VAKIFBANK GLOBAL ECONOMY WEEKLY

The global implications of QE2

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Consequences of FED's second round in Quantitative Easing

- FED is expected to move ahead on Quantitative Easing policy (QE2) in its November meeting due to the downward surprises in inflation accompanied by slowing growth activity.

- QE2 phase is different from the first stage of FED's Quantitative Easing (QE1).

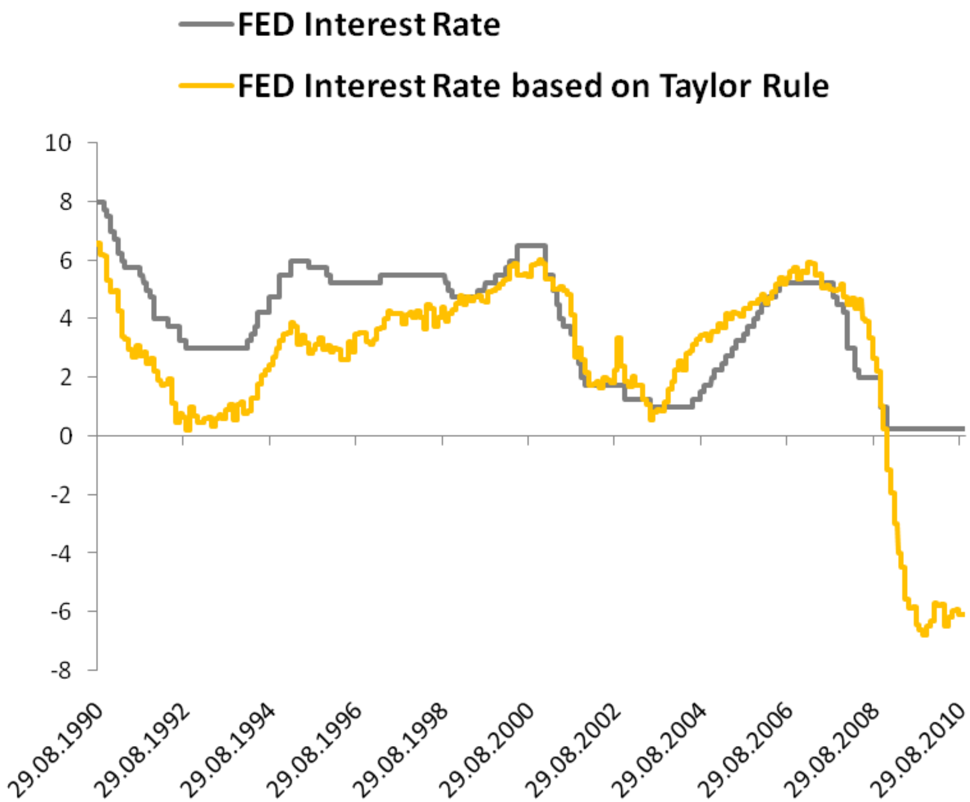
- The main difference between the two phases is the state of the financial markets and the disturbances in the global economy.

- QE1 became effective right after the turmoil which was triggered by the bankruptcy of Lehman Brothers in October 2008. It was an immediate and effective tool to soothe the increasing tension in the market.

- This time QE2 is expected to be effective on overcoming the deflationary effects in the US economy. While the US policy makers are concentrated on its desirable effects in the current state of the economy, it will surely have some side effects after a certain recovery is achieved. It will also have consequences on global economy.

- This study analysis the potential effects of QE2 on the US economy and the EMs.

FED needs to take another step further in unconventional monetary easing



Source: Bloomberg

Taylor Rule indicates that, FED policy rate which is in 0-0.25% band since December 2008, should be at negative levels. Since FED's concern on growth has increased for a couple of months, the Taylor Rule estimate putting more weight on output gap implies a policy interest rate of -6%. Hence, further monetary stimulus seems to be necessary to improve the economic performance in the US.

