Market Analysis, Research & Education
A unit of Fidelity Management & Research Company

Fed Policy: Controversy Goes Global

By Dirk Hofschire, CFA®

Much of the controversy surrounding the Federal Reserve's (Fed) recent announcement to purchase $600 billion in bonds in a new round of "quantitative easing" has centered on domestic critiques about whether the action will be effective in boosting the U.S. economy, will prove inflationary down the road or is even necessary during a domestic economic expansion. However, unusual public criticism of the Fed by many finance ministers and central bankers at the recent G-20 meeting has underscored that the policies also are having a significant impact abroad.[i]

Assessing the global impact of QE2

The Fed has remained steadfast that the intentions of its unconventional quantitative easing program are to help maximize employment and price stability in the United States. However, even if the global effects of its policy are unintentional, they have clearly already had an impact on financial markets and economies around the world. In particular:

1. The Fed's prospective "printing" of additional U.S. dollars has pushed the exchange-rate value of the dollar down versus most other currencies during the past two months. The effect has heightened the pressure on developing economies with relatively flexible exchange-rate regimes, which have been flooded with additional capital flows as investors flock to countries with strong growth and strengthening currencies. For instance, South Africa, Mexico, South Korea, Turkey, Taiwan and India all have seen their currency values rise 5% or more since the end of August. Even relatively weak developed economies, such as Japan, also have seen their currencies strengthen, with the yen near an all-time high versus the U.S. dollar.[ii] Because rising currency values can reduce the cost-competitiveness of a nation's exports, many countries view the continued upward pressure unfavorably.

2. The Fed's planned expansion of liquidity, while perhaps aimed at U.S. financial markets, probably has placed upward pressure on foreign asset prices as well. Money flows transcend national boundaries easily in search of returns, and investors have continued to flock to the stock, bond and real estate markets of emerging economies. For example, investor flows into emerging-market equity funds reached an all-time high of $4.2 billion in September, while many country stock indexes from Turkey to Mexico also have reached record levels.[iii] While this can be a positive development for national economies, it potentially can lead to asset bubbles or other distortions if prices rise too quickly or in too great a magnitude.

3. The boost in global liquidity fed into the commodity markets, which has stoked a sharp increase in the prices of many global commodities. For example, sugar prices are up 38% since the end of August, while corn (22%), copper (16%) and crude oil (15%) also have spiked upward. Because global commodities generally are traded in U.S. dollars, their prices also may receive a natural boost from a falling dollar.[iv] In addition, they also can benefit from the perceived strength

KEY TAKEAWAYS

- The Federal Reserve's unconventional monetary policies have placed upward pressure on global commodity prices, foreign currencies and asset prices, and have increased the near-term policy challenges faced by many developing economies.
- While a boost in global asset prices or the purchasing power of emerging-market currencies may have some beneficial impact on the global economy, the prospect of rising consumer inflation and offsetting monetary tightening measures may have a dampening effect.
- For investors, the Fed's liquidity creation may provide support for riskier asset categories, but it has not eliminated the many other uncertainties that will continue to impact the global financial markets.

in emerging-market demand, as the world's incremental demand growth for raw materials has been coming from developing economies.

Potential risks to the effectiveness of QE2

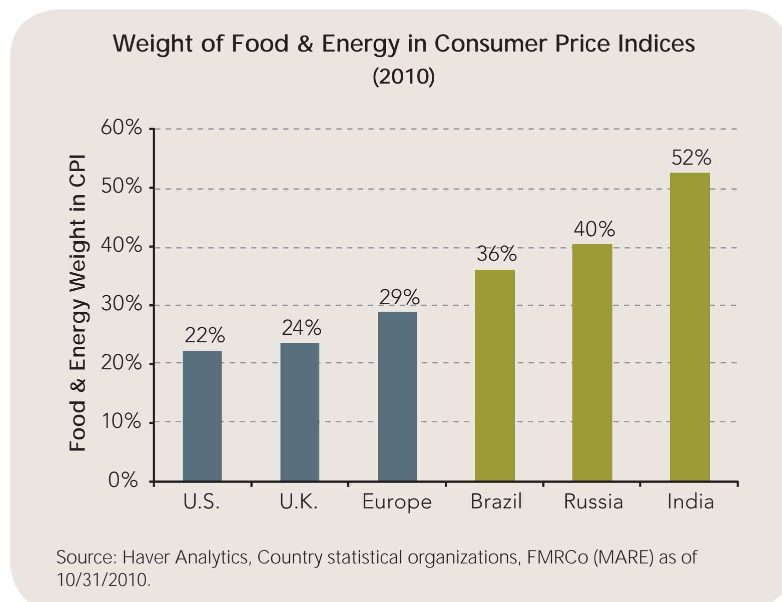
While the Fed's new policies did not single-handedly create all these conditions, the U.S. dollar liquidity resulting from the anticipated quantitative easing has deepened existing trends and created more urgency for foreign policymakers. As a result, a number of developments pose risks to the potential effectiveness of the Fed's stimulative efforts:

1. The broad-based rise in commodity prices threatens to push up consumer prices, particularly food and energy, thus taking a bite out of real incomes and consumer budgets for discretionary spending. This would potentially have a negative impact on U.S. consumption, where wage growth has remained sluggish. However, it also could have a major impact on poorer emerging economies where incomes are growing faster but food and basic necessities tend to make up a larger portion of the consumer budget. For instance, food and energy expenditures make up more than half of India's consumer price index (CPI), compared to roughly one-fifth of the U.S. CPI (see Exhibit 1, below).

2. Rising inflationary pressures due to excess liquidity and increasing commodity prices have the potential to spur a round of monetary tightening on the part of developing economies, which may partially offset the Fed's looser policies. For example, India and China both have raised interest rates over the past several weeks, at least in part due to commodity-based headline inflation rates that have been higher than expected. China and India have consistently maintained policy interest rates at low levels relative to their high-speed economies in recent years, and the latest burst of liquidity and commodity-price pressure may induce them to do more monetary tightening (see Exhibit 2, page 3). Other economies, including South Korea and commodity-exporting Australia, are in a similar boat and have recently hiked interest rates to cool inflationary pressures. However, many emerging countries have resisted pressure to tighten monetary policies, as higher rates often attract greater capital flows from foreign bond investors, and thus potentially can cause an additional (undesirable) appreciation in the currency.

3. Many developing economies are taking steps to intervene in their currency markets or apply capital controls on foreign investor flows, leading to the potential for global tensions and protectionist sentiment to rise as policies become more competitive. Many of these actions, by countries such as Brazil or South Korea, are designed to slow the flow of speculative capital to mitigate excessive exchange rate volatility, which many economists, including some at the International Monetary Fund, endorse as a legitimate near-term response. However, though a broader trade war does not appear anywhere close to imminent, the lack of concrete agreement at the recent G-20 summit in South Korea underscored that common ground for controlling volatility by collaborating on global economic policies remains limited.

EXHIBIT 1: Commodity inflation is particularly important to consumers in many developing countries because food and energy are sizable portions of overall consumer spending.



Source: Haver Analytics, Country statistical organizations, FMRCo (MARE) as of 10/31/2010.

Investment implications

The anticipation of the Fed's quantitative easing program has perhaps already succeeded in advancing two of its key intended objectives, to boost asset prices and raise inflation expectations. Its implementation should provide a steady new flow of liquidity that may continue to be supportive for the prices of riskier assets. However, the Fed's campaign is no free lunch for investors. Its impact is far-reaching and its ultimate success will be dependent on a whole host of economic entities and markets that are largely beyond the Fed's control. U.S. monetary policy is likely

EXHIBIT 2:

China and India have maintained policy interest rates at low levels relative to their high-speed economies in recent years.

