

## Spillovers of Quantitative Easing on Asia

### Introduction

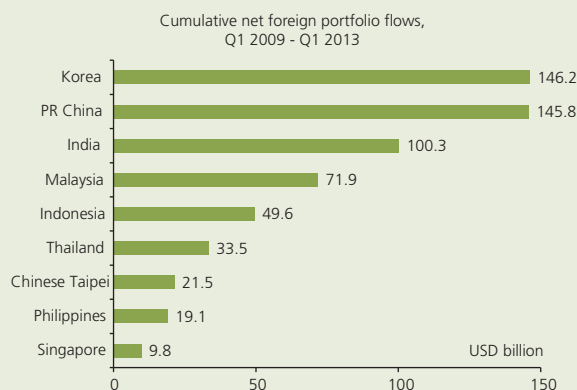
The Global Financial Crisis (GFC) triggered unprecedented policy interventions in the crisis-affected advanced economies. Major central banks reduced policy interest rates to close to zero and implemented unconventional monetary policies such as massive injections of liquidity through quantitative easing (QE). These measures have had a significant spillover impact on global economic and financial conditions. To some extent, these policies have contributed to stabilising financial conditions and supporting the recovery that is gaining momentum in these economies. While the avoidance of a more severe global economic recession has benefitted the emerging economies, there were unintended consequences from maintaining such policies for an extended period of time, particularly, large capital inflows into many emerging economies in search for higher yields. As economic recovery in the advanced economies becomes more entrenched, policymakers will eventually need to unwind these unprecedented injections of liquidity to achieve more normal monetary conditions. This transition, nevertheless, is likely to have an impact on the rest of the world through various channels and in varying degrees. This article explores the spillovers of QE on Asia and assesses the region's strengths and vulnerabilities in facing the challenges that will emerge from the reversal of the unconventional monetary policy measures by the advanced economies.

### Impact of QE on Asia

The introduction of QE has led to a massive injection of liquidity into the financial systems of the advanced economies. The balance sheet of the Federal Reserve (Fed), for instance, grew by about four times between December 2006 and August 2013. The balance sheet of the Bank of England expanded by six times, while those of the European Central Bank and the Bank of Japan doubled. Cumulatively, global liquidity, as proxied by the GDP-weighted M2 of the US, euro area, Japan and the UK, increased from USD7.3 trillion in the third quarter of 2008 to about USD10 trillion in the first quarter of 2013. The massive build-up of liquidity and the search for yields caused large capital inflows into the emerging economies given their more favourable growth prospects and higher rates of return. Between 2009 and 2013, Asia received portfolio inflows amounting to USD597.7 billion, equivalent to 2.4% of its combined GDP<sup>1</sup> (Chart 1).

Chart 1

### Impact of Quantitative Easing on Asia



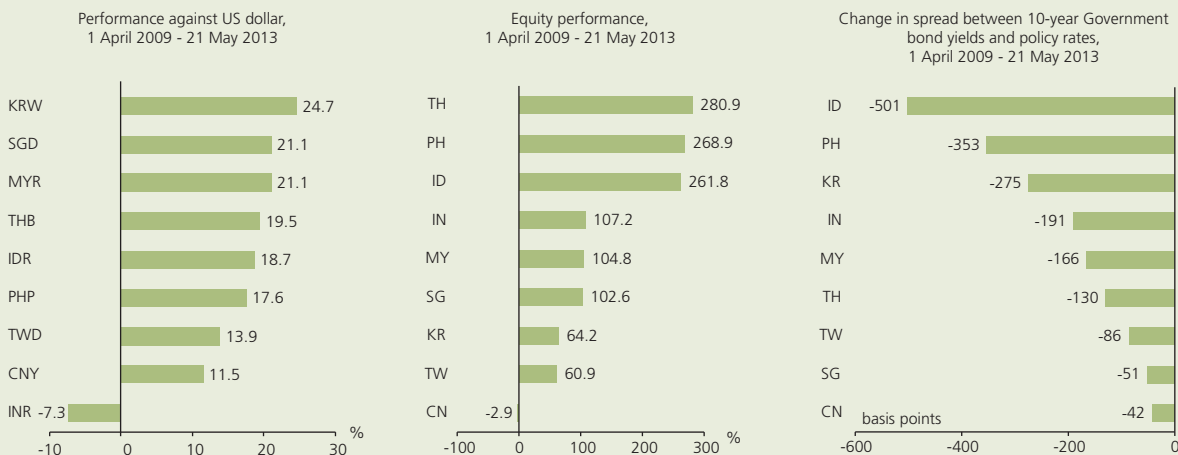
Source: Haver and National Authorities

<sup>1</sup> Asia includes Chinese Taipei, India, Indonesia, Korea, Malaysia, Philippines, PR China, Singapore and Thailand.

