



Pathfinder Economic Alert

How Close is the US to Tapering QE3?

Implications for Emerging Markets

Currently, there is much debate regarding the future of the massive Quantitative Easing (QE) program of key Central Banks, particularly the US Federal Reserves (FED); the European Central Bank (ECB); the Bank of England (BOE); and the Bank of Japan (BOJ). Of these, recent attention has been focused, particularly on whether the FED is considering a ‘tapering’ of its purchases of bonds and mortgages. ‘Tapering’ is the term used to describe a possible slowing down of the FED’s asset purchases which currently amount to \$85 billion per month. This has led to selling by bond-holders thereby driving up interest rates and causing volatility in stock markets. The nervousness has not been confined to the US and has spread around the world. There has even been talk of an emerging market sell-off. If the mere possibility of the FED ‘tapering’ its bond purchases can cause such volatility, the prospect of it actually happening requires careful consideration. It would be useful, therefore, to examine some of the issues involved regarding the FED’s future action on its massive QE program. Any such analysis is complicated by two very different narratives that make it difficult to separate the good news from the bad.

Good News is Bad

One narrative contends that if the US economy accelerates, with a pick-up in job creation and a fall in unemployment, the FED will cut back on its QE3 program which has elevated share prices around the world. Interest rates have also been kept at extremely low levels through this massive infusion of liquidity. It is argued that any reduction in QE3 will provide momentum to the increase in bond yields and that this will drive mortgage rates higher. This is expected to lead to aborting of the US recovery. According to this thesis, markets worry that US growth may be about to accelerate and would sell on this good economic news on the assumption that the FED was about to tighten monetary policy i.e. good economic news results in less investor confidence.

Good news is Just That

The contrary narrative argues that a more rapid recovery will generate a virtuous cycle of rising corporate profits, increasing investment and higher consumer purchasing power, in turn

encouraging more business investment and growth. According to this thesis good economic news is a buy-signal with boosted market confidence.

Performance of the US Economy

The Short-Term

While there is difficulty in separating good news from bad, there is also uncertainty regarding the prospects for the US economy. The FEDs own assessment sees overall economic activity increasing at a “modest to moderate pace”, with expansion in manufacturing; moderate gains in consumer spending; expansion in business services; moderate to strong increase in residential and commercial real estate as well as construction activity; and an upturn in bank deposits, lending and credit policy.

Despite this “modest to moderate” improvement in the US economy the balance of probability is that the FED is unlikely to commence ‘tapering’ its QE3 program. In this connection, it is significant that unemployment grew marginally from 7.5% to 7.6% in April 2013. This is well above the 6.5% that Ben Bernanke (Chairman of the FED) has stated would trigger a ‘taper’ which would signal the beginning of the end of QE3. The argument against immediate ‘tapering’ is reinforced by the fact that 20 million US workers are unemployed, compelled to work part-time or too discouraged to search for work. Furthermore, 58.6% of the working age population is currently employed compared to 63.4% in 2006. In addition, the FED does not as yet know the full impact on growth and employment of the automatic spending cuts and higher taxes which have kicked in as a result of the failure to reach a deal on the Budget.

There seems to be sufficient grounds to conclude that the FED is unlikely to be about to commence ‘tapering’ QE3.

The Medium-Term

The medium-term prospects of the US economy are propitious, provided dysfunctional politics does not derail the recovery. The combination of cheaper fuel (Shale oil and gas); cash rich corporates; a recovery in the housing market; and better household balance sheets offer the prospect of a robust recovery in the medium-term. The US economy is expected to gather momentum in 2H 2013 and record 2.5% - 3% growth in 2014. This means that monetary policy will inevitably be tightened going forward. US bond yields are likely to be closer to 4% than their current less than 2%. This will result in a tightening of liquidity in the global economy as well as a recalibration of investor risk appetite as higher yields will become available in the massive US economy.

Implications for Emerging Markets

In the short-run, there is likely to be events-driven volatility in bond and share markets. However, liquidity conditions are likely to continue to be relaxed and it is unlikely that there will

be an emerging market sell-off. However, going forward less expansionary monetary policy and reduced differentials in yields between the US and emerging markets are likely to have an impact on institutional capital flows as fund managers rebalance their portfolios. This will have an impact on the capacity of emerging economies to attract stock market inflows and portfolio investment in government securities.

The general consensus is that emerging economies with strong fundamentals will not be affected by the ‘tapering’ or even ending of QE3. However, countries with large imbalances in the current account of their balance of payments and fragile external debt dynamics are likely to experience increased difficulty in attracting capital flows to fund their external and budgetary deficits. Inflows to their stock market are also likely to become more constrained in the medium-term. It is important that Sri Lankan policy-makers factor in the medium-term trends in global liquidity in their decision-making.

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