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The timing of the tapering of QE by the Fed and its implications on the markets and economies of Asia, China and HK

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In June, Ben Bernanke announced that the Fed would taper its bond-buying QE program soon, which led to a more than 4% drop in the DJIA. In September, the Fed announced that it would not taper after all. The market breathed a sigh of release.

Originally, the market expected tapering to occur in September. But the failure of this to realize stimulated the US stock market to scale historical high again.

In view of the wrangling over the debt ceiling in Washington DC, and not-so-favorable unemployment figures, it is likely that the tapering will be delayed till December or even next year.

The nomination and expected eventual appointment of Janet Yellen to the chair of the Fed further lead us to believe that the tapering will be delayed, as Yellen is a Keynesian and a liberal. She is concerned about unemployment, about poor people being disproportionately hurt by the Great Recession, and less about inflation.

The time table is probably that tapering will occur after the January resolution of the federal debt ceiling fight. Then, the increase of the federal funds rate (FFR) will not occur until 2015.

A delay in tapering means that interest rates will continue to be low in the US as well as in Asia, e.g. HK and Singapore. This means that asset markets will continue to be active in Asia, e.g. in HK. Because of HK government's measures to cool down the property market, the stock market will be favored by investors. Moreover, the soft landing in Chinese economy helps investor's confidence in HK too. So, I expect HK stock market will continue to do OK or well until the end of this year.

When tapering begins early next year, the US and HK stock market will show some slowing down or even short term decline. But there is no reason to believe that the US or HK stock market will do badly in 2014. US bond rates will begin to increase in 2014 when the tapering begins. This will lead to capital being attracted to the US from Asia, which can have some cooling effect on the stock markets of Asia such as HK.

When the Fed begin to increase the federal funds rate (interbank overnight lending rate) by the end of 2014 or early 2015, HK lending rate will also increase. This will have a chilling effect on the property market of HK. So, that will be the time to buy property in HK.

What is QE? It is the purchasing by the Fed of government long-term bonds and long term bonds issued by government-sponsored agencies such as Fannie Mae and Freddie Mac (these are mortgage-backed securities). The effect is to lower a broad range of long term interest rates, in particular the mortgage rates, thus supporting the mortgage market and the recovery of economy as a whole.

There have been three rounds of QE. As of today, the monthly purchase is USD 85 billion. Tapering means gradually reduction of this amount, with eventual stop at some point down the road.

Why do we need QE? Because the Fed can lower the federal funds rate lower than zero. The FFR is a short term interest rate. QE can help to lower long term interest rates, which include the mortgage rates.

In fact, both quantitative easing and non-quantitative easing (influencing the FFR) are bond-buying in nature. The Fed does not actually set the FFR by administrative order. It influences the inter-bank overnight lending rate by buying or selling short term US government bonds in the open market. For example, by buying short term US government bonds, the Fed injects money into the economy, which also lowers the inter-bank overnight lending rate in the market.

In fact, for the economies of HK and China, faster tapering may be good. For example, it leads to an economic environment with higher interest rates and therefore helps to curb property bubbles in HK. Higher US interest rate would lead to the appreciation of the USD as well as the HKD versus other currencies such as RMB, Japanese yen and euro. This can lower inflation rate in HK. An appreciation of the USD versus the RMB means that China can afford to tighten its money supply without causing an appreciation of the RMB versus the USD. This can help to curb inflation and property bubble in China.

In general the US government shutdown and the wrangling over the government debt limit will not significantly affect the US economy and financial market, as it is expected to be resolved in favor of the White House in this case. No political party can afford to bear the responsibility of causing the US government to default on paying its debts. That would have tremendous implications on the reputation of the USA and American financial institutions as a whole.