QE2 expectations have caused downward pressure on interest rates and supported equity markets

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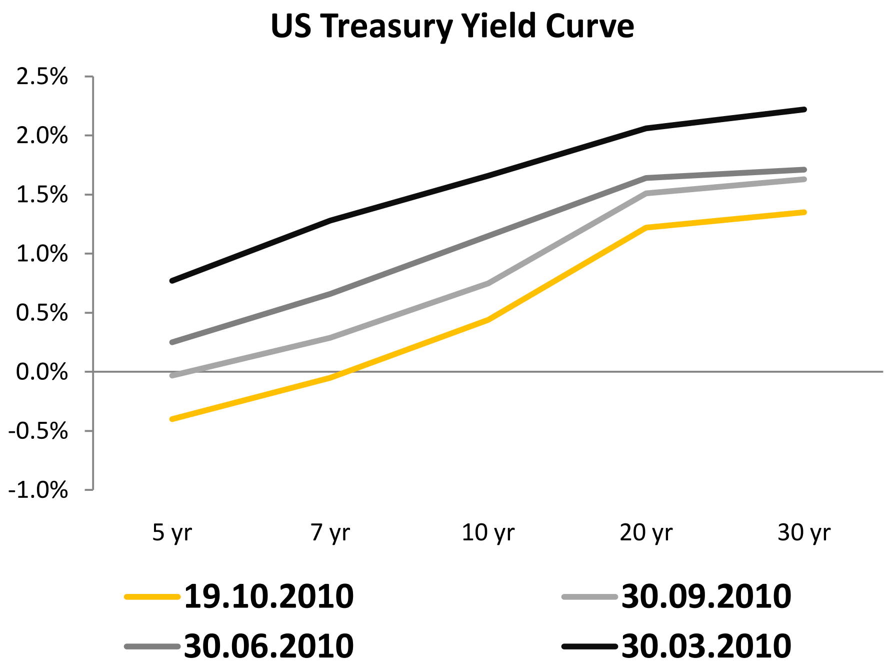
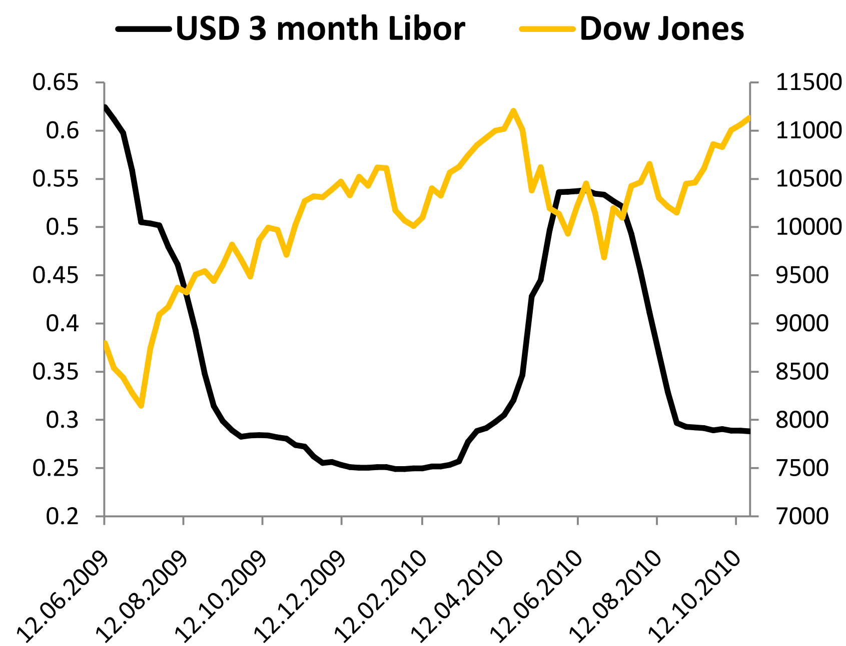


Source: US Treasury



Source: Bloomberg

As a result of the QE2 expectations, US Treasury yield curve has shifted downwards and US Libor rates have been under downward pressure. High liquidity and low interest rate expectations also support the upward trend in equity markets.