This surge in capital inflows exerted significant upward pressure in the currency, equity and bond markets of these Asian economies (Chart 2). The decline in bond yields, in tandem with that of the advanced economies, contributed to a reduction in the domestic cost of financing. The lower interest rate environment and ample liquidity conditions may have contributed to the underpricing of risks, thereby encouraging excessive investments in risky assets and led to the build-up of financial imbalances. As a result, several Asian economies experienced high credit growth and rising property prices.

Chart 2

Impact of QE on Asian Currencies and Financial Markets



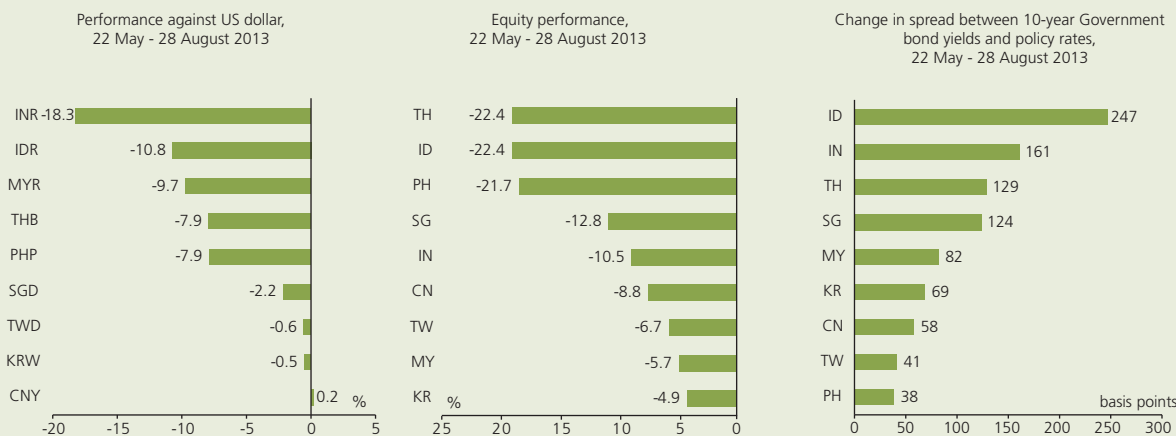
Source: Bloomberg and Bank Negara Malaysia

As the recovery in the advanced economies gains momentum, the unconventional policies and the highly accommodative monetary conditions will be gradually unwound. The transition, if not managed properly, could lead to sudden and sharp reversals of capital flows from the emerging economies, which would in turn trigger disruptions in the global financial markets and affect the pace of global recovery. This was evident in May 2013 following the initial indication of a potential QE scale-back. Uncertainty over the timing and magnitude of the QE scale-back, coupled with the rising expectations of narrowing interest rate differentials between the advanced and emerging economies, prompted investors to rebalance their portfolio position and rapidly unwind their investment positions in the emerging economies. Large capital outflows led to significant downward pressure on currencies and prices in equity and bond markets in the emerging economies between May and August 2013 (Chart 3). In some markets, the reversals caused excessive fluctuation in the bond and equity markets, and overshooting in the exchange rates.

In contrast, the Fed's announcement to begin reducing the pace of asset purchases in December 2013 initially had a more limited impact across economies, as investors had already built in the expectations of an eventual scale back in QE. The enhanced forward guidance in the December FOMC statement had realigned market expectations of the timing of the Fed's first rate hike to a later period. However, the December 2013 decision only marks the beginning of the policy transition in the US. Indications are that the path towards normalisation of monetary policy is expected to be gradual and would take place over a period of time, as well as being conditioned by the strength of the economic recovery. During this transition, the emerging economies will operate in a highly uncertain environment with frequent sharp increases in volatility in the financial markets as investors reassess and shift their positions. In the early part of 2014, volatility in the international financial markets has risen with several emerging economies being severely affected by massive capital outflows. It is also evident that there has been greater differentiation between emerging economies, as investors scrutinise the fundamentals of each country. The risk of contagion, nevertheless, still remains and is on the rise.

Chart 3

Impact of Potential Scaling-back of QE on Asian Currencies and Financial Markets



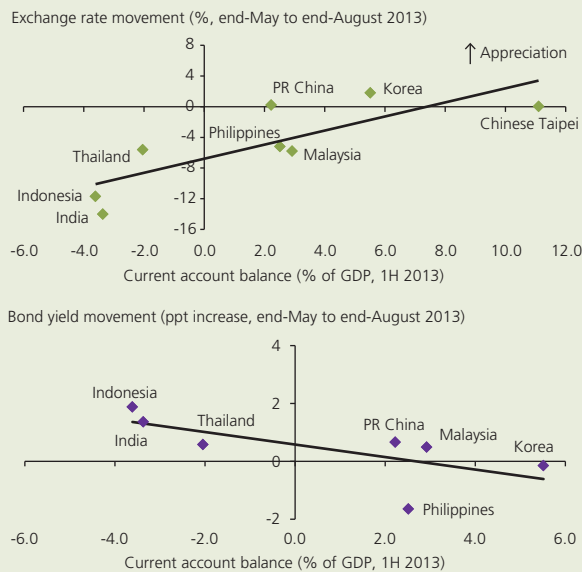
Source: Bloomberg and Bank Negara Malaysia

Asia's challenges and policy responses

While Asia is in a better position relative to the period prior to the Asian Financial Crisis (AFC), recent developments have highlighted the key challenges faced by the emerging economies in an environment of highly volatile capital flows. These include the sustainability of external positions, adequacy of policy space and the health of domestic balance sheets. In particular, countries that have twin deficits are judged to be more reliant on short-term funding and vulnerable to capital reversals (Chart 4). While the narrowing of the emerging economies' current account surplus post-GFC was initially welcomed as a sign of global rebalancing, it has subsequently been seen as increasing the likelihood of potential funding stress if the economies rely heavily on external short-term flows.

