Is the World on the Brink of a Currency War, Inflation or Sovereign Debt Crisis? Understanding QE2, Capital Flows and the Real Economy in 2011

*Session One of the ISIS PRAXIS Seminar 2011 was held on 3 March 2011, at the Renaissance Hotel, Kuala Lumpur. The panelists were **Mr Manu Bhaskaran**, Partner and Member of the Board, Centenniel Group Inc., Singapore, **Ms Baljeet Kaur Grewal**, Managing Director and Vice Chairman, Kuwait Finance House Research Ltd, Malaysia, and **Mr Steven Wong**, Senior Director, ISIS Malaysia. The Session was chaired by **Dato' Dr Mahani Zainal Abidin**, Chief Executive, ISIS Malaysia. **Veena Loh** Senior Fellow, ISIS, reports.*

The first speaker, **Mr Manu Bhaskaran** took a look at the global environment and made an assessment of the situation, taking into consideration key risks in the following areas:-

- Geo-political risks to growth;
- Sustainability of economic recovery in G-3;
- Monetary overhang in China;
- Global inflation;
- Currency tensions/wars; and
- Capital flows and flights into/from EMs

Manu Bhaskaran

KEY GLOBAL THEMES

1. Geo-Political Risks Up

Risk appetites will be hurt by rising geo-political tensions in the Middle East, the Korean peninsula and Pakistan.

1.1 *Middle East tensions*

The Mid East tensions have a major global impact. Post-Egyptian and Tunisian changes in government, other countries in the Middle East are also facing simmering tensions. There is a new dynamic operating in the Arab world leading to an end to the fear of opposing long-entrenched regimes. The unrest is likely to continue for a long enough time to cause the risk premium on oil prices to rise significantly.

1.2 *Conflicts in North Korea and Pakistan*

There are high risks of escalating and calibrated provocations by North Korea to gain concessions in resources as well as legitimacy for their survival. The North has its fair share of domestic travails; twenty eight-year old Jong-Eun is not credible to the rest of the elite and has proven to be unconvincing as a successor to Kim Jong-il. Furthermore, the weak economy limits the regime from buying support.

A resolution is unlikely as the US and South Korea distrust any attempt by North Korea to offer to talk it over. Ties with China have become uneasy. North Korea distrusts China.

Pakistan is teetering on the brink of crisis and this could affect risk perceptions of India. Moreover, Pakistan has a big population and has nuclear weapons. The army had made progress in 2010 but violence remains high, although the incidences are decreasing. Extremists have been flushed out of key bases and victims of terrorism fell from around 9000 in 2009 to 5500 in 2010. There is likely to be renewed tension In 2011 with the killing of the Punjab Governor. The regime of the present President, Asif Zardari, may not last.

2. G-3 Prospects

Improving growth has been felt in the economy, seen in the near term as the impact of policies, but the process of healing is slow. Countries that have rebounded strongly have been dependent on anti-cyclical policy measures which are unsustainable.

2.1 *Downside Surprises in the US*

The stock markets are betting that recovery will solve underlying issues but strong headwinds are still at work as fiscal austerity and higher oil prices are likely to cramp growth. Economies continue to face adjustments in the housing and labour markets, and deleveraging continues.

The net effect is episodic but not sustainable recovery. Lead indicators by OECD show that G-3 economies and emerging countries are decelerating. The impact of a slowdown in Eurozone and Japan is hurting US exports while there is a political gridlock in the US between Republican leaders and President Obama.

Lead indicators by OECD show that G-3 economies and emerging countries are decelerating

2.2 *Eurozone Sovereign Debt Crisis*

More shocks can be expected before resolution. The key issues are solvency, liquidity, and confidence. An orderly default process is needed if solvency becomes an issue. It is not clear if the political will exists yet to address this. Meanwhile, funds and processes are needed to provide liquidity in the interim. Structural changes/reforms specifying Euro-wide fiscal mechanisms and realistic budget targets are needed to restore confidence in financial and bond markets in the Eurozone.

The Eurozone crisis will force change within the region. Huge debt rising of close to US$1trillion is needed. Episodes of financial stress will continue to be seen. Unification of the Eurozone by the elite is holding the region together. The political will to push through reforms will, however, face protest risks from unhappy voters.

2.3 *Japan: When will the Drift End?*

Japan needs a broad consensus to move reforms in reining in national debt and in liberalizing trade and services. The country has been slow to form a consensus and faces many obstacles ahead. The economy is highly dependent on external demand for its manufactures but has to contend with a strong currency. As there are no credible plans to reduce its national debt, it runs the risk of having to pay for rising bond yields for its future borrowings.

