The Global QE Exit Crisis

By Stephen S. Roach *Wed, Aug 28, 2013*

The rate suppression that QE has imposed on developed countries since 2009 triggered a search for yield that flooded emerging economies with short-term "hot" money, warns the former chairman of Morgan Stanley Asia.

The global economy could be in the early stages of another crisis. Once again, the US Federal Reserve is in the eye of the storm.

As the Fed attempts to exit from so-called quantitative easing (QE) – its unprecedented policy of massive purchases of long-term assets – many high-flying emerging economies suddenly find themselves in a vise. Currency and stock markets in India and Indonesia are plunging, with collateral damage evident in Brazil, South Africa, and Turkey.

The Fed insists that it is blameless – the same absurd position that it took in the aftermath of the Great Crisis of 2008-2009, when it maintained that its excessive monetary accommodation had nothing to do with the property and credit bubbles that nearly pushed the world into the abyss. It remains steeped in denial: Were it not for the interest-rate suppression that QE has imposed on developed countries since 2009, the search for yield would not have flooded emerging economies with short-term "hot" money.

As in the mid-2000's, there is plenty of blame to go around this time as well. The Fed is hardly alone in embracing unconventional monetary easing. Moreover, the aforementioned developing economies all have one thing in common: large current-account deficits.

According to the International Monetary Fund, India's external deficit, for example, is likely to average 5% of GDP in 2012-2013, compared to 2.8% in 2008-2011. Similarly, Indonesia's current-account deficit, at 3% of GDP in 2012-2013, represents an even sharper deterioration from surpluses that averaged 0.7% of GDP in 2008-2011. Comparable patterns are evident in Brazil, South Africa, and Turkey.

A large current-account deficit is a classic symptom of a pre-crisis economy living beyond its means – in effect, investing more than it is saving. The only way to sustain economic growth in the face of such an imbalance is to borrow surplus savings from abroad.

That is where QE came into play. It provided a surplus of yield-seeking capital from investors in developed countries, thereby allowing emerging economies to remain on high-growth trajectories. IMF research puts emerging markets' cumulative capital inflows at close to $4 trillion since the onset of QE in 2009. Enticed by the siren song of a shortcut to rapid economic growth, these inflows lulled emerging-market countries into believing that their imbalances were sustainable, enabling them to avoid the discipline needed to put their economies on more stable and viable paths.

This is an endemic feature of the modern global economy. Rather than owning up to the economic slowdown that current-account deficits signal – accepting a little less growth today for more sustainable growth in the future – politicians and policymakers opt for risky growth gambits that ultimately backfire.

That has been the case in developing Asia, not just in India and Indonesia today, but also in the 1990's, when sharply widening current-account deficits were a harbinger of the wrenching financial crisis of 1997-1998. But it has been equally true of the developed world.

America's gaping current-account deficit of the mid-2000's was, in fact, a glaring warning of the distortions created by a shift to asset-dependent saving at a time when dangerous bubbles were forming in asset and credit markets. Europe's sovereign-debt crisis is an outgrowth of sharp disparities between the peripheral economies with outsize current-account deficits – especially Greece, Portugal, and Spain – and core countries like Germany, with large surpluses.

Central bankers have done everything in their power to finesse these problems. Under the leadership of Ben Bernanke and his predecessor, Alan Greenspan, the Fed condoned asset and credit bubbles, treating them as new sources of economic growth. Bernanke has gone even further, arguing that the growth windfall from QE would be more than sufficient to compensate for any destabilizing hot-money flows in and out of emerging economies. Yet the absence of any such growth windfall in a still-sluggish US economy has unmasked QE as little more than a yield-seeking liquidity foil.

The QE exit strategy, if the Fed ever summons the courage to pull it off, would do little more than redirect surplus liquidity from higher-yielding developing markets back to home markets. At present, with the Fed hinting at the first phase of the exit – the so-called QE taper – financial markets are already responding to expectations of reduced money creation and eventual increases in interest rates in the developed world.

Never mind the Fed's promises that any such moves will be glacial – that it is unlikely to trigger any meaningful increases in policy rates until 2014 or 2015. As the more than 1.1 percentage-point increase in 10-year Treasury yields over the past year indicates, markets have an uncanny knack for discounting glacial events in a short period of time.

Courtesy of that discounting mechanism, the risk-adjusted yield arbitrage has now started to move against emerging-market securities. Not surprisingly, those economies with current-account deficits are feeling the heat first. Suddenly, their saving-investment imbalances are harder to fund in a post-QE regime, an outcome that has taken a wrenching toll on currencies in India, Indonesia, Brazil, and Turkey.

As a result, these countries have been left ensnared in policy traps: Orthodox defense strategies for plunging currencies usually entail higher interest rates – an unpalatable option for emerging economies that are also experiencing downward pressure on economic growth.

Where this stops, nobody knows. That was the case in Asia in the late 1990's, as well as in the US in 2009. But, with more than a dozen major crises hitting the world economy since the early 1980's, there is no mistaking the message: imbalances are not sustainable, regardless of how hard central banks try to duck the consequences.

Developing economies are now feeling the full force of the Fed's moment of reckoning. They are guilty of failing to face up to their own rebalancing during the heady days of the QE sugar high. And the Fed is just as guilty, if not more so, for orchestrating this failed policy experiment in the first place.

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