Chart 4

Exchange Rate and Bond Yield Movements versus Current Account Balances



Source: Bloomberg and Haver

Widening fiscal deficits and high public debt following large stimulus measures during the GFC raised concerns over the increase in debt servicing costs and the adequacy of fiscal space to embark on future counter-cyclical policies. Another concern is that rapid capital outflows could lead to sharp declines in asset prices with serious repercussions on household balance sheets.

The policy responses by Asian policymakers in addressing the challenges that have been highlighted can be segregated into two phases. Post-GFC, household balance sheet had been a core policy concern. Hence, policymakers in Asia have, since 2009, progressively implemented policies to tackle rising household indebtedness. In particular, countries such as Hong Kong SAR, Singapore and Malaysia have adopted pre-emptive measures including the implementation of macroprudential and demand management policies to address potential overheating in the property market and to slow the growth of credit. Beginning in 2013, the policy focus in several Asian countries has been extended to address the issue of twin deficits. These countries introduced a series of policies which included easing of export rules and improved management of foreign exchange liquidity to strengthen their external positions. In several economies, policy rates have been raised. Fiscal consolidation plans, including tax reforms and subsidy rationalisation, are also being used to restore the health of the government balance sheet. The credibility of these plans has been reinforced by the commitment of clear milestones for fiscal targets in the short and medium term.

### **Building greater resilience against external shocks**

Beyond these immediate challenges, proactive efforts have been undertaken in the recent years to ensure that capital inflows and their subsequent reversal do not significantly disrupt the domestic financial system and economic activity. This has been complemented by structural reforms that have been steadily rolled out since the AFC to increase the resilience of economies, both at the national and regional level.

The strength in the emerging economies' growth in the five years after the GFC has been supported by more diversified sources of growth. In particular, Asia's domestic demand accounted for 86% of GDP in 2012 (1990: 81%). At the same time, regional economies have diversified their trade partners, with intra-regional trade accounting for close to 50% of total trade in 2012 (1990: 37%). Asia's resilience has also been enhanced by more flexible exchange rate regimes, as well as more developed and stronger financial sectors. Compared to the pre-AFC period, most Asian economies are now less reliant on short-term debt funding, have expanded the sources of funding for the economy and have higher level of foreign exchange reserves. In addition, the quality of foreign debt funding has also improved given the deeper and broader capital markets in many countries in the region. These have significantly improved the resilience of Asia in withstanding and responding to external shocks and safeguarding domestic financial and macroeconomic stability.

In addition, there is now greater regional financial integration and cooperation. Over the past decade, regional initiatives have been strengthened to provide a much stronger framework for cross-border financial assistance to improve the crisis readiness of the region. This includes the enhancement of multilateral liquidity support among the Asian economies, such as the Chiang Mai Initiative Multilateralisation (CMIM), which is complemented by economic surveillance conducted by the ASEAN+3 Macroeconomic Research Office (AMRO) and Monetary and Financial Stability Committee of the Executives' Meeting of East Asia-Pacific Central Banks (EMEAP). The recently enhanced Crisis Management and Resolution Framework among EMEAP member countries also serves as a mechanism for collective policy response, surveillance and information sharing. New financial arrangements to facilitate trade financing and settlement in domestic currencies, primarily through local currency swap arrangements between regional central banks have also added a degree of resilience as these have reduced the vulnerability of regional trade to global financial market volatility.

**Conclusion**

The implementation of unconventional monetary stimulus in the advanced economies was premised upon achieving domestic policy objectives but has had wide-ranging global spillovers. As the pace of economic recovery in the advanced economies gains momentum, the shift towards policy normalisation will eventually take place. This shift will have implications for global capital flows, in particular through the rebalancing of portfolio flows from the emerging economies back to the advanced economies. Against this backdrop, policymakers in Asia face the challenge of managing the impact of capital flow reversals on their domestic economic and financial conditions. Asia, as a whole, has exhibited greater resilience than in previous decades, reflecting in part, the dividends from the post-AFC reforms. In addition, a broader and enhanced policy toolkit will help manage the potential negative externalities that may arise. All these will not necessarily insulate the Asian economies from the spillover effects from policy normalisation in the advanced economies. However, pre-emptive response will enable Asia to alleviate some of these effects and maintain the resilience of the region.