# QE Exit: Lessons for Financial Markets, Medium term Drivers for Growth

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October 17, 2014

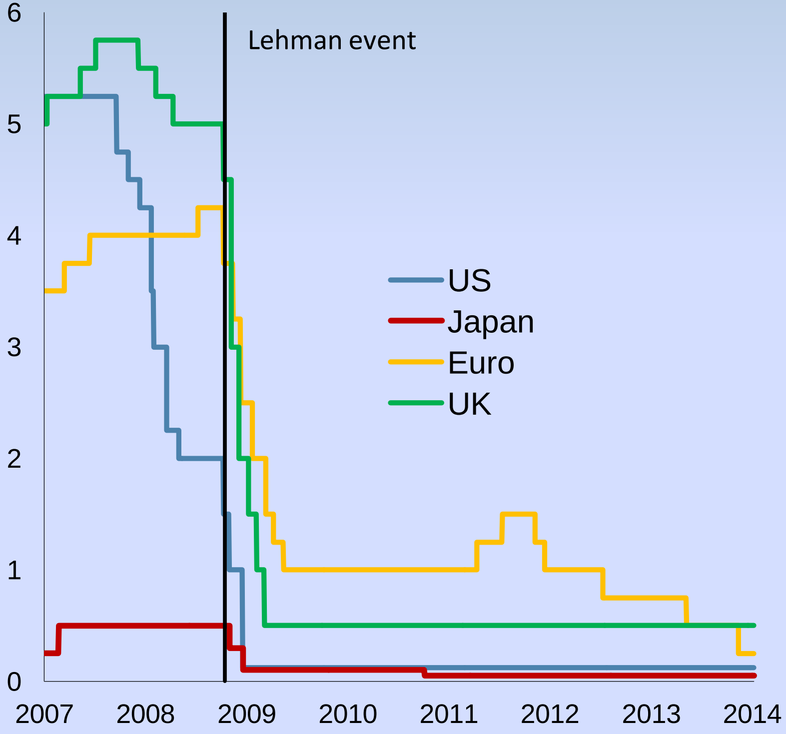
# agenda

- **Context**
- EM Volatility—Assessing Differentiation
- Policy Responses
- Early Policy Lessons
- Drivers for Sustaining Growth

# Unconventional monetary policies in advanced economies: Impact on their Central Bank balance sheets

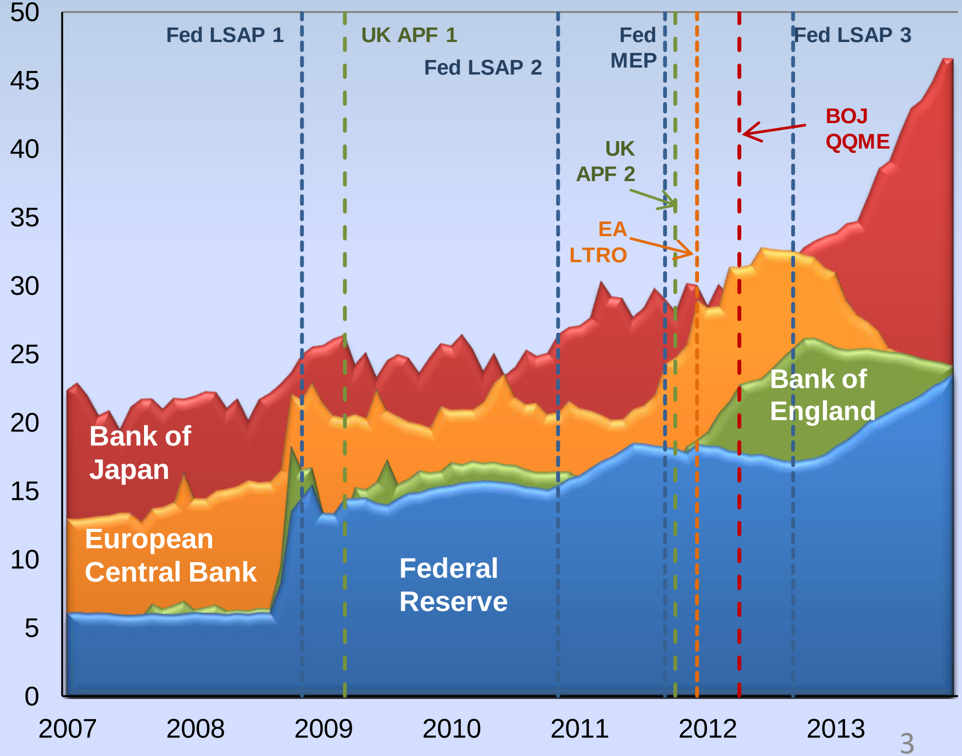
## Policy Interest Rates

(in percent)