3. Quantitative Easing (QE): Can It Work?

The credit mechanism is healing, but slowly, and the base money is expanding with the Fed's quantitative easing (QE). It is not convincing that QE will work. If banks do not lend out money, then the monetary effect of QE will be muted.

If households do not spend but instead increase their savings, or if money is used to buy assets, then asset prices will rise. In the short term, there will be a positive impact. However, any additional QE will impact the US dollar and in the long term, any positive impact is not sustainable.

Global economies are facing both rising excess liquidity since the collapse in 2008 and cost-push inflation from rising commodity prices. While current supply-demand appears finely balanced, any supply disruptions due to the La Nina effect will lead to exaggerated price rises due in turn to excessive liquidity.

3.1 More risks from China's slowdown

During the global crisis, the ratio of loans to GDP went up from under 100 per cent in 2008 to nearly 120 per cent in 2009. However, this has not been backed by a true demand for money. There is an overhang of money supply. Subsequently, non-tradable inflation has gone up, reflecting an increase in domestic prices.

Inflationary expectations of Chinese households over the next three months are rising based on a quarterly survey conducted in February 2011 by the People's Bank of China (PBOC). While household deposits are falling, annual loan targets remain high and continue to be exceeded.

Excess demand has been building up and China's inflation target has been raised from 3 per cent to 4 per cent

Generally, policy signals from authorities are weak. Previous policies have been slow to target inflation. Excess demand has been building up and China's inflation target has been raised from three per cent to four per cent. China's real estate is in a precarious situation. Asset markets in 11 out of 35 cities are 30-50 per cent overvalued. As a result, more tightening can be expected. Additional pressure will come from surging wages as the labour force declines due to over-done population policies.

Prices of food are rising as supply declines; the over-use of fertilisers in the past has led to the build up of acid in the soil. As China's financial market is not fully developed, the authorities use quantitative instructions on loans rather than interest rate controls. This is likely to lead to abrupt seizures in credit flows. A slowdown in China's growth will negatively impact China's trading partners.

3.2 *Currency wars*

How the RMB is being managed poses a risk to currency wars, but it is a diminishing one. Nominal appreciation is being stepped up and real appreciation is already happening. There is no appetite among countries to start wars; rational policy calculations are more likely. The risk, however, may come from domestic US politics.

4. Capital Flows to Emerging Markets (EM)

There is a risk of intensifying restrictions on capital inflows to EMs as seen recently. More harsh measures may be likely. Risk aversion may sometimes affect capital flows to EM negatively. As a result, spasmodic flows to EMs are likely to be the case.

5. Conclusion

In conclusion, the geo-politic situation in 2011 is likely to get worse; growth in G-3 will recover but weaken again thereafter. Any form of consensus views going forward remains questionable. QE 2 will be weakly effective but will distort exchange rates. Global inflation is higher than expected. Currency wars are not likely.

Mr Bhaskaran was followed by **Ms Baljeet Kaur Grewal**, who explained in detail QE and its consequences on the US and other countries, followed by the outlook on major developed and emerging economies.

1. Quantitative Easing (QE)

QE is an unconventional monetary policy where the central bank creates money which it uses to buy government bonds and other financial assets, in order to increase money supply and create excess reserves of the banking system. QE is used to invigorate borrowing, and the stock market, and to perpetuate spending. It can artificially lower the US dollar (USD) and encourage exports. It can effectively ease the process of deleveraging as it lowers yields.

However, QE can lead to risks of: (1) higher inflation than desired if it is improperly used, and too much money being created (asset bubbles and carry trade), (2) failure if banks opt simply to sit on the additional cash in order to increase their capital reserves in a climate of rising defaults in loan portfolios, and (3) in the context of a global economy, lower interest rates possibly contributing to asset bubbles in other economies.

2. US Quantitative Easing

2.1 QE1:

During the peak of the financial crisis in 2008, the Fed expanded its balance sheet dramatically by adding new assets and new liabilities without 'sterilizing' these with corresponding subtractions. The Fed held US$700-US$800bn of Treasury notes on its balance sheet even before the recession. In late November 2008, the Fed started buying US$600bn worth of mortgage-backed securities (MBS). By March 2009, it held US$1.75tr in bank debt, MBS and Treasury notes, and reached a peak of US$2.1tr in June 2010.