The Impacts of QE2 on Macroeconomic Variables of the US

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Estimated Effects of $1 trillion Dollar Asset Purchase Program	
Macroeconomic Variables	*Estimated Effects*
Real GDP	0.20%
Core Inflation Rate	0.45%
Unemployment Rate	-0.50%

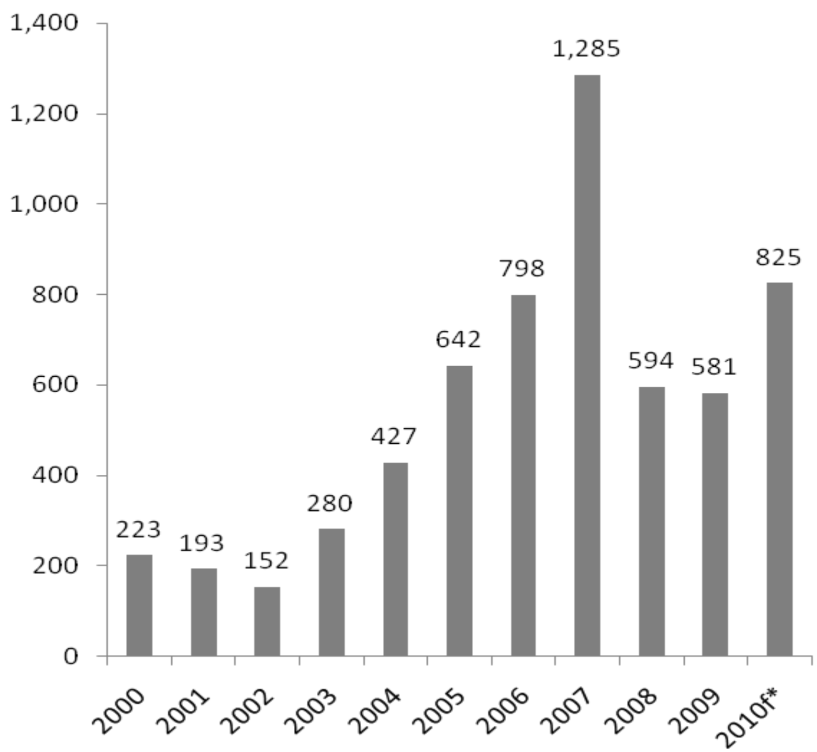
- The dynamic (VAR) model results show that $1 trillion of FED asset purchase increases US real GDP by 0.2% and this effect is smaller than the expected effect.

- $1 trillion asset purchase of FED increases core inflation rate by 0.45%. This shows deflation concerns in US may end soon.

- $1 trillion asset purchase decreases unemployment rate by 0.5%. This result underlines that unemployment rate might be on high levels in the US for an extended period.

