Tapering and the Emerging Markets

Author: Joseph P. Joyce · March 24th, 2014 · Comments (0)

The response of the exchange rates of emerging markets and their equity markets to the Federal Reserve’s “taper,” i.e., reduction in asset purchases, continues to draw comment (see, for example, here). Most analysts agree that these economies are in better shape to deal with capital outflows than they were in the past, and that the risk of another Asian-type crisis is relatively low. But that does not mean that their economies will react the way we expect.

Gavyn Davies of Fulcrum Asset Management, who has a blog at the Financial Times, has posted the transcript of a “debate” he organized with Maurice Obstfeld of UC-Berkeley, Alan M. Taylor of UC-Davis and Dominic Wilson, chief economist and co-head of Global Economics Research at Goldman Sachs, on the financial turbulence in the emerging markets. “Debate” is not the best word to describe the discussion, as there are many areas of agreement among the participants. Obstfeld points out that there are far fewer fixed exchange rate regimes in today’s emerging markets, and many of their monetary policymakers have adopted policy regimes of inflation targeting. Moreover, the accumulation of foreign exchange by the central banks leaves them in a much stronger position than they were in the 1990s. Taylor adds fiscal prudence and less public debt to the factors that make emerging markets much less risky.

But all the participants are concerned about the winding down of the credit booms that capital inflows fueled. Wilson worries about economies with current account deterioration, easy monetary policy, above-target inflation, weak linkages to the recovery in the developed markets and institutions of questionable strength. He cites Turkey, India and Brazil as countries that meet these criteria. Similarly, Taylor lists countries with relatively rapid expansion in domestic credit over the 2002-2012 period, and Brazil and India appear vulnerable on these dimensions as well.

Another analysis of the determinants of international capital flows comes from Marcel Förster, Markus Jorra and Peter Tillmann of the University of Giessen. They estimate a dynamic hierarchical factor model of capital flows that distinguishes among a common global factor, a factor dependent on the type of capital
inflow, a regional factor and a country-specific component. They report that the country component explains from 60 – 80% of the volatility in capital flows, and conclude that domestic policymakers have a large degree of influence over their economy’s response to capital flows.

But are “virtuous” policies always rewarded? Joshua Aizenman of the University of Southern California, Michael Hutchison of UC-Santa Cruz and Mahir Binici of the Central Bank of Turkey have a NBER paper (http://www.nber.org/papers/w19980) that investigates the response in exchange rates, stock markets and credit default swap (CDS) spreads to announcements from Federal Reserve officials on tapering. They utilize daily data for 26 emerging markets during the period of November 27, 2012 to October 3, 2013. They looked at the response to statements from Federal Reserve Chair Ben Bernanke regarding tapering, as well as his comments about the continuation of quantitative easing. They also looked at the impact of statements from Federal Reserve Governors and Federal Reserve Bank Presidents on these topics, as well as official Federal Open Market Committee (FOMC) statements.

Their results show that Bernanke’s comments on winding down asset purchases led to significant drops in stock markets and exchange rate depreciations, but had no significant impact on CDS spreads. There were no significant responses to statements from the other Fed officials. On the other hand, there were significant responses in exchange rates when Bernanke spoke about continuing quantitative easing, as well as to FOMC statements and announcements by the other policymakers.

The countries in the sample were then divided between those viewed as possessing “robust” fundamentals, with current account surpluses, large holdings of foreign exchange reserves and low debt, and those judged to be “fragile” due to their current account deficits, small reserve holdings and high debt. Bernanke’s tapering comments resulted in larger immediate depreciations in the countries with current account surpluses as oppose to those with deficits, more reserves and less debt. Similarly, Bernanke’s statements led to increased CDS spreads in the countries with current account surpluses and large reserve holdings, while lowering equity prices in countries with low debt positions. The immediate impact of the news regarding tapering, therefore, seemed to be tilted against those with strong fundamentals.

The authors provide an explanation for their results: the robust countries had received larger financial flows previous to the perceived turnaround in Fed policy, and therefore were more vulnerable to the impact of tapering. Moreover, as the change in the Federal Reserve’s policy stance was assimilated over time, the exchange rates of the fragile nations responded, and by the end of the year had depreciated more than those of the more robust economies. Similarly, their CDS spreads rose more. By the end of 2013, Brazil, India, Indonesia, South Africa and Turkey had been identified as the “Fragile Five.”

What do these results tell us about the impact on emerging markets from future developments in the U.S. or other advanced economies? There may be a graduated response, as the relative standings of those nations that have attracted the most capital are reassessed. However, if capital outflows continue and are seen as
including more than “hot money,” then the economic fundamentals of the emerging markets come to the fore. But financial markets follow their own logic and timing, and can defy attempts to foretell their next twists and turns.


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