2.2 QE2:

Further purchases were halted since the economy had started to improve. Holdings started falling naturally as debt matured (projected at US$1.7tr by 2012). However in August 2010, the Fed decided to renew QE, i.e. QE2, because the economy was not growing as robustly as anticipated. Its goal was to keep holdings at the US$2.054tr level. To maintain that level, the Fed bought US$30bn in 2 to 10-year Treasury notes a month.

In Nov 2010, the Fed announced under QE2, it would be buying US$600bn of

QE is used to invigorate borrowing, and the stock market, and to perpetuate spending

Treasury securities (at a rate of US$75bn every month) by end-2011. The market currently expects QE2 to continue until end-2011 (US$1.2tr).

3. QE2 and its Consequences

3.1 Effect on the US

Monetary inflation is one result of QE2. When the Fed buys US Treasuries, it injects newly created money into the financial system, which in turn reduces the value of the US dollar.

A lower US dollar could stimulate US exports, but with unintended consequences, e.g. excess liquidity that could lead to asset price bubbles in the US.

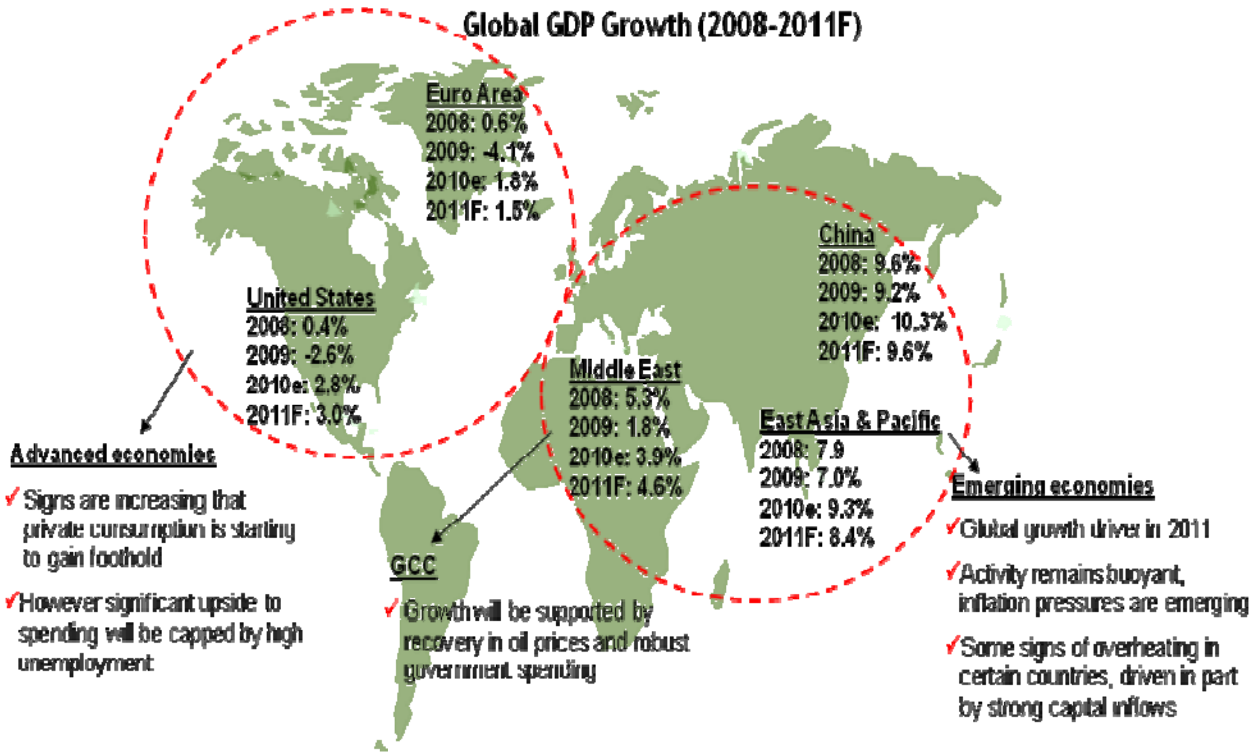
3.2 Effect on other Countries

Low interest rates are fuelling a US dollar carry trade that creates asset price bubbles beyond the US. Nations exporting to the US must control inflation through raising interest rates, but must also debase their currencies to maintain export competitiveness.

QE2 is a doubly destructive policy for exporting nations i.e. capital inflows are inflationary while exports are reduced due to currency appreciation.

Debasing the US dollar reduces the value of China's US Treasury holdings while China relies on exports to the US, totalling between US$200-US$300bn annually.

While it stimulates exports and helps create conditions for renewed economic growth in the US, QE2 represents a debasement of the US dollar and it suggests that demand for US debt may be weakening.



