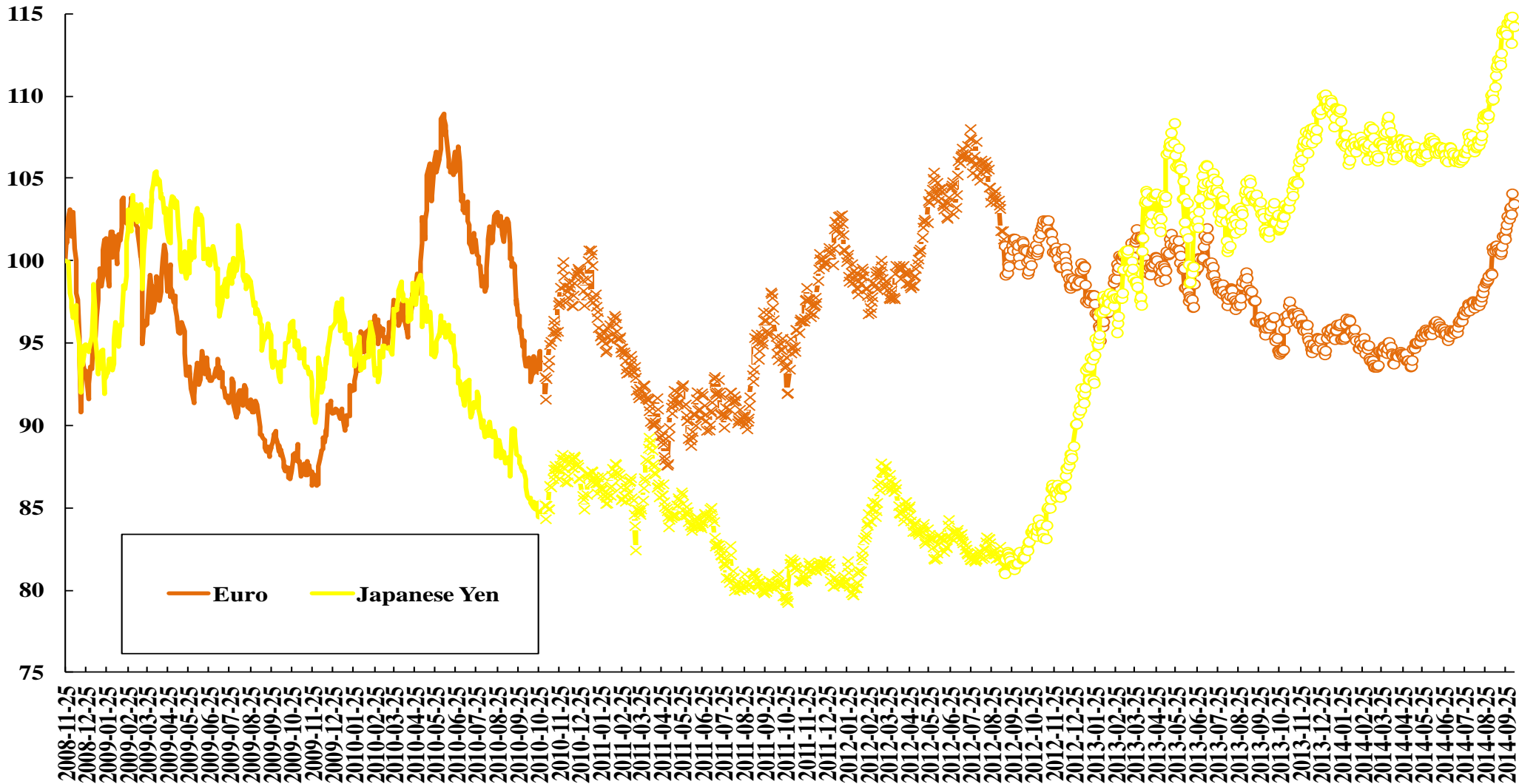


“Counter-Quantitative Easing” by the Euro Zone and Japan

- ◆ The exchange rate of the Japanese Yen reached a high of 75 Yen/USD at one point, greatly hurting its exports. Then the Japanese Government decided to launch its own “Counter-QE” in December 2012. The Japanese “Counter-QE” was quite effective and drove the Yen/USD exchange rate back to a level of almost 110 Yen/USD.
- ◆ The Bank of Japan could have achieved the same result by intervening directly in the foreign exchange market to stabilise the Japanese Yen/USD exchange rate, but there was probably opposition to its direct intervention from the U.S. Government on ideological grounds.
- ◆ The Euro did not appreciate too much relative to the USD except during QE1 because of its sovereign debt crisis and other economic problems within the Euro Zone itself.

