Asia Flash

QE3: A positive for Asian capital inflows and asset values

We believe the net impact of the new QE3 program announced by the Fed should have a positive impact in Asia on currencies, equities, and growth. With growth slowing in most Asian economies, QE3 comes at a welcome time. Resulting capital inflows should facilitate a pickup in investment and help to reduce downside risks to the outlook.

The US Federal Reserve Bank announced new quantitative easing measures yesterday as part of its ongoing efforts to stimulate a flagging US economy (see our US team's *Fed Watch*). The key element is a commitment by the Fed to purchase US$40bn of mortgage backed securities (MBS) per month until it sees evidence of a sustained improvement in the US jobs market. Unlike its predecessors, the latest round of quantitative easing (QE3) is open-ended, although the monthly purchase amounts are smaller[1]. The Fed also announced yesterday an extension of its outlook for the current low interest rate environment by six months, "at least through mid-2015," and noted that it could expand the new program depending on economic conditions. The open-ended nature of the Fed's MBS program was not fully anticipated by the markets, and Asian equities and currencies rallied strongly today.

This latest round of QE can be expected to have positive spillover effects on relatively high-yielding, high-growth emerging market economies such as those in Asia[2]. As described below, we believe these spillovers will have a beneficial net impact in Asia on currencies, asset prices, and growth. As such, some of the downside risks we have been flagging to Asia's growth outlook (see our *Asia Outlook*) should be alleviated.

Based on past experience, it is possible that some of the region's policymakers may fear that QE3 could have a destabilizing effect on financial markets by generating asset price bubbles. While this may occur, overall we believe the economic impact should be positive. First, unlike QE2, which occurred during a period of economic overheating in Asia, QE3 comes at a time when growth is weakening and asset prices have softened; as such, capital inflows should facilitate an increase in investment and domestic demand, in line with government stimulus measures. Second, capital inflows will help drive asset price values higher—property and equities in particular—which will result in positive secondary effects on Asian economies. Some of the positive effects on economic activity, however, could be offset by the depressing effect of currency appreciation on exports. Even here, however, to the extent that QE3 boosts US and global growth, exports from Asia should benefit.

Critics of QE3 might also point out that a liquidity-driven rise in commodity prices could be inflationary. In the case of India, higher commodity prices could also put strains on the current account deficit, and for large commodity consumers/importers such as China and Japan, it could have a depressing effect on economic activity. That said, inflationary pressures are subdued for the most part in Asia, and the net effect on economic activity, as noted above, should be positive.

In terms of market impact, QE3 should be felt most significantly in the economies most susceptible to capital inflows, including Korea and Indonesia. Open economies such as Singapore and Japan would also feel the effect, and Australia would benefit from higher commodity prices.

While QE3 is likely to boost regional currencies, there is a chance that the current rally could lose steam. Foreign investors may wait for a clear turnaround in growth momentum, in particular in China and India, before deciding on additional capital flows to the region. Also, if the rally in currencies persists then it is likely that some authorities may intervene to prevent excessive appreciation. These factors might limit the scope of appreciation in the near term.

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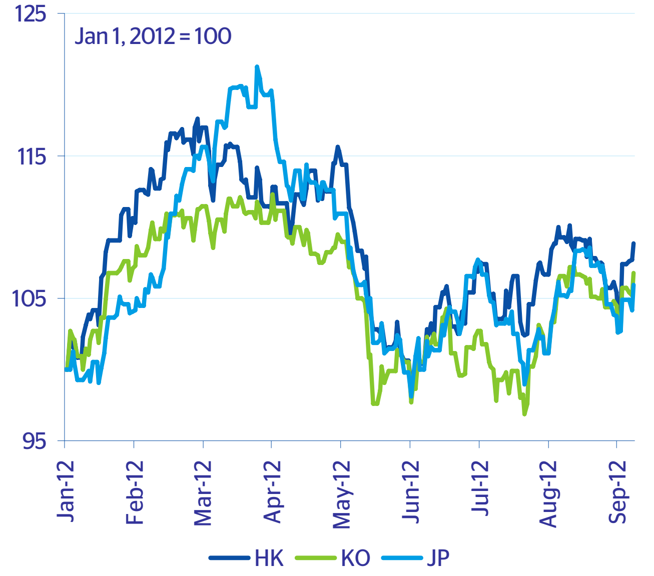
[1] QE1, launched in November 2008 included a combined US$1.55 trillion of purchases of MBS and US Treasuries through March 2010; QE2, launched in November 2010 entailed Fed purchases of US$600bn in US treasuries through June 2011.

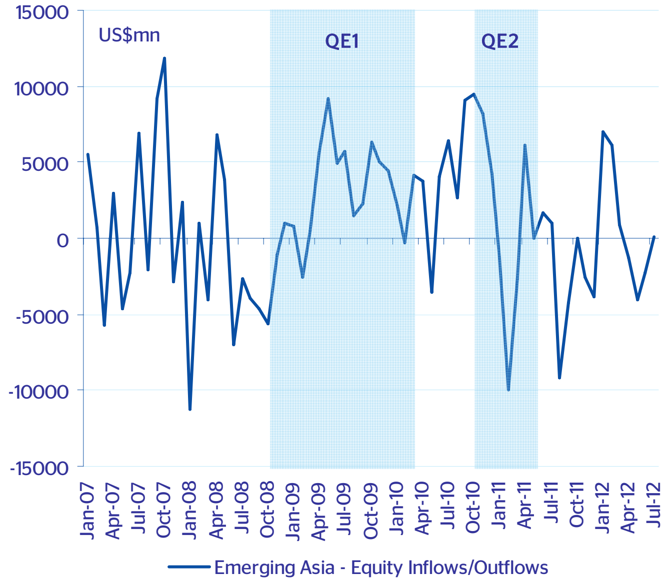
[2] Academic studies reveal that previous QE programs resulted in significant effects on emerging markets. See, for example, *Impact of US Quantitative Easing Policy on Emerging Asia* by Peter J. Morgan, November 2011, ADBI Working Paper Series; and *International Spillovers of Central Bank Balance Sheet Policies*, Qianying Chen, Andrew Filardo, Dong He and Feng Zhui, Hong Kong Monetary Authority and Bank for International Settlements, November 2011.

Chart 1
Regional equity markets are rallying



Source: Bloomberg and BBVA Research

Chart 2
Previous rounds of quantitative easing have facilitated capital inflows to Asia



Source: EPFR and BBVA Research

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