Source: IMF, KFHR

3.3 AAA Rating

Current facts regarding the US economy do not justify the AAA rating of US sovereign debt. In February 2010, Moody's warned that it might have to cut the rating on US government debt. The warning was reiterated in December 2010.

3.4 Deteriorating Confidence

Confidence in US sovereign debt and in the US dollar will continue to deteriorate unless the economy shows stronger growth, and the federal government gets deficit under control (expected at 8.3 per cent of GDP for 2011).

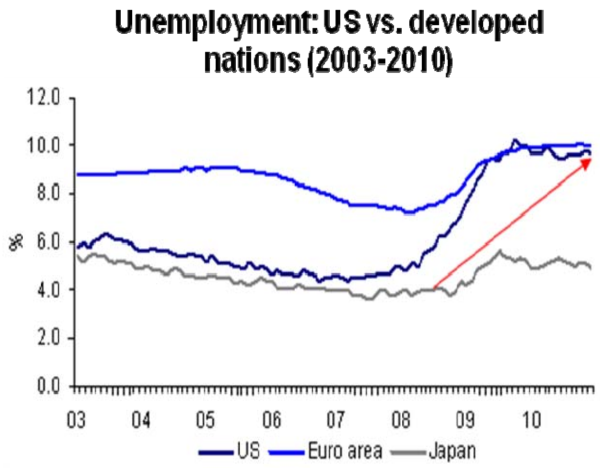
4. Global Economic Outlook 2011

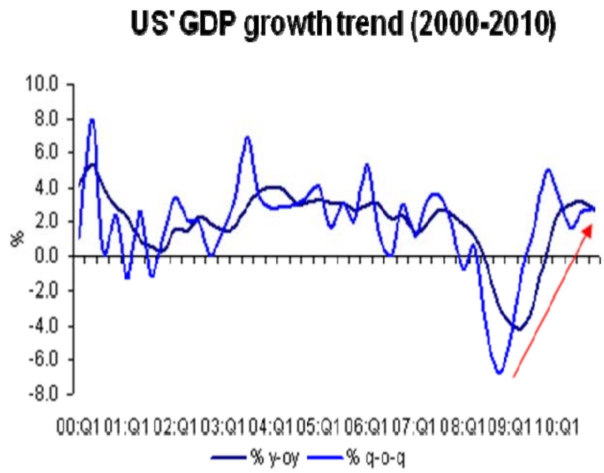
The IMF projects world GDP growth of 4.4 per cent in 2011, up from the earlier forecast of 4.2 per cent, mostly due to QE2 in the US that is expected to boost economic growth by 0.5 per cent to 3.0 per cent.

Emerging economies will drive global growth in 2011, underpinned by strong private consumption and infrastructure spending plans.

5. US Economic Outlook 2011

The US economy expanded by 2.8 per cent in 2010, the most in five years, after shrinking 2.6 per cent in 2009. Household purchases rose 4.1 per cent in 4Q2010 (3Q2010: 2.4 per cent), boosted by various tax cuts, and the renewal of emergency jobless benefits for the unemployed. Consumer confidence increased in February to the highest level in three years, supported by a drop in unemployment, but risks to growth may come from rising oil prices and more cutbacks by state and local governments, given the rising costs of food and fuel.





5.1 Inflation Manageable

US CPI rose slightly by 1.6 per cent in January 2011 (December: 1.5 per cent), as higher prices of food and fuel may have started to filter through to other goods and services. Core CPI stood at 1.0 per cent in January 2011 (December: 0.8 per cent), the most since February 2009. Even with soaring commodity prices, the Fed remains concerned that inflation is below its long-term target of 1.6-2.0 per cent. Spending is capped by high unemployment spending at or above 9.0 per cent since May 2009.

5.2 US Housing Market Struggling

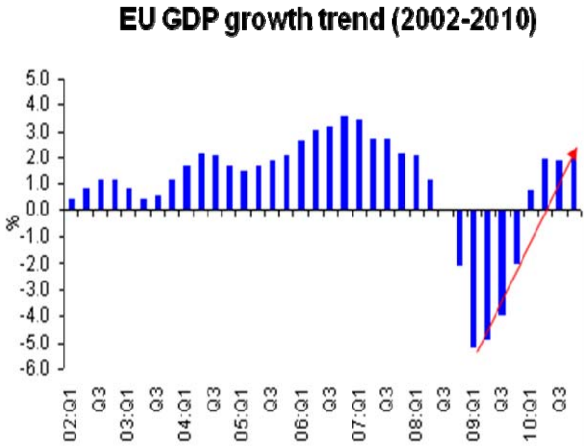
US home values fell 2.4 per cent in December 2010, the biggest decline since December 2009. Mortgage delinquency rate was the highest at 10.1 per cent in 2010, easing to 8.22 per cent by end-2010. Foreclosures are expected to increase as banks resume seizures. The number of homes receiving a foreclosure notice is expected to climb 20 per cent in 2011. This may depress home values further, prompting would-be buyers to hold off on purchases.