EM Financial Markets and QE2

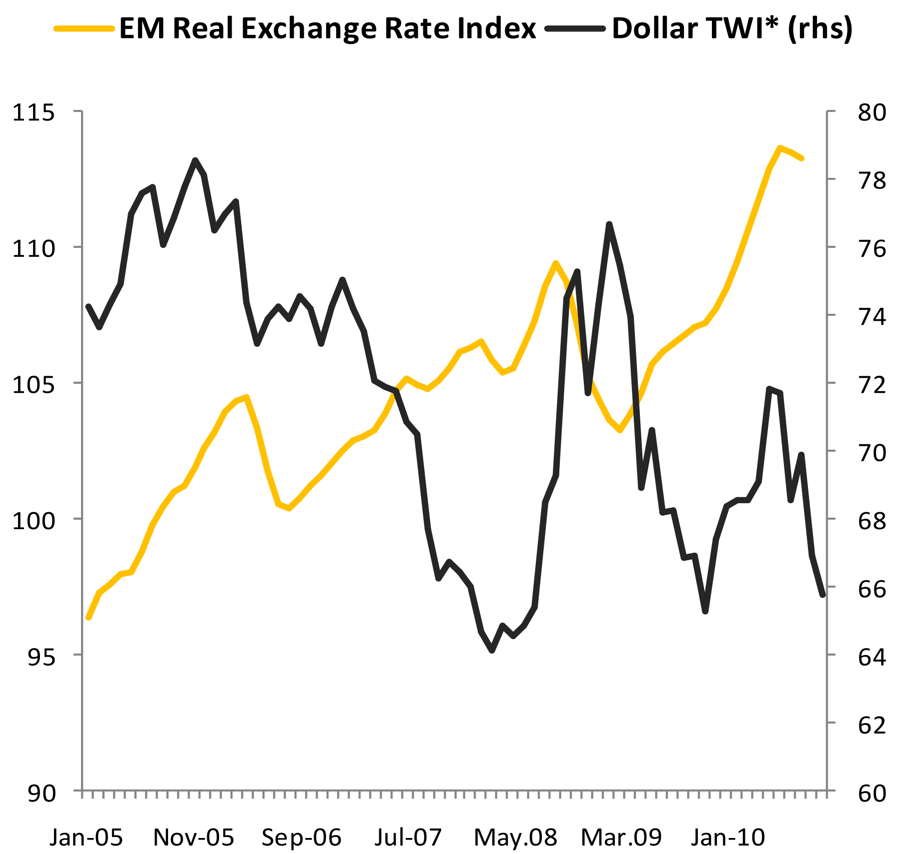
EM Net Private Flows (billion $)



Source: IIF, *IIF forecast

- In global financial markets, it is expected that FED's QE2 purchases of Treasury securities will amount to $1 trillion and the balance sheet of FED will increase by 40%.
- QE1 has affected EM's as much as US and other developed countries in 2008.
- QE1 resulted in depreciation of the dollar and triggered financial flows especially to Asian and Latin American markets.
- By the second half of 2010 capital inflows to EMs increased because of the low growth performance of the US economy.
- The main reason of capital flows is the growth performance of emerging Asia and Latin America as well as low interest rates as a result of the increasing liquidity in the US.

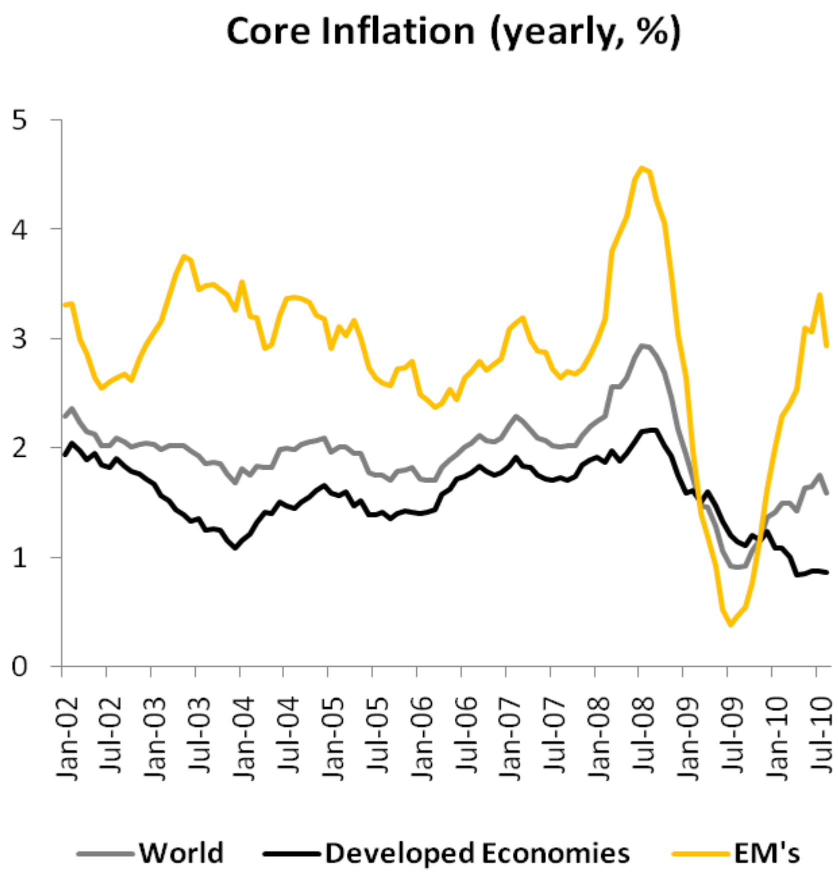
EM currencies are expected to appreciate further