Exchange Rate Indexes of the Euro and the Japanese Yen (11/25/2008=100)

Exchange Rate Indexes of the Euro and the Japanese Yen (11/25/2008=100)

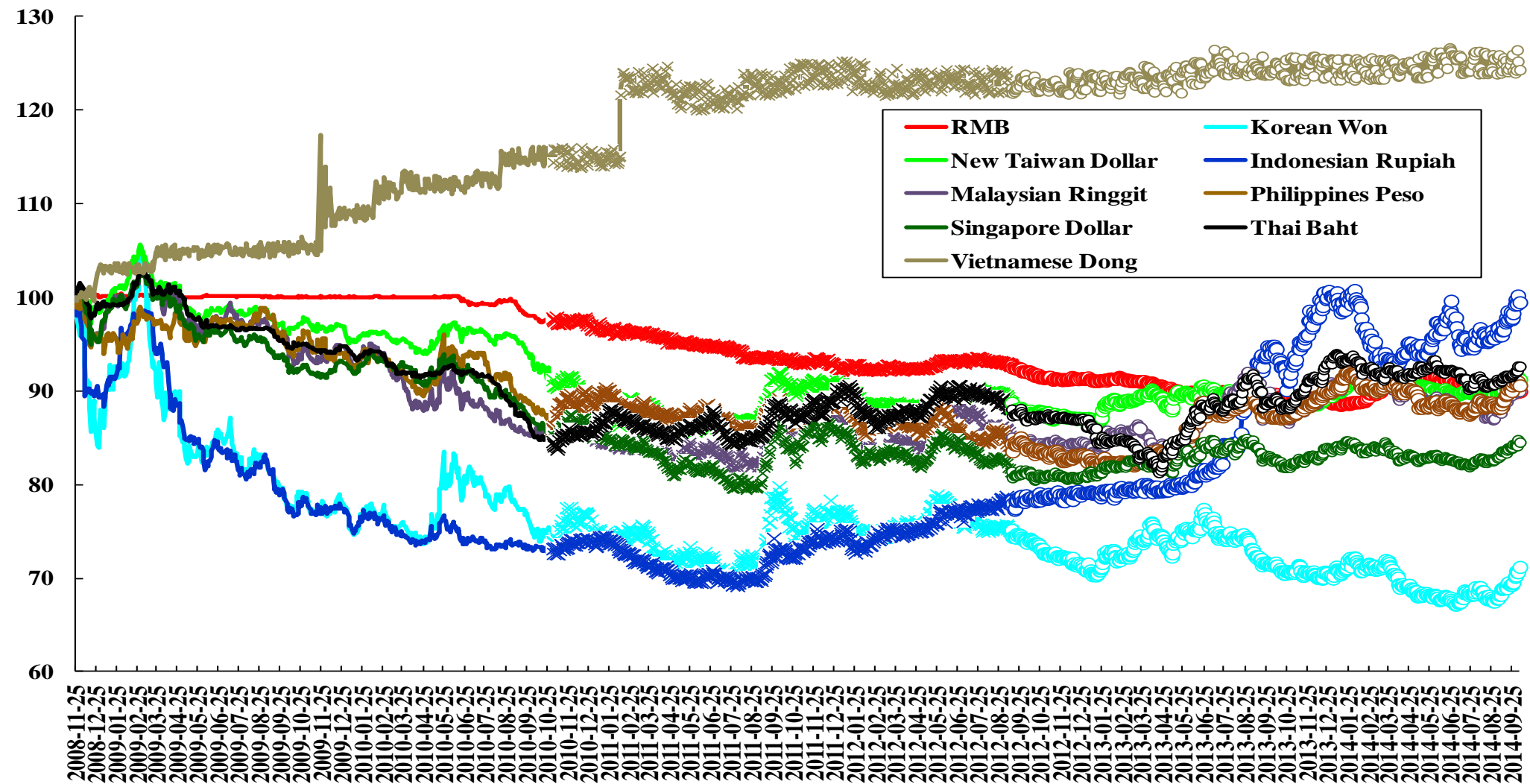


The Past Impacts of Quantitative Easing on Asian Economies: Exchange Rates

- ◆ The movements of the exchange rates of East Asian economies since the beginning of QE1 are presented in the following charts and tables.
- ◆ Again, the impacts of QE1 in causing the East Asian currencies to appreciate are clearly evident, with the exception of the Hong Kong Dollar, which is pegged to the US\$, and the Vietnamese Dong.
- ◆ The impacts of QE2 and QE3 are much less clear and less significant.
- ◆ However, with the public disclosure of the possibility of “tapering” on 22nd May 2013, the movements of the exchange rates of quite a few currencies, including the Indonesian Rupiah, the Filipino Peso, and the Thai Baht, reversed course and began to devalue.

Exchange Rate Indexes of Selected Economies (11/25/2008=100)

Exchange Rate Indexes of Selected Economies (11/25/2008=100)



The Past Impacts of Quantitative Easing on Asian Economies: Exchange Rates

- ◆ With QE1, the currencies of almost all East Asian economies, with the exception of the Chinese Yuan, the Hong Kong Dollar and the Vietnamese Dong, have appreciated significantly vis-a-vis the US\$, in varying amounts between 10% and 35%.
- ◆ QE2 and QE3 up to 22nd May 2014 had relatively little impact on the East Asian exchange rates. The Japanese “Counter-QE” did have very significant impact on the Yen/US\$ exchange rate.
- ◆ Cumulatively, from 25th November 2008 to 22nd May 2013, the East Asian currencies appreciated between 10% and 33%.
- ◆ However, from 22nd May 2013 onwards, most of the East Asian currencies have been devaluing.
- ◆ Cumulatively, from 25th November 2008 to the present, most of the East Asian currencies are still on the appreciation side, with the exception of the Hong Kong Dollar, the Indonesian Rupiah, the Japanese Yen, and the Vietnamese Dong.