Statement before the House Financial Service Committee's Subcommittee on Monetary Policy and Trade

International Impact of the Federal Reserve's Quantitative Easing Program

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The views expressed in this testimony are those of the author alone and do not necessarily represent those of the American Enterprise Institute

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Thank you Chairman Campbell, Ranking Member Clay, and members of the Subcommittee for affording me the great honor of testifying before you today. My name is Desmond Lachman and I am a Resident Fellow at the American Enterprise Institute. I am here in my personal capacity and I am not here to represent the AEI's view.

Introduction

In a highly integrated global economy, US monetary policy typically has significant spillover effects on the rest of the world economy. It does so both through the way in which it affects the state of the US domestic economy as well as by the manner in which it influences capital flows from the United States to the rest of the world economy. The unusually large degree of US monetary policy loosening over the past five years has been no exception to the rule. Indeed, there is reason to believe that both the very scale and the form of the most recent episode of US monetary policy easing has had more than the usual degree of spillover to the rest of the world economy.

While the initial spillover effects from US monetary policy loosening appear to have been beneficial to the global economy, it could pose a significant challenge for the global economy as the US Federal Reserve begins the process of exiting from its aggressive policy of quantitative easing. This challenge could be particularly pronounced for a group of important emerging market economies as well as for a number of countries in the Eurozone's economic periphery. Since many of those countries have been lulled into a false sense of security by easy global liquidity conditions and have allowed large external and domestic imbalances to develop. This makes those countries especially vulnerable to a any abrupt reversal of US capital flows that might be prompted by the Federal Reserve's prospective exit from quantitative easing.

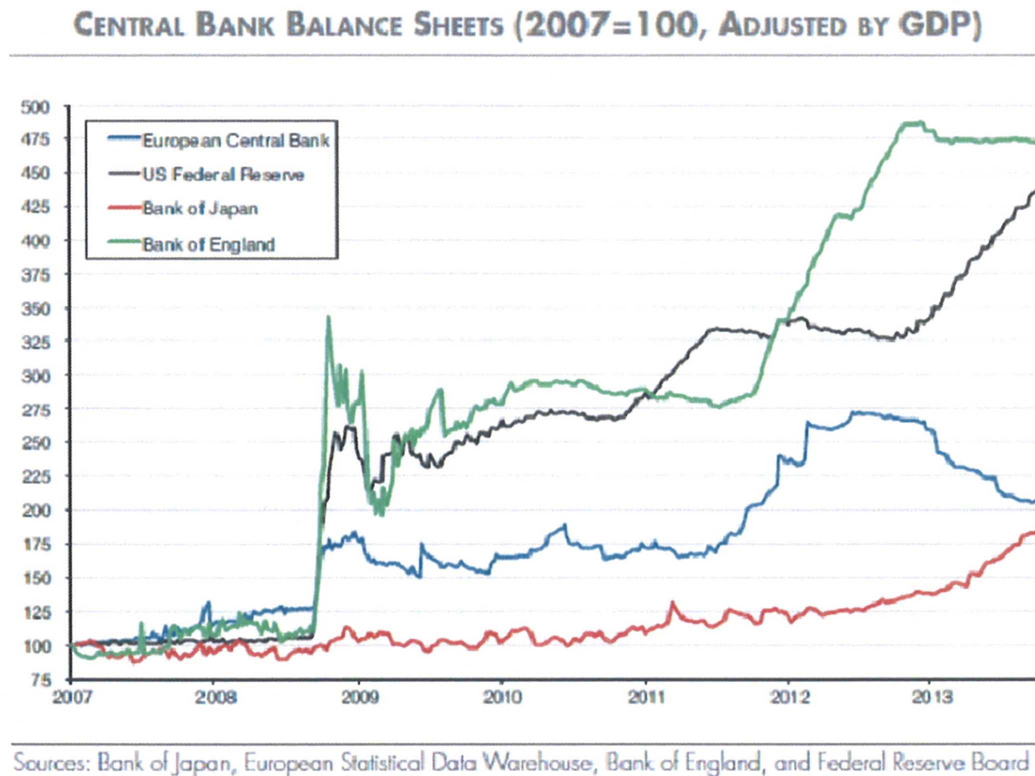
Monetary Policy Spillover Channels

There are a variety of ways that US monetary policy action might affect the rest of the global economy. First, to the extent that US monetary policy might contribute to a better state of the US economy than would have otherwise have been the case, it provides the rest of the world with better export prospects to the United States. Second, to the extent that US monetary policy affects both short and long-term US interest rates, it influences capital movements to and from the United States. Those capital movements in turn have important effects on the recipient countries' interest rate and exchange rate levels as well as on their pace of domestic credit expansion. Third, by encouraging risk taking, US monetary policy can have an important positive effect on global equity prices and on global property values.

