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The world awaits a masterful exit

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QE tapering Exactly when Bernanke ends his grand experiment is a question not just for the US but for the world, writes **John Kehoe.**

Before he steps down in January next year, the world's most powerful economic player, Federal Reserve Âchairman Ben Bernanke, hasone final portentous Âdecision tomake.

Should he tighten the washers on his $3.2trillion ($3.58trillion) money tap as part of responsible management of his own economy, or must he consider the impact this has on the rest of the world?

As President Obama ruminates over punishing Syria for its atrocities in Damascus, the issue of US global power is right back in the frame. And whatever Obama decides has the potential to change the context for Bernanke.

Both are being forced to look outwards, although their preference may be to think local.

Bernanke would no doubt like a legacy that remembered him as the man who not only embarked on the great liquidity experiment that saved his economy, but also Âprepared for a return to more balanced Âeconomic management.

Until recently it looked possible. So in June Bernanke mooted a limited and modest exit strategy, given evidence the world's biggest economy looked like it was gradually pulling out of the most prolonged recession since the Great Depression of the 1930s. Since then a confluence of events has rattled global equity, currency and bond markets.Global impact of tapering

Now the question is newly posed: is the US ready? Is the rest of the world ready?

In recent days investors around the globe have seen currencies plunge in emerging markets as foreign investors pull out; the near certainty of military conflict in Syria; a surging oil price that has reached an 18-month high; and political instability in Italy. To cap it off, the US government will hit its $US16.7trillion debt limit earlier than expected in October.

Economic data in the US, including housing starts and manufacturing, have recently disappointed, although better than expected second quarter GDP figures on Thursday eased some of the US domestic economic Âconcerns.

The market is jumping at shadows every time there is talk of who will succeed Bernanke in January - former US Treasury Secretary Larry Summers, or the perceived slightly more dovish Fed vice-chairman Janet Yellen, who some investors believe may be inclined to leave the liquidity tap on for longer.

It's hardly an environment helpful to a Fed seeking to scale back the $US85billion in monthly purchases of US treasuries and mortgage bonds, which had helped anchor interest rates near record lows.

Already interest rates on Treasury bonds and mortgages have jumped in anticipation.

Barry Bosworth, a senior fellow at the Brookings Institution and former economic adviser to Bill Clinton, says that the Fed's Âpolicy has become "contentious".

"I agree that the purchases cannot go on forever, but I am puzzled about why the FRB [Federal Reserve Board] raised the issue in the midst of a large wallop of fiscal restraint and considerable uncertainty," Bosworth tells AFR Weekend.Timing sensitive

Bosworth's caution predominantly relates to whether the US economy, growing at a sub-par 2per cent, is strong enough for the Fed to start "tapering" after its scheduled board meeting on September 17-18.

But some others are looking beyond the US coastline and warning the Fed's policy could hit global markets and emerging economies in particular, as it exits from the unconventional monetary policy too early.

Almost $US4trillion gushed into emerging markets over the past four years, IMF research shows. The capital inflows were driven by investors in search of yield, after the Fed pushed down the official cash ratetozero and forced Treasury and Âmortgage rates lower by buying large licks ofsecurities.

But the drug could only last for so long and Bernanke's hints since June that the "taper" could begin as early as September, have investors running scared. Emerging markets are already collateral damage.

Equity and currency markets in India and Indonesia have plummeted, while Turkey, South Africa and Brazil are also feeling the pain. Economies that are net borrowers from the rest of the world have been the hardest hit.

The selloff in Asian and Latin America markets has been driven by the threat of Fed tapering and the belief that billions of dollars of surplus QE-induced capital will cease tobe on hand to prop up economies andmarkets.Brazil, Indonesia under pressure

Emerging economies' sharemarkets have collapsed almost 15per cent since the start of the year, compared to a rise of more than 10per cent for the developed world.

Brazil was forced into a $US60billion intervention to protect its currency, to stem the world's worst currency free fall of 20per cent against the US dollar since the start of the year.

While a repeat of the 1997-98 Asian financial crisis is not likely (because those previously affected have stockpiled large amounts of foreign currency reserves), some countries like Brazil and Indonesia have been forced to ratchet up interest rates to stem the outflow of hot money.

As one commentator noted this week, what happens in Washington (the home of the Board of Governors of the Federal Reserve), doesn't stay in Washington.

Of course, the Fed is not alone. Central banks in Japan, the United Kingdom and Europe are running ultra-loose monetary policy that has pumped up asset prices.

Stephen Roach, a faculty member at Yale University and former Chairman of Morgan Stanley Asia, this week launched a stinging attack on central bankers, claiming the Fed was in denial about its responsibilities and "guilty" of inflicting serious problems on emerging markets.

"The QE exit strategy, if the Fed ever summons the courage to pull it off, would do little more than redirect surplus liquidity from higher-yielding developing markets back to home markets," Roach says.Exit 'too early'

International Monetary Fund managing director Christine Lagarde suggested to the world's central banking elite at the renowned Jackson Hole symposium lastweekend, that it was too early for Âcentralbanks to exit from ultra-loose monetary policy.

"Let me say it up front: I do not suggest a rush to exit," she said.

But surely the show cannot go on forever.

And there are doubts from some eminent economists about how beneficial the Fed's policies have been for growth in the real economy, as opposed to simply inflating asset prices.

QEI from 2009 helped the US sharemarket soar 74per cent. QEII from 2010 piled on 29per cent, and the most recent round of quantitative easing under the guise of QEIII has helped the market rise a further 11per cent.

Bernanke has argued QEI and QEII helped stimulate growth to produce two million extra jobs.

Yet San Francisco Fed researchers Vasco Curdia and Andrea Ferrero recently found that bond buying has "at best moderate effects on economic growth".QE benefits questioned

James Dorn, a senior fellow at the Cato Institute, which champions a small-government and free market economy, has doubts about the QE strategy.

"The Fed's massive purchases of treasuries and mortgage-backed securities have not had a significant impact on economic growth or job creation - because ultimately real factors, not money growth, are the key variables determining economic growth," Dorn says.

"The unconventional monetary policies should be ended because they distort Ârelative prices, lead to mal-investment, and politicise the Fed."Will the Fed consider other economies?

But with emerging markets already haemorrhaging, will the Fed defer its exit plans in the interests of other economies?

The US is a nation that inherently believes that self-interest will dictate the best Âeconomic outcomes.

Furthermore, the dual mandate of the Fed's monetary policy is low inflation and full employment - in the US.

Pantheon Macroeconomics chief economist Ian Shepherdson says the emerging markets' importance to US exporters is modest, "and the Fed will not be swayed by their pain".

Brookings' Bosworth says the Fed must do "what is best for the US". "It has consistently resisted arguments that it ought to be the central banker to the world economy," he says.

"Emerging markets knew that the quantitative easing would not go on forever, and I do not understand their current surprise."

The former Federal Reserve chairman this week laid some of the blame on the emerging economies themselves.

"One of the ways that monetary policy from the United States was transmitted to the rest of the world was by resistance to exchange rate appreciation in many other countries."

By holding down their currencies and failing to let them adjust upwards as they should have when hot money rushed in, the emerging markets are now facing a rapid exit of funds.

Dorn says as rates rise, capital will move to the US, as already appears to be the case. "But as US growth accelerates, the global economy should also benefit from a normalisation of monetary policy."

The decision for Bernanke, who unleashed the policy four years ago to resuscitate the battered American economy, is likely to be one of his final acts as chairman before stepping down in January.

The world will be watching, and the effects long lasting, well beyond his exit.

85 $ billion monthly purchases of US treasuries and mortgage bonds during quantitative easing

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