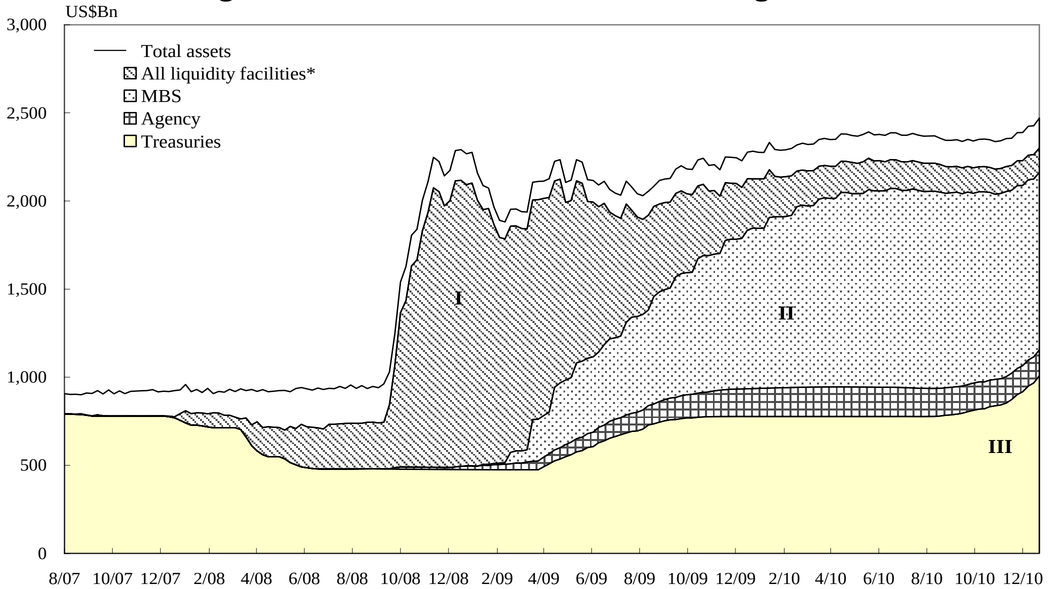
Box 2.1

The Federal Reserve's another round of quantitative easing (QE2)

The US Federal Reserve (the Fed) announced on 3 November 2010(1) that it would purchase a further US$600 billion of longer-term Treasury securities by the end of the second quarter of 2011, at a pace of about US$75 billion per month. The fresh round of quantitative easing (commonly termed as "QE2") aroused much discussion, and this article explores some key issues regarding QE2 and its implications for the Hong Kong economy.

The abrupt escalation of the financial crisis in the latter part of 2008 prompted the Fed to step up its pursuit of unconventional monetary policy. From ***Chart 1***, roughly three stages of development in the Fed's balance sheet can be discerned. The first stage of asset purchases aimed at providing liquidity facilities to combat the liquidity and credit crunch faced by financial institutions after the subprime problems and fall of Lehman Brothers. The Fed's balance sheet ballooned to around US$2 trillion by end-2008, from below US$1 trillion prior to the crisis. This QE1 helped to forestall a meltdown of the financial systems. Then from early 2009, the Fed adjusted its balance sheet to target the troubled securitised markets through purchasing mortgage-backed securities (MBS). As market conditions improved and economic recovery gained some traction in the latter part of 2009 and early 2010, there had been talks of an exit strategy. The Fed allowed various liquidity facilities to run their course(2), and in February 2010 outlined several tools for exiting policy accommodation (See ***Box 2.1*** of the ***2009 Economic Background and 2010 Prospects*** for a more detailed discussion). As seen from ***Chart 1***, the liquidity facilities portion of the Fed's balance sheet assets had shrunk markedly since the second half of 2009, but was largely offset by the expansion of the MBS portion.

Chart 1 Changes in the Fed's balance sheet since the global financial crisis



Note: (*) All Liquidity Facilities include: Term Auction credit; other loans; Commercial Paper Funding Facility; outstanding principal amount of loans to American International Group, Maiden Lane LLC, Maiden Lane II LLC, Maiden Lane III LLC, and TALF LLC; and central bank liquidity swaps.

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(1) FOMC statement: http://www.federalreserve.gov/newsevents/press/monetary/20101103a.htm.

(2) For example, the Money Market Investor Funding Facility (MMIFF) expired on 30 October 2009. The Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (AMLF), Commercial Paper Funding Facility (CPFF), Primary Dealer Credit Facility (PDCF), and Term Securities Lending Facility (TSLF) were closed on 1 February 2010. The Term Asset-Backed Securities Loan Facility (TALF) was extended until 30 June 2010 for loans collateralized by newly issued CMBS and through 31 March 2010 for loans collateralized by all other TALF-eligible securities.

Box 2.1 (Cont'd)

But in spring 2010 the sovereign debt problems in Europe intensified, while economic activity in the US showed signs of losing steam around the mid-year. All these prompted the Fed to reinvest maturing agency debt and mortgage-backed securities into longer-term Treasury securities since August 2010, serving to maintain the size of the Fed's balance sheet without adding to its holdings of securitised securities. Finally in November 2010, the Fed rolled out QE2 to support the economy, in view of the elevated unemployment rate and the downtrend of core inflation (***Chart 2***). This move was consistent with the Fed's dual mandate of supporting maximum employment and maintaining price stability.