5.3 US Fiscal Deficit Topped 10.6 per cent of GDP in FY2010

US fiscal deficit official forecast was US$1.267tr or 8.3 per cent of GDP in FY2011 (FY2010: 10.6 per cent of GDP). The stimulus measures were: extended unemployment benefits and healthcare subsidies for the unemployed, tax and credit incentives for small businesses to invest and to hire workers, extended payroll tax cuts for the middle class, and increased funding for states, infrastructure and transportation. The US plans to reduce fiscal deficit in 2012 and bring it below 4 per cent of GDP by 2014.

6. EU Economic Outlook 2011

Official GDP in the Euro region is projected to increase by 1.6 per cent in 2011, up from an earlier forecast of 1.5 per cent. Services and manufacturing industries in February grew at the fastest pace in more than four years. The unemployment rate fell to 9.9 per cent in January 2011, down from 10 per cent in December 2010. Inflation gathered pace to 2.4 per cent in February 2011, and is expected to average at 2.2 per cent this year, above the European Central Bank's (ECB) ceiling of 2.0 per cent.



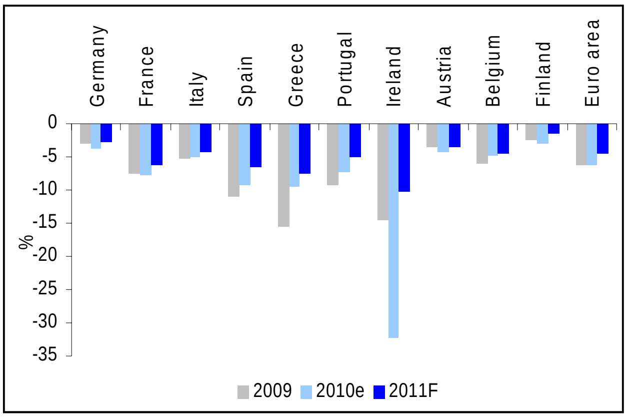
6.1 ECB is Expected to Raise Interest Rates to Counter Rising Inflation

Quickened inflation puts pressure on the ECB to raise rates later in 2011. The ECB has toughened its inflation-fighting rhetoric over the past two weeks, indicating it is moving closer to raising rates from a record low even as Europe grapples with a sovereign debt crisis. The market expects the ECB to make its move in September 2011.

6.2 Sovereign Debt Crisis

Ireland, Greece, Portugal and Spain had the highest fiscal deficits to GDP in 2010. They will see some success in bringing down their deficits in 2011 but the ratings of sovereign debt have been downgraded by as much as seven times for Ireland.

Euro area fiscal deficit per cent GDP (2009-2011F)



Country	Rating prior to 2009 (Moody's/ S&P/ Fitch)	Rating as at Mar 2011 (Moody's/ S&P/ Fitch)	Downgraded by (notches) (Moody's/ S&P/ Fitch)
Ireland	Aaa/AAA/AAA	Baa1/A-/BBB+	7/6/7
Greece	A1/A/A	Ba1/BB+/BB+	6/5/5
Portugal	Aa2/AA-/AA	A1/A-/A+	2/3/2
Spain	Aaa/AAA/AAA	Aa1/AA/AA+	1/2/4

7. Emerging Economies Registered Strong Growth Rates

Global economic growth will be driven by emerging economies this year, namely Asia Pacific (8.4 per cent) and Gulf Cooperation Council (GCC) countries (4.6 per cent). The growth drivers are high commodity prices, strong private consumption and huge infrastructure spending plans. The 2011 GDP growth projections are: China at 9.6 per cent in 2011 (2010: 10.3 per cent), India at 8.4 per cent (2010: 9.7 per cent), SEA at 5.5 per cent, Brazil at 4.5 per cent. However, the risks are political unrest in the Middle East and North Africa (MENA) region and rising inflationary pressures.

