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RESEARCH ARTICLE

FED TAPERING IMPACT ON DEPENDENT ECONOMIES

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ABSTRACT

This paper is a take on how the Federal Reserve's actions not only affect the United States but also a series of other economies related through trade. It is an era of globalisation where one or the other country is connected. It has given rise to situations where things are likely to follow a ripple effect. This paper will focus mainly on the kind of effects the Fed's decision have on other economies and what all those economies do in order to minimize the damage and maximise the benefit of it.

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INTRODUCTION

Tapering is a term given to an expected series of upcoming actions on the part of the Federal Reserve to pull back new infusions (the size of the bond-buying program known as quantitative easing (QE)) of cash into the U.S. economy. The program, which is designed to stimulate the U.S. economy, has served the secondary purpose of supporting financial market performance in recent years. Ever since the credit crisis and subsequent Great Recession, the Fed had been injecting liquidity into the banking system to stimulate the economy and keep interest rates low. The reason of departure from QE was that the economy had become strong enough for the Fed to feel confident in reducing the level of stimulus. Investors and other financial observers feared that as the Fed begins this tapering process (tapering off the buying of assets to inject liquidity into the economy) markets and the economy might suffer. While the Fed's surprising pronouncement led to substantial turmoil in the financial markets during the second quarter, the Feddid not officially announce its first reduction in QE until December 18, 2013, at which point it reduced the program to $75 billion per month from its original level of $85 billion. In this paper we look at how due to dependence of various countries on US financial system, they are affected. We shall mainly look at the emerging economies with specific focus on few and impact on their currency and why they were affected. After the first round on 18th December 2013, the second round for the same was finally announced on 29th January 2014, with the bond buying now down to $65 billion a month. We shall now look at some anticipated impacts, the preparation and finally the final impact on the various economies.

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Anticipation

The Expected impact on markets around the world:

1. Rising Interest Rates:

Perhaps the most obvious way that taper talk has spooked the Markets is the fact that the rate on the benchmark 10-Year Treasury note has increased by approximately 1.3 percentage points in September since May from about 1.6 percent to nearly 2.9 percent. At a glance, the change may seem trivial, but before June, the 10-year yield had not broken above 2.5 percent since summer 2011.

2. Increased Volatility:

Shifting expectations about the market itself and Fed policy had added more tension to an already dubious market. The sudden and dramatic increase in the benchmark 10-year rate is also evident in the rates on longer-term loans, such as mortgages. As a result, mortgage applications have generally been on the decline.

3. Outflows from Emerging Markets / Currency Fluctuations:

The currencies of many developing countries, such as India and Brazil, have dropped in value dramatically. Quantitative easing effectively reduced the cost of the U.S. dollar, and many investors used the opportunity to flock to emerging markets and seek higher yields than were available at home. Now that the flow rate of cash printing is expected to be reduced, many investors have withdrawn their money from emerging markets, resulting in currency depreciation (discussed in detail ahead). Developed and emerging countries discussed over this issue at the recent G20 summit. India and China in fact called for the United States to be mindful of the effect that tapering could have on the rest of the world. In the wake of declining currency values in emerging economies, most notably the recent tanking of the Indian Rupee, fears had risen over whether there could be a repeat of the Asian economic crisis of the late 1990s.

Following are a few observations seen after the tapering talks started in May 2013:

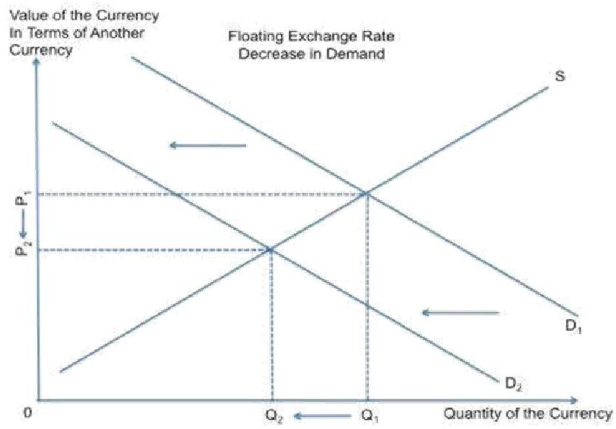
- Countries with stronger macroeconomic fundamentals (smaller budget deficits, lower debts, more reserves, and stronger growth rates in the immediately prior period) were rewarded with smaller falls in exchange rates, foreign reserves, and stock prices
- The largest impact of tapering was felt by countries that allowed exchange rates to run up most dramatically in the earlier period of expectations of continued Federal Reserve easing, when large amounts of capital were flowing into emerging markets.
- The largest impact was in countries that allowed the current account deficit to widen most dramatically in the earlier period when it was easily financed.