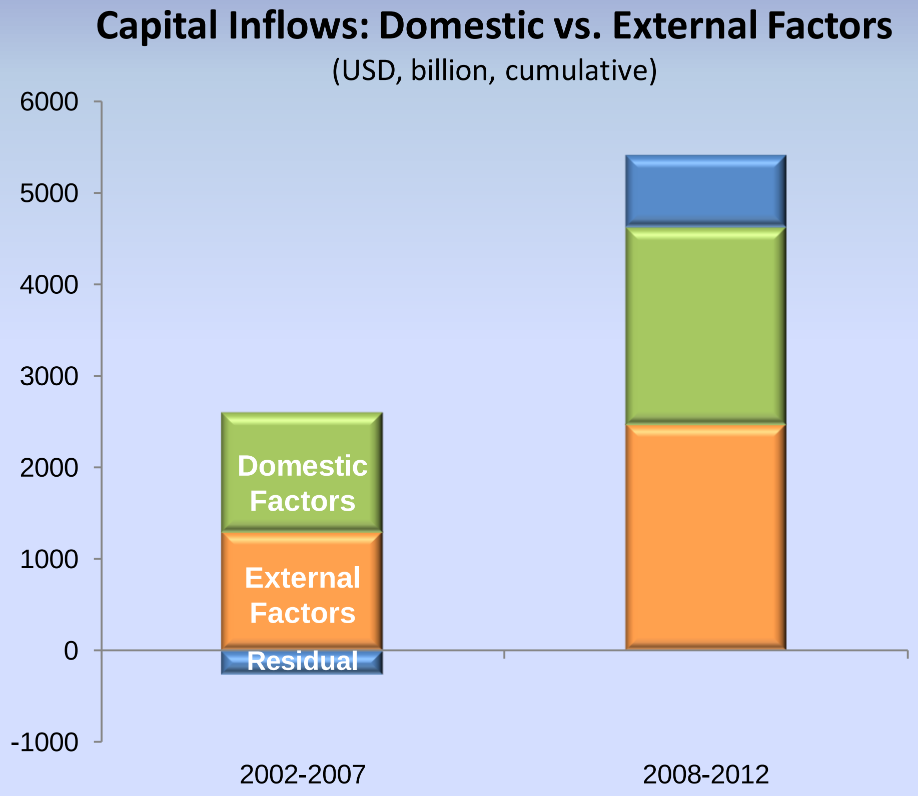


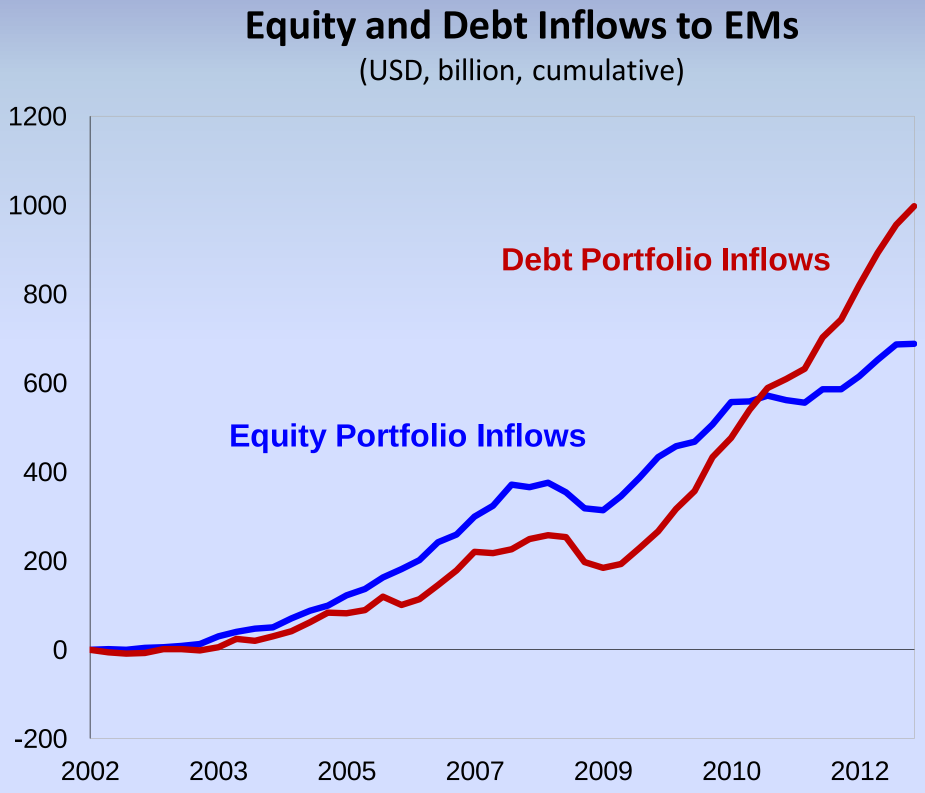

## Central Bank Balance Sheet Assets

(percent of GDP; Jan. 2007-Dec. 13)