In assessing the most recent round episode of US monetary policy easing over the past few years, it is well to recall how aggressive that easing has been. The Federal Reserve's policy interest rates were quickly reduced to their zero bound, while through forward guidance the Federal Reserve has committed itself to hold policy rates at that zero bound at least until 2015. At the same time, through successive rounds of quantitative easing, the Federal Reserve's balance sheet has

more than quadrupled in size to its present level of close to US$4 trillion. Until the issue of tapering was broached by Mr. Bernanke in May 2013, those policies had the effect of reducing US long-term rates to their lowest level in the post-war period. They have also had the effect of contributing to a strong increase in US equity and housing market prices that have been supportive of the US economic recovery.

Figure 1



CENTRAL BANK BALANCE SHEETS (2007=100, ADJUSTED BY GDP)

Sources: Bank of Japan, European Statistical Data Warehouse, Bank of England, and Federal Reserve Board

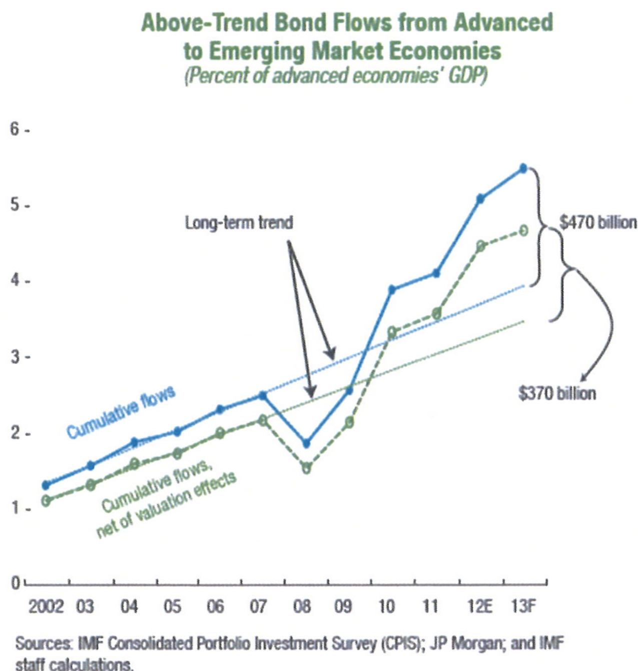
The aggressive US monetary policy loosening of the past five years has not occurred in isolation. Rather it has contributed to major monetary policy loosening in the world's other major advanced economies, motivated in part by concerns of the central banks of those countries about an undue appreciation of their currencies against the US dollar. Of particular note, has been the easing of Japanese monetary policy since early 2013 when the Bank of Japan (BOJ) committed itself to doubling Japanese base money by end-2014. It did so with the explicit objective of extricating Japan from deflation and of increasing Japan's inflation rate to around 2

percent by end-2014. The BOJ's policies have contributed to a depreciation of the Japanese yen by around 20 percent over the past year.

Capital Flows to the Emerging Markets

Since end-2008, the substantial easing in monetary policy by the Federal Reserve and by the other major advanced countries has resulted in substantial capital inflows into the emerging markets. According to estimates by the International Monetary Fund, foreign portfolio investment in emerging market country bonds has risen by a cumulative US$1.1 trillion through 2013. These inflows have averaged more than 2 percentage points of recipient country GDP a year during the past four years. They have also resulted in capital inflows into the emerging markets that were an estimated US$470 billion above the long term structural trend.