Why the aforesaid problem arose with developing economies

Many developing economies such as Brazil (EWZ) peg their currencies to the U.S. dollar. The reason is to stabilize capital flows into and out of the country, which can benefit economic development. However, when the currency of EM (emerging market) country is pegged to USD, deviations in USD affects and changes its monetary policy and the economy. This was a problem in the late 1990s for countries such as Argentina that suffered deflation by pegging their currency to the U.S. dollar as the tech boom sharply increased productivity. The most recent example of currency pegs hurting EM countries was this past summer, when the taper talk drove up market volatility.

Following is an illustration of how markets were affected in simple terms

As the Fed Taper talks began, the investors pulled money from emerging economies hence reducing their demand. As their demand reduced, the value of the currency in terms of dollar began to fall. As can be seen the exchange rate moved from P1 to P2. This was seen because of the simple fact that they had moved out of U.S. because of higher yields than in the home country when there was quantitative easing. Now that it was no longer there, and Fed was rather withdrawing, they withdrew their investments too. The most affected were the Fragile 5 as they are termed; namely; Turkey's lira, Brazil's real, Indian rupee, Indonesia's rupiah and South Africa's rand.



Following shows the impact on currency even before the actual taper began:

As emerging market currencies fall, the fear was that borrowers in these countries may not be able to pay back their dollar-denominated loans. Should they default en masse, their domestic banks could suffer or even fail. Meanwhile, just because their own currencies are falling, doesn't mean prices will be going down too. In countries that import food and oil from abroad -- often priced in U.S. dollars -- basic necessities will become more expensive to the average person.

Measures Taken by various Economies to reduce impact

Asian stocks, currencies and bonds rose after the Fed, recently, held off from reducing the $85 billion pace of monthly bond buying, saying it needs more evidence of lasting improvement in the economy. The threat of diminished global liquidity from cuts in the Fed’s purchases had earlier sparked the biggest emerging-market currency sell off in five years, with the Indian rupee and Turkish lira hitting record lows. Many emerging-market nations will need to adjust to a lower growth rate and refocus their economies after boosting domestic sources of expansion in the past three years post- global recession. The countries had built “this domestic growth model that created the current-account deficit, budget deficit, which need to be watched very carefully,” “They need to rebalance their economic-growth model. The balance of risks is still on the positive or upside, and that needs to be watched carefully by them because even if the tapering off is going to be delayed, at some point, the policy adjustment is going to come.” Some countries are imposing import tariffs, while others are better targeting their subsidies or scaling them back. Malaysia and Indonesia raised fuel prices this year to reduce subsidies and ease pressure on their budgets. Brazil and Indonesia have embarked on a series of rate increases to buoy the real and rupiah, while the Indian central bank took steps to boost the supply of dollars to alleviate depreciation pressure on its currency. Higher borrowing costs are going to come because of the direction of adjustment on monetary policy in major economies, and also because of inflation factors. “Especially because of domestic-demand growth that many of the economies adopted since the global financial crisis, the adjustment on that is going to be very important for governments, the private sector.” Some developing nations have accumulated debt quite rapidly in the past three years, and that is a “source of vulnerability” as interest rates rise and growth moderates. Countries will need to watch for balance-sheet risks at the level of households, corporates and the government.

The Group of 20 countries repeated their concern this month that stimulus pullback in developed nations may prove damaging to global markets. The BRIC countries along with South Africa pledged this month to create a $100 billion pool of currency reserves to guard against shocks from the withdrawal of stimulus.

A look at some specific emerging economies:

Sri Lanka

Policymakers in his island nation had expected the U.S. central bank's bond buying to slow eventually, and had prepared the economy by carefully managing capital inflows. "Actually during the course of 2013, bond market investment into Sri Lanka was far greater than what went out, which was completely the reverse of what took place in many other emerging nations.

"So, the possible fallout of tapering will be very minimal in Sri Lanka, and we don't expect it to have an impact overall." Tighter credit conditions in China and expectations the Fed will move to bring its bond-buying program to a close this year have helped fuel large retail investment outflows from developing markets, with currencies in Turkey, Argentina and Russia hitting record lows. At the same time, data on capital flows shows many long-term investors have either stuck with, or even added to, their emerging holdings. The fear is that at some point these big investors will be forced to cut losses as the effect of falling currencies becomes too painful to bear. The central bank was not targeting a particular range for the rupee, but would intervene if it saw excessive volatility in the market. The central bank has said it expects the rupee to strengthen in the medium term as capital inflows and exports rise. Sri Lanka has intervened in currency markets before, but interventions would be kept to a "minimal level." "The (currency) movement to take place in whichever direction, but at a pace which does not cause any harm to the economic stakeholders,"