Chart 2 : US unemployment still elevated and inflation remained low

Debates and discussions ensued surrounding the effectiveness of QE2 to bolster the real economy. According to the Fed, QE2 would work by lowering the longer-term interest rates, in addition to the already close-to-zero-bound Fed funds rate(3), thereby spurring household and business spending and boosting the pace of recovery. However, some critics noted that in the current environment of deleveraging, the additional liquidity may just be clogged up as banks' excess reserves, or channeled to other overseas economies, rather than trickle down to the US economy. In other words, QE2 does not necessarily induce banks to lend or employers to hire, and hence may fail to spur the economy. Indeed, QE2 had been so anticipated and factored into long-term interest rates that the US long-term interest rates actually went up after the official announcement of QE2 (***Chart 3***). Some critics suggest that the higher rates reflect rising concerns over the US public finance, as the US government has to lay out a more concrete plan to reduce public debt over the medium to longer term. Yet the higher long-term rates may also be an indication that QE2 is working by raising growth and inflation expectations. In fact, recent US economic data have largely been better than expected.

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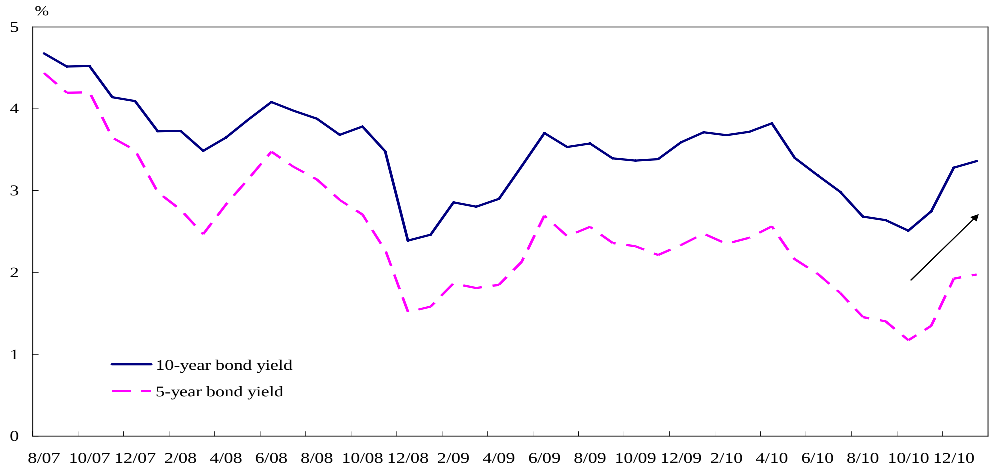
(3) Bernanke's speech on 19 November 2010: http://www.federalreserve.gov/newsevents/speech/bernanke20101119a.htm.

Box 2.1 (Cont'd)

Chart 3 : US long-term interest rates actually went up after QE2



Whether the QE2 will lead to a sustained solid recovery of the US economy is still subject to uncertainty, but it has aroused some backlash from other economies, especially the emerging market economies. Some critics suspect that QE2's real purpose is to weaken the US dollar and hence boost US exports at the expense of others. This may increase the risks of competitive devaluation and even trade and currency wars. The rise of protectionist sentiment and heightened exchange rate volatility, if happened, are certainly unfavourable to trade and would pose a challenge to the exports of Asia, Hong Kong included.

The Fed had also suggested that QE2 might work through the wealth channel[(4)]. That is, QE2 would push the return on safe assets to such a low level that investors would increase their demand for the riskier assets. The rise in the asset prices could, in principle, render a positive wealth effect on final consumption. Yet it is uncertain to what extent the US economy would benefit from this channel with the housing market still depressed. Again, this line of reasoning has brought severe criticism from emerging market economies, as the resultant ample liquidity in the global banking systems would fuel asset market bubble risks and inflationary pressures in economies in Asia and the rest of the world.

In sum, whether the QE2 will attain the Fed's intended goals remains to be seen but it is already posing some notable side-effects on the rest of the world, especially the emerging market economies. The latest FOMC statement released on 26 January 2011 suggests that the Fed is likely to proceed with the purchase programme under QE2 as planned. Given President Obama's latest US$858 billion tax concession and unemployment benefit package, which is expected to render some further support to the US economy this year, as well as the recent better-than-expected performance of the US economy, the need for a further round of quantitative easing, QE3, appears to be diminishing. Nevertheless, the loose monetary environment on a global scale is still expected to persist for an extended period of time. From Hong Kong's point of view, the advent of QE2 had heightened the risk of asset market bubbles and inflation. To forestall the formation of a housing bubble in Hong Kong, the Government had introduced several rounds of measures over the past year or so to ensure the healthy and stable development of the housing market. The Government will continue to monitor the property market situation as well as the inflation trend closely, in order to safeguard macroeconomic stability and, when necessary, to alleviate the impact of inflation on the lower-income families.

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(4) Bernanke's testimony on 7 January 2011: http://www.federalreserve.gov/newsevents/testimony/bernanke20110107a.htm.