

The Federal Reserve's large scale asset purchase program and its impacts on Asian economies

The US economy experienced a deep economic downturn triggered by the subprime crisis in 2008. Even though the Federal Reserve aggressively reduced the federal funds rate almost to zero, the recovery remained fragile and the unemployment rate was elevated. To provide further supports for the economic recovery, the Federal Reserve announced in 2008 Q4 it would conduct the first round of quantitative easing (QE1), purchasing mortgage-backed securities and debt issued by government-sponsored enterprises (GSEs) totaling 1.425 trillion dollars in order to remove troubled assets from financial institutions' balance sheets, thereby improving their financial positions and facilitating bank lending. In addition, the Federal Reserve also purchased government bonds up to 300 billion dollars in order to lower the medium- and long-term Treasury bond yields, increase liquidity, and drive up inflation expectations.

After QE1, the US economy initially showed signs of recovery, but beginning in 2010 Q2 the economic upturn slowed down as reflected in persistently high unemployment and very low inflation. Consequently the Federal Reserve announced the second round of quantitative easing (QE2) on 3 November 2010. Under this program the Federal Reserve will purchase one- to 30-year Treasury bonds totaling 600 billion dollars by the end of 2011 Q2. The main objective is to lower Treasury yields and raise inflation expectations.

Impacts of QE1 and QE2 on the US economy

Quantitative easing will increase the amount of cash holdings in financial institutions' reserve accounts held at the Federal Reserve and reduce the amount of securities held by financial institutions, thereby reducing interest rate risk that may arise when rising interest rates reduce securities' values. At the same time, banks' selling of risky assets (for example, debt securities and asset-backed securities issued by GSEs) to the Federal Reserve lowers credit risk, as the probability of default is now greatly diminished (Table 1).

As QE1 works to reduce both interest rate and credit risks, it is successful in restoring financial market functioning. This is reflected by the decline in the yields of mortgage-backed securities and the increase in the amount of asset-backed securities issued. Nevertheless, its impact on the economic recovery appears ambiguous because asset prices only marginally increase, thereby failing to significantly increase household's wealth. Bank loans also do not grow as strongly as expected due to the weakness of balance sheets of financial institutions.

The expected impact of QE2 on stimulating the economy may be limited because long-term Treasury yields may not fall as expected, given that market functioning has been restored and that the economy is now poised to expand. As a result, mortgage interest rates linked to long-term treasury yields do not edge

lower as intended. This would hinder the recovery of the housing market which has been depressed by a rising supply from foreclosure resales. The subdued recovery of house prices will also limit the increase in household wealth. Incidentally, QE2 will indirectly facilitate US exports through the dollar depreciation. However, this positive impact on the economy seems to be rather small given that the share of US exports in output is only 13 per cent.

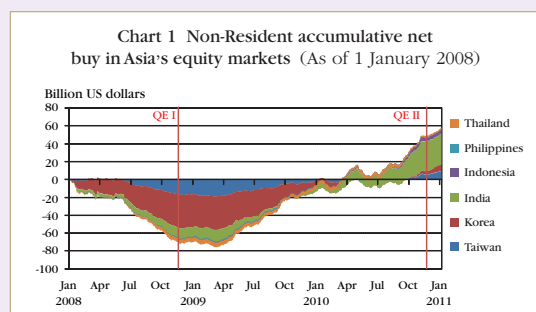
Table 1: Depository institutions' balance sheets

	Assets	Type of risk associated with assets	QE1		QE2	
			Change in assets	Change in risk profile	Change in assets	Change in risk profile
Liquidity assets	Vault cash & reserve at Fed	no	+1,725		+600	
	Treasury security	Interest rate risk	-300	Interest rate risk ↓	-600	Interest rate risk ↓
Other assets	Other assets	Interest rate risk & credit risk	-1,425	Interest rate risk & credit risk ↓		
	Total			Overall portfolio's risks ↓		Overall portfolio's risks ↓

Effects on Asian economies

When QE1 was implemented in 2009 Q1 during the period of the global downturn, demand for safe haven assets, particularly those denominated in dollar, remained high. As a result, Asian economies experienced extensive capital reversals to the US that led to depreciation of Asian currencies. Only in 2009 Q2

when the Asian economies started to recover, while the advanced economies still struggled with recession, that capital then started to flow back into the Asian region again.



Source: Bloomberg

Unlike QE1, QE2 was implemented when the global economy started to recover – albeit slowly in many countries. Investors now gain confidence

and are willing to invest in risky assets, propelling capital flows into Asian economies where better growth prospects relative to the advanced economies are expected. While increased liquidity in emerging market economies potentially lead to increased pressures on asset prices, including house prices, part of the liquidity from QE2 will remain in the US economy, as reflected by an increase in currency in circulation in the US. As a result, capital flows into Asia will not be as large as feared. Moreover, investors' concern over the European sovereign debt problem may deepen, as in 2010 Q4, and that will drive capital flows back to the US.