Source. IMF, Bloomberg
*TWI: Trade Weighted Index

- When the first QE is applied, interest rates and exchange rates were immediately affected by the change in the monetary policy.
- Similarly, QE2 expectations in global markets causes the dollar to lose value and interest rates to fall.
- According to trade weighted dollar index, dollar has lost value by 8.3% since June. On the other hand, EM real exchange rate index has risen by 4.5% from January to August.
- It is expected that this appreciation in the EM currencies will continue.

QE2 might avoid tightening of monetary policies in EMs



Source: IMF

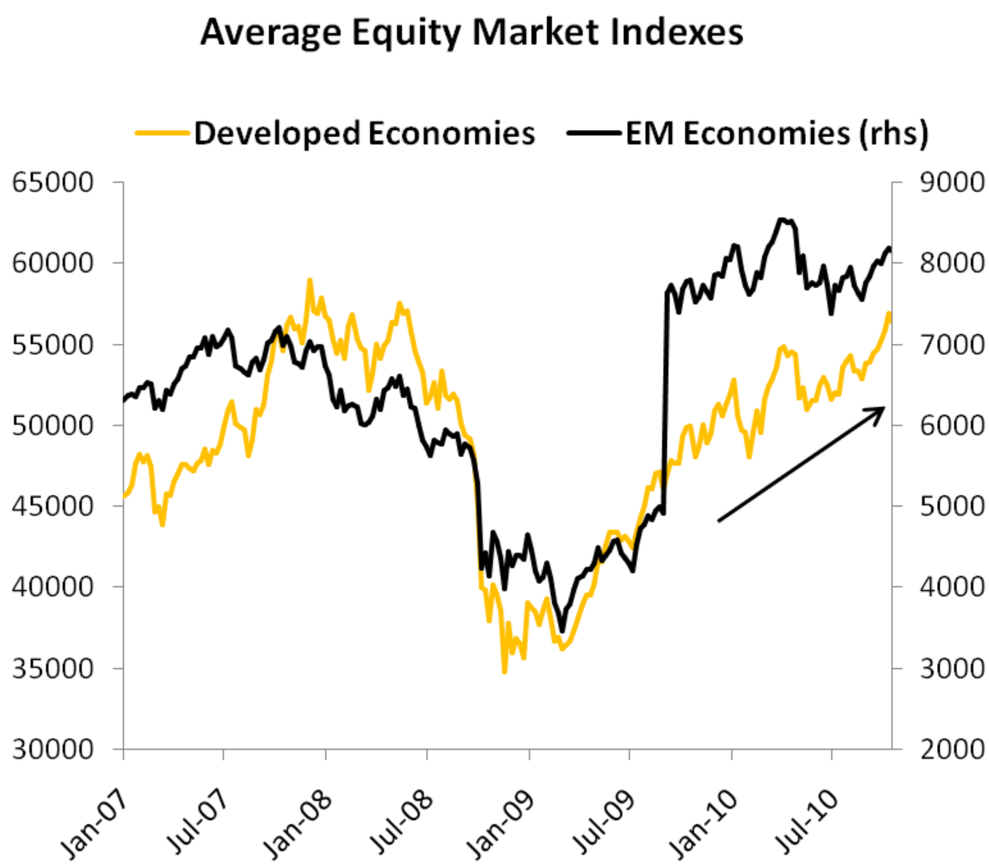
- It is seen that EMs reacted with measures against increasing capital flows because of the appreciation in their currencies.