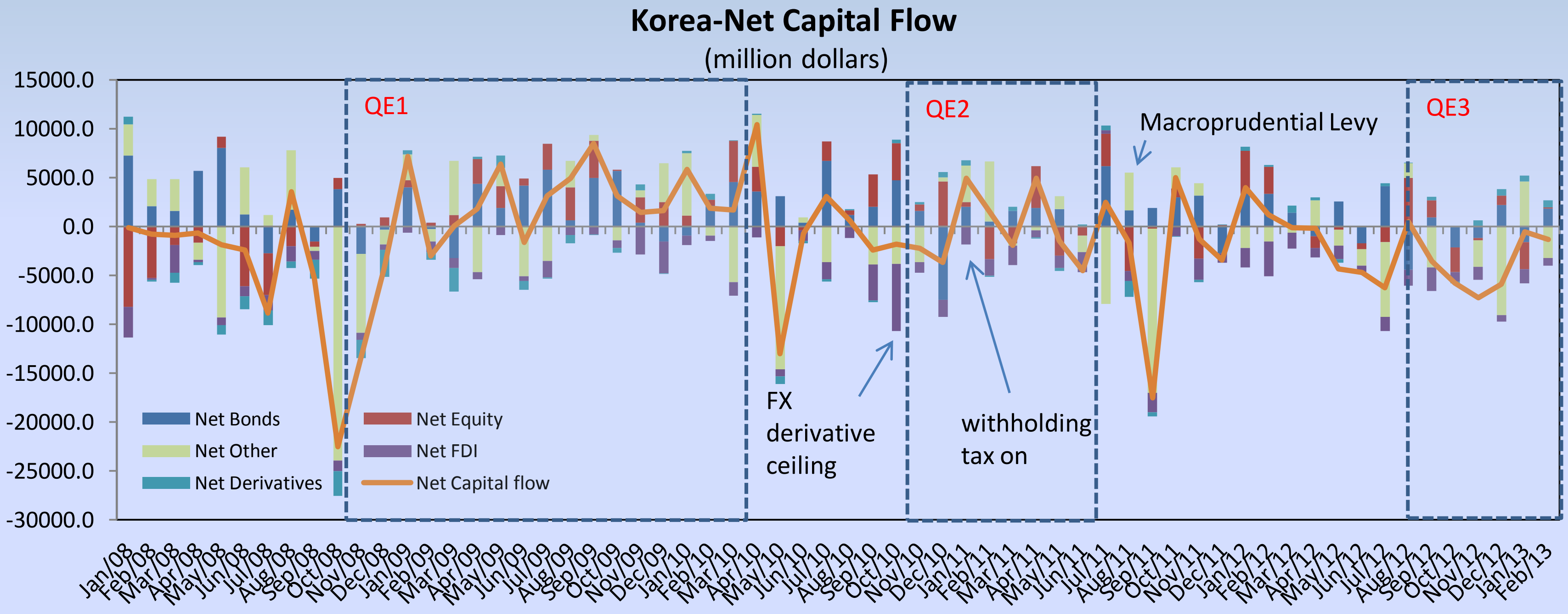
# EM inflows: driven by Domestic and external factors, Sharp shift toward debt instruments