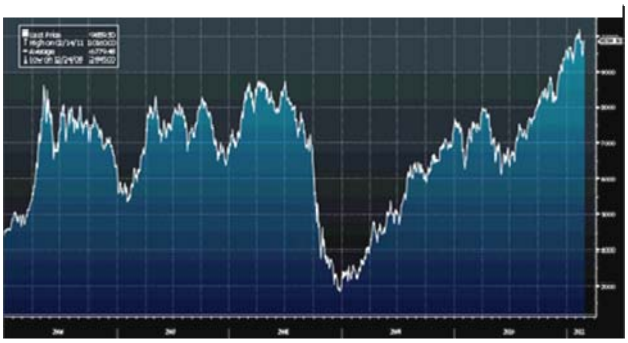
7.1. Recovery in Commodity Prices

Countries that are resource-rich will benefit from rising commodity prices. The price of crude oil surged to a 29-month high at US$99.63 per barrel amidst political unrest in the MENA region, gaining 10.9 per cent YTD (year to date). Commodity prices surged as investors turned to safe-haven investments. Gold prices gained 2.04 per cent YTD at US$1,433.28/ounce, aluminium rose 6.4 per cent YTD, platinum surged 76.7 per cent YTD.

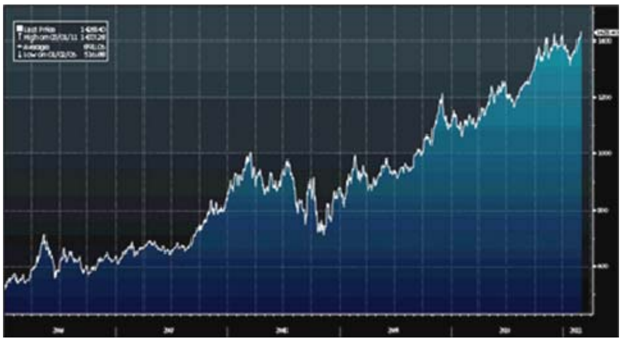
7.2. Divergent Inflationary Trends

Inflation is accelerating at a six per cent pace in emerging economies vs. two per cent in developed nations.

Copper price (2006-2 Mar 2011)



Gold price (2006-2 Mar 2011)

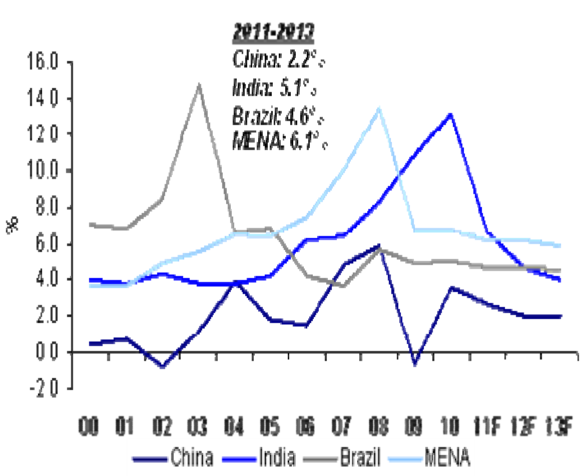


Crude oil price (2006-2 Mar 2011)

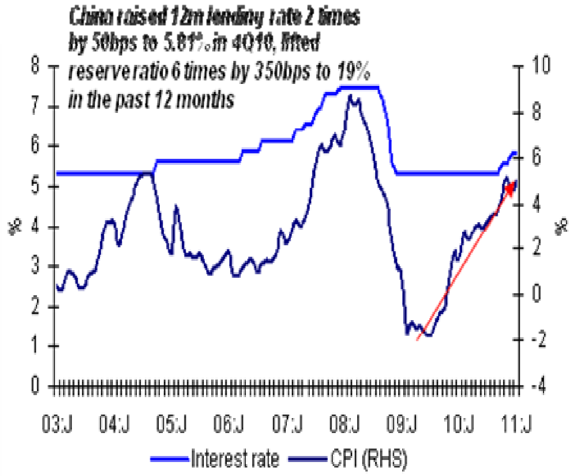
7.3 Central Banks Raise Rates to Fight Inflation

Australia was the first country in Asia Pacific to raise its interest rates four times since December 2009, going from 3.0 per cent to 4.75 per cent. China raised the 12 month lending rate two times by 50bps to 5.81 per cent in 4Q2010, and lifted reserve ratios six times by 350bps to 19 per cent in the past 12 months. India raised the reverse repo rate six times, by 225bps, to 5.5 per cent in the past 12 months. These countries have seen strong capital inflows into their stock markets. Malaysia raised the overnight policy rate (OPR) three times since February 2010, by 75bps, to 2.75 per cent.