- It is predicted that EMs will continue measures against capital flows and will have to avoid monetary tightening. However, inflation risk in EMs is an obstacle for easy monetary policies.

- EMs might delay rate hikes by allowing the valuation of domestic currency.

- While US dollar is losing value, EM currencies are appreciating. Although this might be important in reducing the global current account imbalances, it would be difficult to expect such a trend to be continuos.

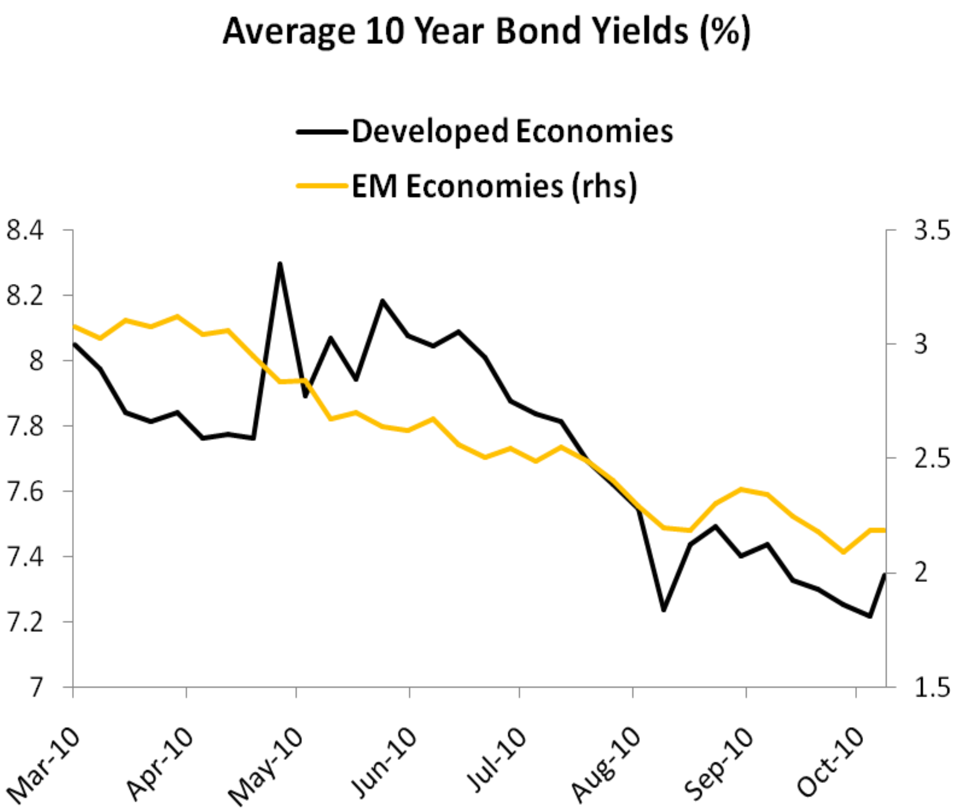
The Impact of QE2 on EM Equity Markets



Source: Bloomberg
Developed Economies: US, Japan, Germany, UK
EM: Brazil, South Africa, Turkey, China.

- Expectations of QE2 and low US growth rate forecasts increase demand for EM equity markets such as Brazil's Bovespa or Turkey's ISE .
- Flow of liquidity into equity markets may cause an equity market bubble.
- High demand of foreign investors for EM equity markets may result in currency and trade wars.

The Impact of QE2 on EM Bond Markets



Source: Bloomberg
Developed Economies: US, Japan, Germany, UK
EM: Brazil, South Africa, Turkey, Hungary, Poland.

- EM government bond yields are higher than the sovereign yields of developed countries.
- High liquidity expectations lead investors to bond markets in EM.
- There is a bond bubble debate as a result of flow of liquidity into bond markets in EMs.
- This high demand is an advantage for some EM economies to have access for long term loans and achieve higher growth performances.

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