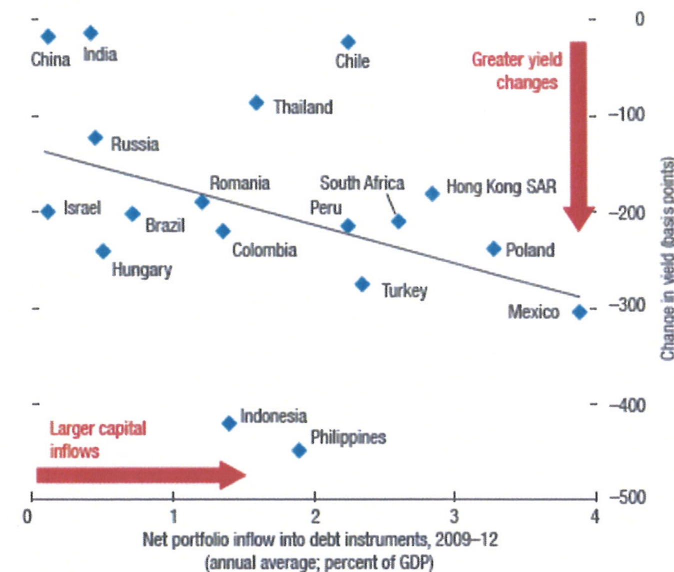
Figure 2



Large capital inflows into the emerging market countries have resulted in a

general appreciation of those countries' currencies. They have done so despite efforts by those countries to limit the impact of those flows on their currency markets. In addition, the large capital inflows have contributed to substantial yield compression in the recipient countries' capital markets. That compression has been most pronounced in those countries like Mexico, Poland, South Africa, and Turkey that have received relatively large capital inflows. In a number of emerging market countries, the easing of global liquidity conditions has also contributed to significant increases in property prices and to increased leverage in the banking system.

Figure 3



Sources: Bloomberg, L.P.; CEIC Data; Haver Analytics; IMF International Financial Statistics database; and IMF staff calculations.

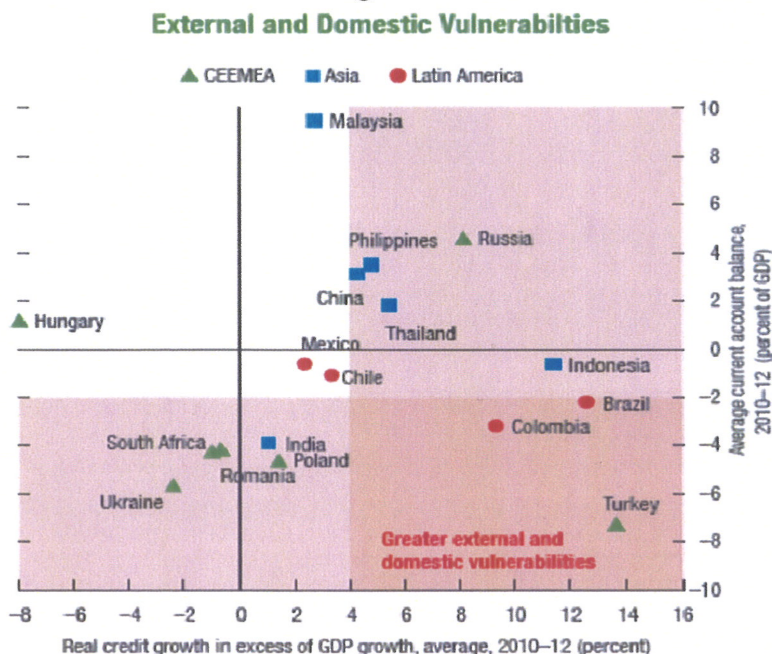
Emerging Market Vulnerability

Over the past decade, the emerging market economies have grown at a considerably faster pace than the industrialized economies and have been responsible for more than half of world economic growth. They have done so in the context of a considerable improvement in their economic fundamentals, the resort to more flexible exchange rate policies, and the building up of their international reserve positions. Given their increased importance to the health of

the global economy, one has to be concerned about the possible adverse impact that the considerable easing in global liquidity conditions might have had on the emerging markets' longer term growth prospects. In particular, one has to be concerned about their increased vulnerability to any significant reversal in global capital flows.

An important way in which increased global liquidity might have compromised the economic fundamentals of a number of emerging market countries is that it has tended to undermine market discipline. It has done so by reducing borrowing rates of emerging market countries to levels below those that would be justified by those countries' economic fundamentals. It has also done so by allowing countries that would normally not have had access to market financing to finance themselves. In a number of notable cases, including Brazil, India, Indonesia, South Africa, and Turkey (the so called Fragile Five), easy financing has led to the postponement of needed structural reforms and budget adjustment. It has also led to excessive credit expansion and to the buildup of financial leverage that makes these countries vulnerable to any abrupt unwinding of quantitative easing by the Federal Reserve or by the BOJ.

Figure 4



Sources: IMF, International Financial Statistics and World Economic Outlook databases.
Note: CEEMEA = central and eastern Europe, Middle East, and Africa.