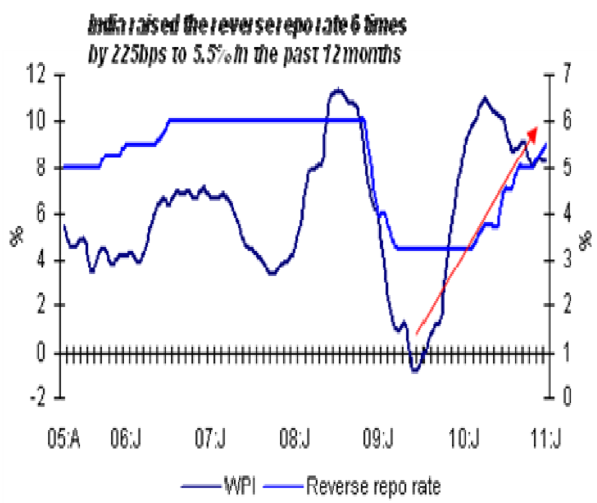
Emerging economies inflation (2000-2013F)



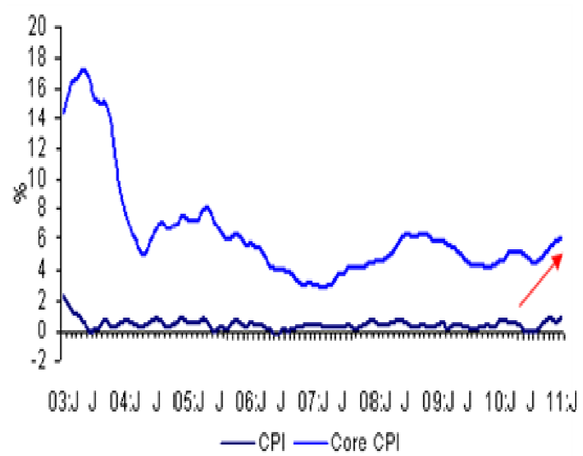
China CPI vs. interest rates (2003-2011)



India WPI vs. interest rates (2005-2011)



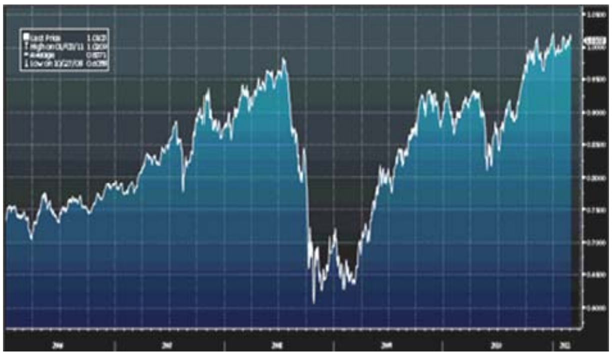
Brazil inflation trends (2003-2010)



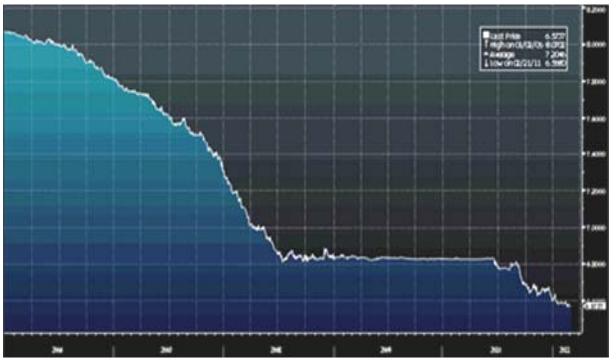
7.4 *Currency Appreciation for Asia Pacific and Emerging and Economies*

China's yuan has strengthened 4.23 per cent, since mid-2008, to 6.5750/US$. The Australian dollar has reached parity vs. the US dollar. South Africa's rand appreciated by 44 per cent vs. the US dollar in the past two years. The ringgit appreciated by 10.4 per cent to 3.0350/ US$ in the past 12 months. South Africa and Indonesia have shown that stronger currencies can quell rising prices. Russia favours a 'very flexible' exchange rate.