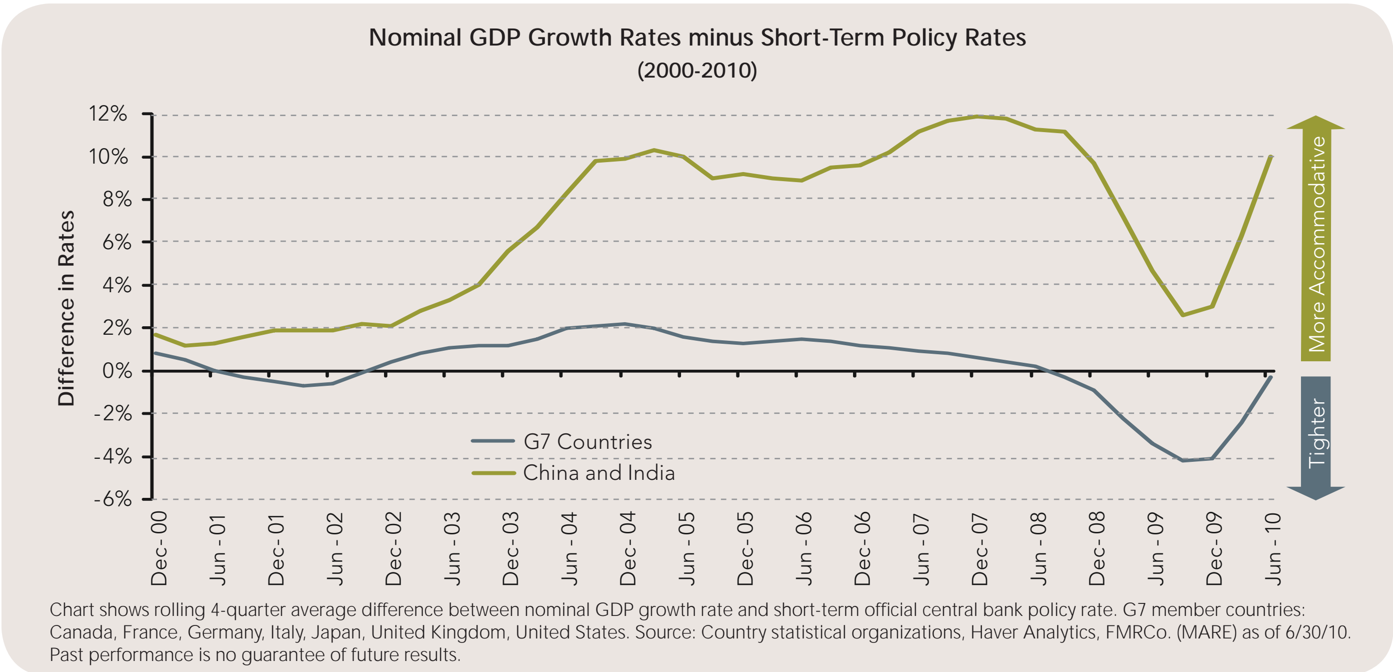


Chart shows rolling 4-quarter average difference between nominal GDP growth rate and short-term official central bank policy rate. G7 member countries: Canada, France, Germany, Italy, Japan, United Kingdom, United States. Source: Country statistical organizations, Haver Analytics, FMRCo. (MARE) as of 6/30/10. Past performance is no guarantee of future results.

to remain a key factor affecting sentiment in the financial markets, but the prospective unintentional global effects—monetary tightening, increasing tensions over exchange rate policies abroad, and rising global commodity prices—also will play a significant role.

Global trade imbalances and the accompanying sources of international economic policy tension existed long before the Fed signaled its latest round of quantitative easing (see MARE article, *The Roots of Rising Currency Tensions*). Despite the near-term strains, the broad direction of the global economy—where faster-growing emerging economies attract capital flows and experience currency appreciation—is part of the long-term rebalancing needed to shift the engine of global growth from developed-country consumers to those in developing nations. The Fed's policy has perhaps accelerated the process, and as a result may have introduced more volatility into the global environment. ■

The **Market Analysis, Research and Education** (MARE) group, a unit of Fidelity Management & Research Co. (FMRCo.), provides timely analysis on developments in the financial markets.

Past performance is no guarantee of future results.

Investment decisions should be based on an individual's own goals, time horizon, and tolerance for risk.

Foreign securities are subject to interest-rate, currency-exchange-rate, economic, and political risks , all of which are magnified in emerging markets.

[i] G-20: A group of finance ministers and central bank governors representing 19 countries and the European Union that meets regularly throughout the calendar year to discuss key issues in the global economy. The member countries are Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Mexico, Russia, Saudi Arabia, South Africa, South Korea, Turkey, United Kingdom, and the United States of America.
[ii] The South African Rand, Mexican Peso, South Korean Won, Turkish New Lira, Taiwanese Dollar, and Indian Rupee all appreciated 7%, 6%, 6%, 6%, 6%, and 5%, respectively, against the U.S. dollar. The Japanese Yen has appreciated 2% versus the U.S. dollar. Source: FactSet, FMRCo. (MARE) as of 11/12/10.
[iii] Source: Investment Company Institute, Haver Analytics, FactSet, FMRCo. (MARE) as of 9/30/10.
[iv] S&P GSCI Commodity Sub-Indices (Sugar, Corn, Copper, and Oil). Source: FactSet, FMRCo. (MARE) as of 11/12/10.

Brokerage products and services and workplace savings plan products and services offered directly to investors and plan sponsors provided by Fidelity Brokerage Services, Member NYSE, SIPC, 900 Salem Street, Smithfield, RI 02918.

Investment and workplace savings plan products and services distributed through investment professionals provided by Fidelity Investments Institutional Services Company, Inc., 100 Salem Street, Smithfield, RI 02917. #567159.1.0

Fidelity INVESTMENTS