# Another name for Hot Money –QE?

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In November 2010, the U.S. Federal Reserve unleashed a second round of a type of monetary stimulus known as quantitative easing (QE). The Federal Reserve (central bank) declared that it would buy $600 billion in long-term Treasury bonds in an attempt to push down long-term interest rates. Immediately after the move, the rest of the world accused the United States of deliberately attempting to depreciate the dollar and flood the world markets with hot money and footloose capital.

Arguably many emerging-market countries have been accused of using a mix of similar interventions and capital controls to keep their own currencies from appreciating. There are only winners and losers in an interventionist approach: in order for one country's currency to depreciate, another country’s currency must appreciate.

According to former IMF Economist, Raghuram Rajan, and the author of “Fault Lines: How Hidden Fractures Still Threaten the World Economy”. Most countries through currency manipulation; are nurturing domestic economic policy strategies that have allowed them to thrive in the past. For developed countries such as the United States, this has meant an emphasis on consumption; strategies in East Asia and other emerging markets, on the other hand, have emphasized exports.

In conjunction, these strategies have precipitated significant trade imbalances globally. In the long run, prolonged trade imbalances usually lead to financial and political instability, a recipe for disaster in other words. Should the domestic policy strategy of the concerned nations remain unchanged, these imbalances will likely exacerbate and threaten Global economic stability.

When a central bank cuts interest rates, the country's currency weakens as capital leaves for greener pastures (better returns). Nevertheless, lower interest rates also increases domestic demand, as households and firms spend more. In a nutshell, what monetary easing does is it creates overall demand.

By allowing its currency to remain undervalued, a nation can enlarge its market share and production by essentially usurping demand from other states. The circumstances under which the Federal Reserve embarked on the second round of quantitative easing made the move suspect. With short-term U.S. interest rates already near zero, and with large firms able to borrow at very low rates. It is alleged QE would make dollar bonds unattractive, because long-term bond yields would diminish when taking into account of higher inflation. In the long run, capital would flee the United States, lower the value of the dollar, and expand U.S. exports at the expense of other nations.

Initially, as expected after the Feds announced of their QE moves, U.S. long-term interest rates dropped and the dollar weakened. Ironically though, worries about government debt in the eurozone economies soon led the dollar to rebound!

Prior to the Recession in 2008, consumer credit, especially for housing, was greatly enhanced. Some of this inducement was political; politicians, both from Democrats and Republicans looked to homeownership to placate the masses whose incomes had not grown as much as promised. Thanks to successive deregulation since the 80s, a financial sector left to its own devices and running out of control also found incentive to loan more. Financed mainly with debt, U.S. consumption increased from about 67 percent of GDP in the late 1990s to about 70 percent by 2007.

Did we Malaysians take the cue too? Our household debt grew almost three-fold between 2001 and 2009 to about RM520 billion in 2009. In fact household loans grew from a low 16% of banking sector loans in 1998 to 55% currently. It is evident that during the last decade, Malaysian household debt has been on the rise as consumers continue to borrow more to spend more. In tandem, the average borrowing rate fell from about 11% per annum in 2000 to a meager 4% p.a. in 2009/2010 (a drop of about 700 basis points over a decade). The household sector's financial assets to household sector debt ratio of 238% at the end of 2010 reflects this. Similar to other emerging economies, households in Malaysia typically borrow to purchase residential properties and transportation vehicles. On March 8, 2011 Prime Minister Datuk Seri Najib Razak officially launched My First Home Scheme. However, it must be emphasized here that the scheme is not the same as "the Ownership Society' launched by the then US President George W Bush in 2004. The folly of the American scheme was that it actually emphasized on asset appreciation coupled with "innovative" financial derivatives without actually looking into its long-term sustainability!

It is hoped that our home ownership is based on a growing real economy and not that built on a credit-fuelled bubble. For it is clear that a person purchasing a house must be able to pay the monthly installments diligently in the long run and this translates into employment with income not stagnating. Thus far our Central Bank seems to have taken this into consideration, when introducing the tighter 70% loan-to-value (LTV) ratio requirement for property purchases as a measure to prevent speculative home-buying tendencies. However this move is limited to the purchase of the third property and will have a limited impact on controlling household debt. Perhaps more direct measures involving taxes and prudent restrictions are more effective means to curb property speculation.

What is of concern though is reigning in rising inflation. Our Consumer Price Index (CPI) rose to 2.9% on a year-to-year basis in February from 2.4% in January. It must be noted that the inflation rate was 1.7% in 2010 and this was attributed to the economy recovering from the global financial crisis of 2008/2009. Bank Negara in its 2010 Annual Report forecasts a higher inflation rate of between 2.5% and 3.5% for this year. Retrospectively Malaysia's inflation rate hovers around 2.9 %, which is pretty low and episodes of high inflation rate usually went in tandem with episodes of high oil prices. For example, domestic retail fuel prices rose by 7.9% in 1981 while inflation rose to 9.7%, similarly in June 2008 when domestic retail fuel prices rose by 40 %, inflation rose to a 10 year high of 8.8%. This time around though creeping inflation results from increase fuel and food prices. It is inflation that is the villain that could derail us from achieving a high-income nation status by 2020 for we need to grow at an annual real growth rate of about 6% for the remainder of the decade.

The pundits in Washington DC though, they wish to shift growth in spending from industrial countries to emerging markets, simply because developed countries, are saddled by high levels of household and government debt. They are hoping that emerging markets will shoulder the "burden" of expanding global consumption and investment.

What is clear though, consumption in poorer countries, such as Brazil, China, and India, as well as in Africa and the Middle East, is actually lower than average consumption levels in richer nations and so are their average physical capital and infrastructure –houses, roads, ports etc. There is an opportunity for growth here, and so when the powers that be try to shift consumption abroad, Malaysians could jump in the bandwagon by supplying the intended incipient nations with our bag of goodies by meeting their demand with our supply!

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