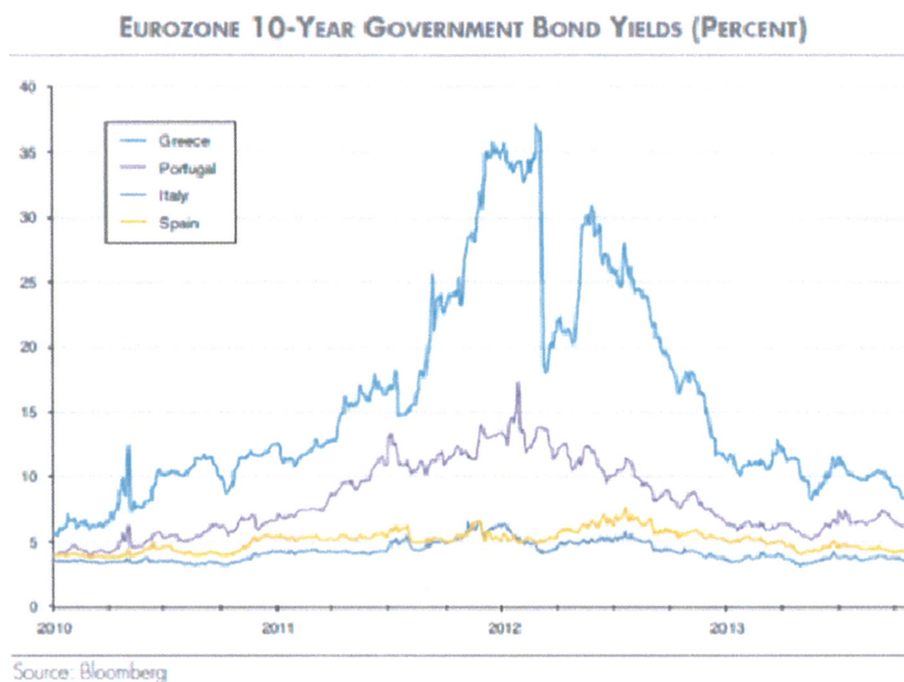
The very scale of the unorthodox monetary policies of the world's major central banks has also compromised the external positions of a number of emerging market countries. In thin markets, large-scale capital inflows have in many cases resulted in excessive currency appreciation despite the efforts of the recipient countries to limit such appreciation. This has had the effect of compromising those countries' export sectors and has increased those countries' external vulnerability by causing their external current account deficits to widen. Large currency swings have the potential for complicating those countries' efforts to promote domestic economic growth in the context of a non-inflationary domestic economic environment.

European Policy Complacency

Perhaps of even greater concern for the global economic outlook than is the increased vulnerability of a number of important emerging market economies is the complacency presently characterizing European policymaking circles concerning the European sovereign debt crisis. This is of particular concern considering the marked deterioration of the economic and political fundamentals of key European countries like France, Italy, and Spain.

Fueling European policy complacency has been the considerable reduction in sovereign borrowing costs of countries in Europe's troubled economic periphery that was induced by the unorthodox monetary policies of the European Central Bank (ECB), the Federal Reserve, and the BOJ. The ECB's announcement in mid-2012 to do whatever it takes to save the Euro through its Outright Monetary Transaction Program appears to have eliminated the market's perception of any tail risk that the Euro might come asunder. Meanwhile the stepped up pace of quantitative easing by both the Federal Reserve and the BOJ since September 2012 has contributed to further spread narrowing in Europe as investors stretched for yield.