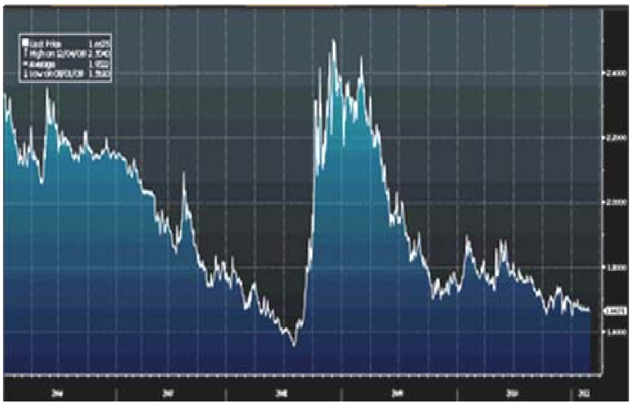
Australia's AUD/USD (2006-2 Mar 2011)



China's yuan/USD (2006-2 Mar 2011)



Brazil's real/USD (2006-2 Mar 2011)



8. Conclusion

Despite the aggressive fiscal stimuli provided by central banks around the world since the beginning of 2009, private expenditure has not picked up, and economic recovery remains fragile and uneven. While bond yields and mortgage rates are at record lows, credit growth in the US remains very subdued.

We think the further lowering of interest rates (via QE2) would do little to stimulate demand due to the still high unemployment rate and the weak housing market in the US. Consumers continue to deleverage by paying down debt. While QE2 improved sentiments temporarily, it is unlikely to pull the US economy out of its current lacklustre economic cycle.

On the contrary, QE has caused its own share of side effects which include:

- Further establishing the US dollar as a funding currency for carry trades;
- The rallying of global markets, as lower bond yields make equities and other risky assets relatively attractive; and
- A decline in US dollar, forcing emerging economies' policymakers to intervene in the forex markets

Emerging economies are forced to trace the Fed's decision of monetary easing to prevent unwanted currency appreciation i.e. an 'international currency war' with emerging economies trying to avoid the appreciation of their currencies in order to support the growth of exports in a challenging global economic environment. The search for yield, growth and inflation protection is likely to continue.

Mr Steven Wong, Senior Director of ISIS Malaysia, gave his views on five areas of macro-policy concerns – output, inflation, unemployment, fiscal balance and public debt in G-20 countries as well as in Malaysia.

- Output growth is trending in a tight band, and one that appears to be a little too low for comfort. At these levels, the buffer is not very thick and there are risks that even moderately strong political and financial shocks can send economies spiralling into recession.

  Inflation forecasts are more dispersed and generally of a higher order of magnitude. This would seem to suggest an upward bias i.e. the risk of prices taking flight, especially if driven by even more cheap US money and substantial food and energy increases.

- Unemployment is also of concern. Of the three macro indicators, this seems to be the most stubborn and the hardest to dislodge, indicating that countries will have to contend with the politics of high potential unemployment into the medium-term (i.e. cheap money, labour protection, etc.).

- On fiscal policy, however, there seems to be greater scope. Not all countries have been reckless in the past three years and most can accommodate some increase should the need arise. The pervasive mindsets about financial markets over fiscal spending, however, will need to be broken.

- On gross public sector debt, the wiggle room is less, given that notional safe debt ceilings are lower (40-60 per cent). Major Western economies have already racked up very significant debts and may be close to 'maxing out' their credit. East Asian economies (except Japan), however, still have some room for manoeuvre.

Broad Macroeconomic Indicators for Twenty Three Countries in 2012

OUTPUT (% change)				
< 2%	2%~<4.0%	4.0%~<6.0%	6.0% ~+<7.0%	7.0%>
FR, IT	AR, AU, CA, DE, GB, JP, TR, US, ZA	BR, KR, MX, **MY**, SA, SG, TH, PH, RU	ID, IN	CN
INFLATION (% change)				
< 0%	0%~-<2.0%	2%~+<4.0%	4.0%~<6.0%	6.0%>
JP	DE, FR, GB, IT, US	AU, CA, CN, KR, MX, **MY**, SG, TH	BR, ID, IN, PH, ZA	AR, RU, SA,TR
UNEMPLOYMENT (% labour force)				
10.0%>	7.5%~<10%	5.0%~<7.5%	2.5%~<5.0%	<2.5%
SA, ZA, TR	AR, BR, FR, ID, IT, US	AU, CA, DE, GB, IN, PH, RU	CN, JP, KR, MX, **MY**	SG, TH
FISCAL BALANCE (% GDP)				
-10%>	-10.0%~<-5.0%	5.0%~<2.5%	-2.5%~+<0%	+0%>
	FR, GB, IN, JP, **MY**, US	AR, AU, BR, CA ID, KR, PH, RU, SG, TH, TR, ZA	CN, DE, IT, MX	SA
PUBLIC DEBT (% GDP)*				
0%~25%	25%~50%	50%~75%	75%~100%	100%>
AU, CN, RU, SA	AR, KR, ID, MX, PH TH, TR, ZA	BR, DE, IN, **MY**	CA, FR, GB, SG	US, IT, JP