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Unintended Consequences of QE

Overdose of Quantitative Easing: Economic Weather Changing?

By Christopher H Lim & Vincent Mack

Synopsis

The decade-long quantitative easing (QE) measures have resulted in the current reverse flow of capital from emerging markets to developed markets. This has led to an “economic drought” in the emerging markets. Would all these drive a currency meltdown in the emerging markets?

Commentary

OVER THE course of the past decade, the collapse of Lehman Brothers and the fear of a repeat of the 1930 Great Depression had led to the [globally concerted efforts](#) by all the major central banks to pursue the unprecedented monetary measures of quantitative easing (QE) and near zero or below zero interest rates.

Despite the huge sacrifice to the tune of trillions of dollars pumped into the financial system by taxpayers, the past decade was known or labelled as [The Advanced Economies' Lost Decade](#).

Profit Maximisation

At the onset of the global financial crisis in 2007/2008 originating from the United States subprime mortgage crisis, most countries around the world suffered various shocks. These ranged from a liquidity crunch to downward pressures on asset prices due to the interconnectedness of global financial markets.

For most parts of the past decade (2008-2018), the G3 economies (the US, European

Union, and Japan) had been on the decline and were relatively less healthy than the emerging economies and some developed countries such as Australia and Canada.

However, soon after the introduction of QE and historically low interest rates, capital flows arising from QE shifted towards the markets outside of the G3 economies, where short-term relative returns were high and where there was greater capacity to absorb funds.

This extensive overdose of financial measures had created a distorted demand in different assets. These included the [surge](#) in foreign buying of emerging-market bonds as well as urban housing in a number of cities — a variant of the ghost cities problem in China.

Overpriced Properties

By 2014, cities such as Vancouver and Toronto in Canada, Auckland in New Zealand, and Sydney and Melbourne in Australia were suffering overpriced residential properties, with price-to-income ratios at historical highs. As a result, many professionals were priced out of the market in these cities; at the same time, a number of investors were prepared to own empty houses with the anticipation of further appreciation in prices.

The 2013 McKinsey Global Institute Studies had [observed](#) that the emerging-market bonds outstanding has climbed by US\$5 trillion since 2008, despite the fact only an estimated 15 percent of the overall bond market was foreign owned.

Subsequently, following the statements issued by the US Federal Reserve in May and June 2013 indicating the intention of tightening monetary policy in late 2013, more than 10 percent decline was observed in the emerging-market equity and aggregate bond indexes between April and August.

Change of Fortune

Yet, we observe two divergent trends in the West.

EU still faces a number of [uncertainties](#)—the huge surge of refugees from the Middle East and North Africa creates an identity crisis for the European population.

In addition, Brexit has caught the EU off-guard. Together with youth unemployment and the rise of nationalism in many EU Member States, this has instigated many within the EU to clarify the EU vision and purpose in the run-up to the European elections in 2019.

In contrast, since 2017, the US - the ground zero of the last global financial crisis - has experienced changing fortunes. In October 2017, the US Federal Reserve took a [decision](#) to terminate QE and to gradually increase interest rates in 2018.

Coupled with the [upward revision](#) of the US economic growth, improvement in household purchases, enhanced employment opportunities since late 2016 and lower

taxes under the Trump Administration, the reversal of QE has led to a rebound in asset markets, company mergers and stock buybacks.

Furthermore, data compiled by the University of Florida as reported in the [Wall Street Journal](#) showed that 83 percent of the US-listed initial public offerings (IPO) in 2018's first three quarters had lost money in the year leading up to their IPO. For example, the company SurveyMonkey experienced a [40 percent jump](#) in share prices after its IPO in September 2018, despite never posting a profitable year.

Extreme Economic Weather

All the above observations can be attributed to QEs influencing the financial market due to their quantum and domino effects on the fund management community globally. Furthermore, the principle of arbitrage - taking advantage of price differences - has directly or indirectly created the herd instinct for the movement and direction on the flow of funds.

In addition, for decades, the advocacy of the free flow of capital by the internationalist and liberal West was based on their belief in the importance of an "efficient market hypothesis" in the market-based economy - without realizing how this would facilitate the formation of an economic bubble in the era post-global financial crisis.

In line with the rise of footloose capital, the launch of QE measures over the past decade has been followed by a rapid influx of capital into real estate, stock and bond markets in emerging economies and selective developed economies that are less affected by the global financial crisis.

As the corollary of the "efficient market hypothesis", the frequent "drought and flood" phenomenon in movements of funds as experienced by the emerging markets are synonymous with the sudden shocks of "extreme economic weather conditions" due to the policy stances of the G3 central banks.

In other words, many economies in the emerging markets are like farmers without the means of installing a proper irrigation control system in their financial sector. They are facing the volatile forces of "drought and flood" in their economies within a day or shorter.

Probability of Currency Meltdown

The US is, once again, perceived as the safe haven and land of opportunities as massive funds are flowing back to the US where investor sentiments and herd instinct behaviour are [unmatched](#) even with respect to the dot.com era in 2000.

As of early 2018, the global debt had increased close to [US\\$247 trillion](#) - about 300 percent of the global annual output. In parallel, the drumbeats of the currency crises in the emerging markets are getting louder and where unfortunately the "irrigation control valve" is not in the hands of those in charge in the emerging markets. The prediction of a currency meltdown in some emerging economies is no longer far-fetched.

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