Figure 5



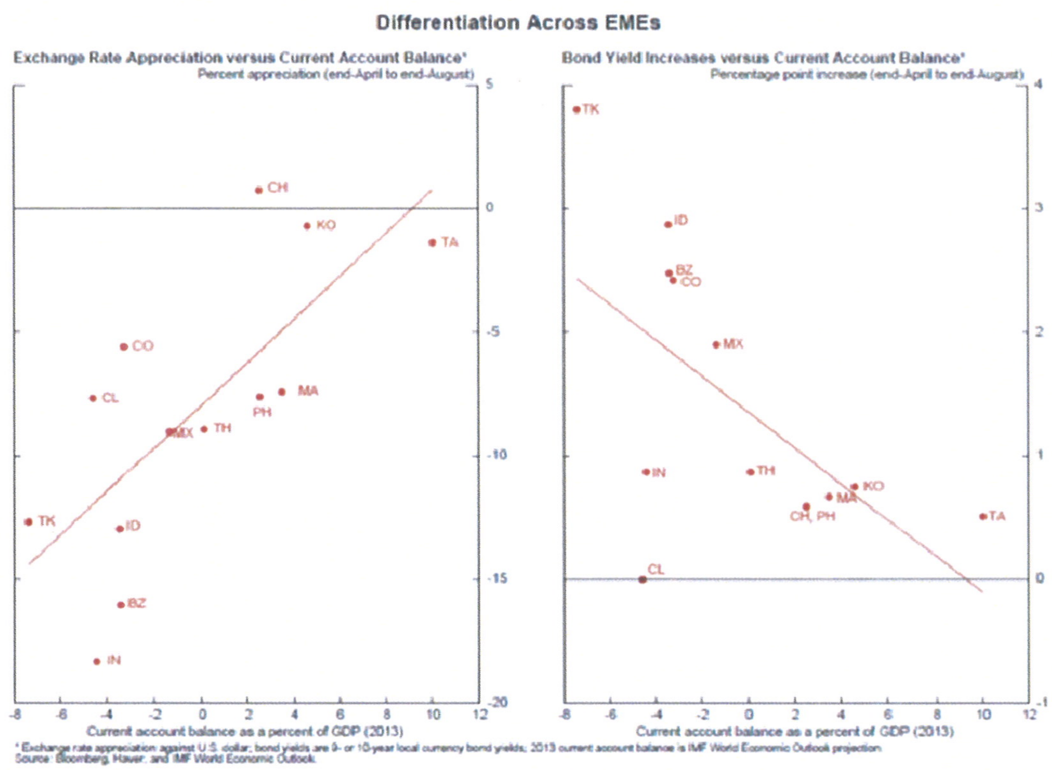
Lower borrowing costs in Europe have substantially reduced the impetus for much needed policy reform and adjustment. Countries in the European periphery like Greece, Italy, Portugal, and Spain are increasingly resisting calls on them to further reduce their budget deficits and to persevere with painful structural economic reform. Meanwhile, the present calm in the European bond markets is reducing the sense of urgency of European policymakers to proceed with a move towards a European banking union and towards a European fiscal union. Such moves would seem to be so necessary to the Euro's long-term survival. This could expose Europe to a renewed intensification of its ongoing debt crisis should Europe be faced with a less benign global international liquidity environment than was the case in 2013.

Initial Experience with Fed Tapering

An indication of the downside risks to the global economy that could be posed by an unwinding of quantitative easing was provided by the sharp sell off in emerging market assets in the aftermath of Chairman Ben Bernanke's May 2013 congressional testimony. In that testimony, Mr. Bernanke intimated that the Fed had under consideration the unwinding of its third-round of quantitative easing. In

the three months following that testimony, the currencies and bonds of those emerging market countries that had experienced high rates of credit expansion and that had wide external current account deficits, including notably Brazil, India, Indonesia, South Africa, and Turkey, came under considerable market pressure. This pressure was seen in an 8 percent drop in assets under management for emerging market fixed-income investment. It was also seen in as sharp a rise in emerging market local currency bond yields as occurred in the initial phase of the September 2008 Lehman crisis.

Figure 6



There are many reasons to believe that the emerging market economies are in a better position today to deal with a reversal of capital flows than they were in 1998 Asian crisis. For the most part they have better levels of international reserves, lower levels of short-term external debt, and stronger budget positions. In addition, they now enjoy the benefits of having flexible exchange rate regimes. Nevertheless, one has to expect that the shift towards very much more restrictive economic policies in response to a less benign international liquidity environment will take a considerable toll on these countries' economic growth outlooks. In this context, it is of note that following the large market sell-off in emerging market

assets in the third quarter of 2013, the IMF revised down its economic forecast for emerging markets for 2014 by around 2 percentage points. Reflecting the increased importance of the emerging markets in the world economy, this lower forecast occasioned a significant downward revision in the IMF's global economic forecast.

Implications for Fed Policy

In determining the pace at which it unwinds its quantitative easing program, the Federal Reserve will need to be very mindful of the international spillovers of its exit policy. This would particularly appear to be the case given the large impact that the massive expansion over the past several years of its balance sheet has had on the economic fundamentals of a number of key emerging market economies and on those countries in the European economic periphery. Those economies constitute an increasingly important part of the global economy and their performance could have a very significant bearing on the US economic outlook.

The key challenge for the Federal Reserve will be to find the right balance in the pace at which it exits quantitative easing. Too slow a pace of exit could further contribute to the undermining of market discipline in the emerging market economies and in the Euro-zone. At the same time, too fast a pace of exit runs the risk of a sudden stop in capital flows to the emerging market economies and Europe, which could prove to be disruptive to the global economy.