India

Fiscal consolidation has taken place, there's more FDI flowing into India, the rupee is stable and a number of other measures have been taken to bring stability into the capital market". Measures taken to bolster the forex reserves and control the current account deficit (CAD), to handle the fallout of any decision to reduce the stimulus. India has unveiled a slew of measures between May and September to stem capital outflows and stabilise the rupee. It also clamped down on gold imports to control the current account deficit that hit a record high 4.8 per cent of gross domestic product (GDP) in the fiscal year that ended in March. But gold import curbs along with a rebound in merchandise exports have helped narrow the deficit to 1.2 per cent in the last quarter. India is also talking with JP Morgan and others to gain entry to benchmark indexes for emerging market debt in hopes of attracting billions of dollars in investment that could act as an insurance against any external shock. The government is still discussing inclusion in global bond indices and would prefer incremental change in foreign investment limit in the sovereign debt. Government was committed to the path of fiscal consolidation and had drawn red lines for fiscal and current account deficits. “Continue its purchases of treasury and agency mortgage-backed securities and employ its other policy tools as appropriate, until the outlook for the labor market has improved substantially in the context of price stability”.

China

The government "will keep flexibility for policy adjustment in face of possible shocks" from changes in U.S. monetary policy. The Chinese government is "extremely serious" about the reform agenda it set out including "the commitment to let market forces determine the distribution of resources, the opening of Shanghai free trade zone" and reform of hukou (household registration) system

South Korea

Authorities won’t leave currency volatility unattended and will act preemptively if needed. The tapering may result in fund outflows from Hong Kong and cause its interest rates to rise ahead of the U.S., The U.S. shift was embraced in some quarters. Chinese Vice Finance Minister Zhu Guangyao said it was a “welcome move” and as “a first step to transitioning its monetary policy from abnormal to normal, it reflects that the U.S. economy is stabilizing.” In Europe, German Finance Minister Wolfgang Schaeuble called the Fed’s decision understandable given the international consensus “that we have to step back from a very loose monetary policy stance in a very cautious way.” Malaysia is strengthening fiscal policy with measures such as deferring high-import content to counter the impact of tapering. The Philippine central bank said it will watch for any need to fine-tune policy as it foresees “some” financial-market swings in the near term.

Actual impact

For emerging markets and especially the Fragile Five, one of the main impacts is with their currencies. The Indonesian Rupiah and the South African Rand are declining and the Turkish Lira has hit a record low. The fall in currencies is especially a problem for the Fragile Five because one of the many things they have in common are deficits. The free money from the Fed allowed these countries and others to run deficits as their higher interest rates created a demand for their bonds and currencies. Now that has reversed. Partially to protect their currencies Brazil, India and Indonesia have all raised interest rates. South Africa’s are flat. In contrast Turkey’s interest rate has declined, one of the reasons for the Lira’s tumble. Falling currencies resulting in rising inflation and then rising interest rates potentially means slower growth. Slower growth means a political impact. Political risk is another aspect that the Fragile Five have in common. In elections years the ruling parties are happy to spend their way to maintaining power. Any unpopular but essential reform necessary to convince markets of the strength of the economy is likely to be ignored until after the election. But with rising interest rates and falling currencies, markets will not be either sympathetic or patient with the problems of entrenched politicians. It is not just the markets that are unlikely to be impressed. Credit rating agencies have at least four of the Fragile Five in their sights for a potential downgrade in 2014. High on the list is India. Standard & Poor’s considers the chances for a credit rating downgrade higher for India than Indonesia. The Fragile Five have another problem not necessarily related to their economic situation. Their financial markets are relatively large compared to other emerging markets. So when US interest rates rise and investors move capital back to the US, they sell developing countries with large liquid markets where exiting without large losses is easier.

Current scenario

The Fed on 29th January 2014 announced its next round of tapering and cut down its bond buying to $65 billion. In the anticipation of the same a lot of movement in Gold prices and currencies was seen and yet finally it was announced. It was stated that the U.S. economy is recovering and thereby there is no issue with continuing with the taper. Some economists were surprised the Fed didn't mention turmoil in some emerging economies. Emerging market currencies as mentioned earlier; Turkish lira, Brazilian Real, Indian Rupee, Indonesian Rupiah and South African Rand have recently fallen rapidly, as investors have pulled money from the countries. The turmoil in financial markets during the summer stands as a stark reminder that abrupt changes in US treasury yields can have significant impacts for capital flows, growth prospects and financial stability in developing countries, with effects being concentrated among those more financially integrated and with the largest vulnerabilities. The recovery is consolidating in most developing regions and pre-emptive policies were undertaken in a number of countries to reduce their exposure, but assuming smooth adjustments ahead might be a bit premature. Though it is much smoother than before, the wobbles in global markets did not materially affect the Fed's outlook and the policy course is steady as she goes for now. Economists are hoping for more encouraging U.S. news from a Commerce Department report Thursday morning, which is expected to show the country's Gross Domestic Productgrew at a 3% to 4% rate in the fourth quarter of 2013.

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