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Tapering talk: The impact of expectations of reduced Federal Reserve security purchases on emerging markets☆

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ABSTRACT

In May 2013, Federal Reserve officials first began to talk of the possibility of tapering their security purchases. This “tapering talk” had a large negative impact on the exchange rate and financial markets in emerging markets. In this paper, we analyze who was hit and why. We find that countries with larger and more liquid markets and larger inflows of capital in prior years experienced more pressure on their exchange rate, foreign reserves, and equity prices. We interpret this as investors being able to rebalance their portfolios more easily when the target country has a large and liquid financial market.

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1. Introduction

In May 2013, officials of the Federal Reserve System first began to talk of the possibility of the US central bank tapering its securities purchases (gradually reducing them from the prevailing \$85 billion monthly rate to something lower, presumably as a prelude to phasing them out entirely). A milestone to which many observers point is May 22, 2013, when Chairman Bernanke raised the possibility of tapering in his testimony to the Congress. This “tapering talk” had a sharp negative impact on economic and financial conditions in emerging markets.

Three aspects of that impact are noteworthy. First, the impact was sharp and, in the view of many commentators, surprisingly large. The most alarmed commentators raised the possibility that some emerging countries might be heading towards a full blown crisis like that in Mexico in 1994 and Asia in 1998. Second,

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the impact was not felt uniformly; different countries were affected rather differently. Third, there were complaints from policy makers in the developing world about the Fed's turn to tapering that were seemingly hard to square with earlier criticisms of quantitative easing by the US central bank as a form of "currency war."

This paper is a first attempt to shed light on these issues. We use data for a cross section of emerging markets to analyze who was hit by the Fed's tapering talk and why. We focus on the change in exchange rates, foreign reserves, and equity prices between April 2013, just prior to the talk of tapering, and August 2013, by which time the response was largely complete (in September, new data on the condition of the US economy led Federal Reserve officials to make statements that moderated prior expectations of tapering).

We relate the reaction of these variables to several classes of potential determinants: (a) observable macroeconomic fundamentals like the budget deficit, public debt, foreign reserves, and GDP growth rate in the prior period; (b) the size and openness of a country's financial markets; and (c) the extent of capital flows and the extent to which capital-flow-sensitive indicators like the real exchange rate and current account balance had been allowed to move in the prior period when quantitative easing was underway, when there had been no expectations of tapering, and policy makers in emerging markets had complained of currency wars.

Our answers are as follows. First, there is little evidence that countries with stronger macroeconomic fundamentals (smaller budget deficits, lower debts, more reserves, and stronger growth rates in the immediately prior period) were rewarded with smaller falls in exchange rates, foreign reserves, and stock prices starting in May. What mattered more was the size of their financial markets. Investors seeking to rebalance their portfolios concentrated on emerging markets with relatively large and liquid financial systems, these were the markets where they could most easily sell without incurring losses and where there was the most scope for portfolio rebalancing. The obvious contrast is with so-called frontier markets with smaller and less liquid financial systems. This is a reminder that success at growing the financial sector can be a mixed blessing. Among other things, it can accentuate the impact on an economy of financial shocks emanating from outside.

In addition, we find that the largest impact of tapering was felt by countries that attracted large volumes of capital flows and allowed exchange rates to run up most dramatically in the earlier period of expectations of continued easing on the part of the Federal Reserve, when large amounts of capital were flowing into their economies. Similarly, we find a large impact in countries that allowed the current account deficit to widen most dramatically in the earlier period when it was easily financed. Countries that used policy and in some cases, perhaps, enjoyed good luck that allowed them to limit the rise in the real exchange rate and the growth of the current account deficit in the boom period suffered smaller reversals. This provides some intuition for how it was that the same countries could complain about quantitative easing while it was underway – QE had large, disconcerting impacts on local markets – and then also complain about tapering talk. Talk of tapering had a relatively large negative impact on those local markets that earlier allowed their asset prices to run up sharply and their current accounts to widen relatively dramatically.

We interpret these real exchange rate and current account measures as picking up the impact, positive, negative, or neutral, of macroprudential policy broadly defined. We control for the stance of fiscal policy (since fiscal tightening can also limit the appreciation of asset prices in a period when capital is flowing in), as well as for the intensity of capital controls in the prior period. However, these do not appear to have exerted a consistently significant impact on the effects of tapering, nor does their inclusion alter the estimated effect of the change in the real exchange rate. Evidently, capital controls, fiscal tightening, or even a combination of the two did not suffice to damp down the effects of financial inflows. Instead, a broader array of macroprudential policies – limits on the rate of growth of bank lending, loan-to-value regulation for the mortgage market, and similar measures – may have made a difference by moderating either the upward pressure on the exchange rate or the widening of the current account deficit and may therefore be called for in the future.

2. Data

In what follows, we consider the impact of the tapering talk on exchange rates, foreign reserves, and stock prices and on a composite index, which we call the capital market pressure index. We calculate the latter as a weighted average of changes in exchange rates, foreign reserves, and stock prices in two separate indices. The first index, which we call the Capital Market Pressure Index I, is a weighted average of the percent

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