Domestic factors: Growth in EMs, REER misalignment, and domestic interest rates. External factors: Growth in the United States, US interest rates, the expansion in the Fed balance sheet, and global risk appetite. The unexplained residual totals US$550 billion during 2002-2012. Source: IMF Staff Discussion Note 14/09

# Korea: Has not faced a surge—moderate flows focused on bond flows




Source: Safe Haven Korea, IMF Working Paper, 14/53

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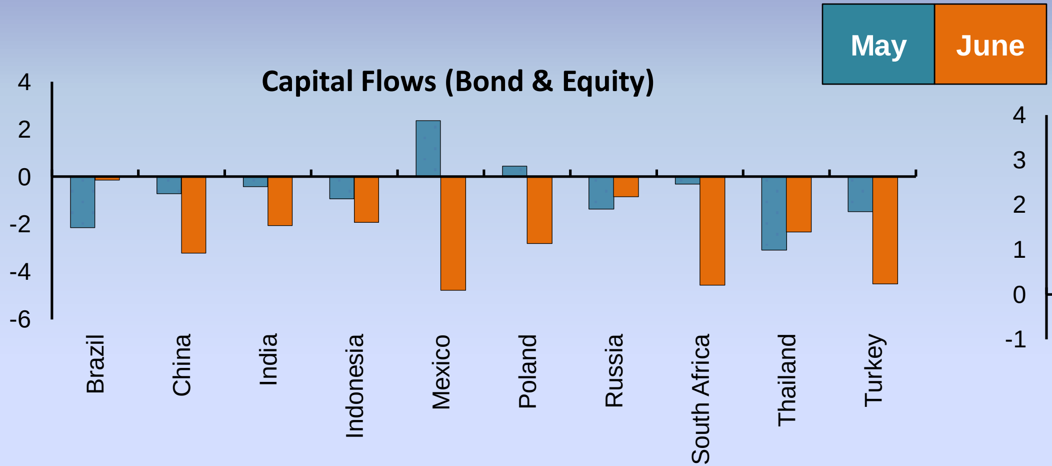
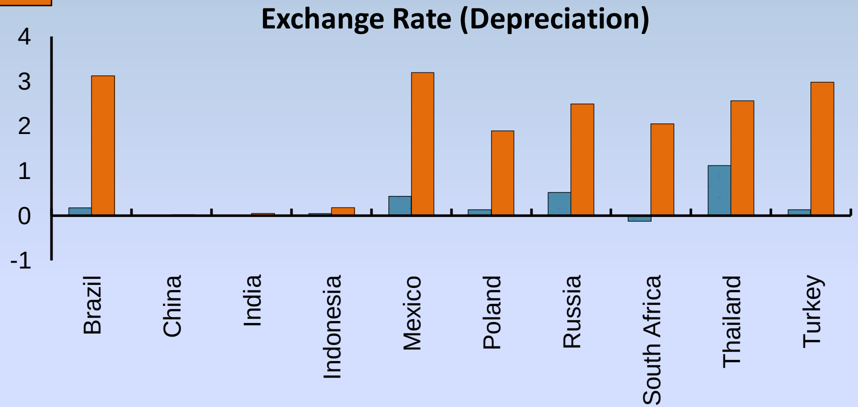
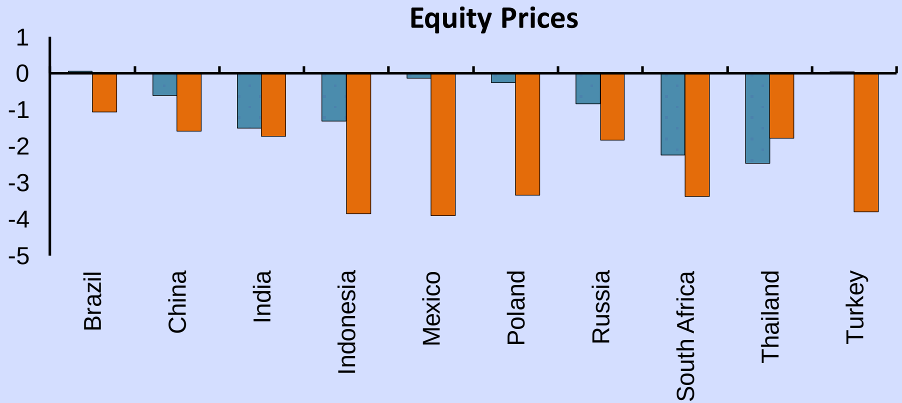
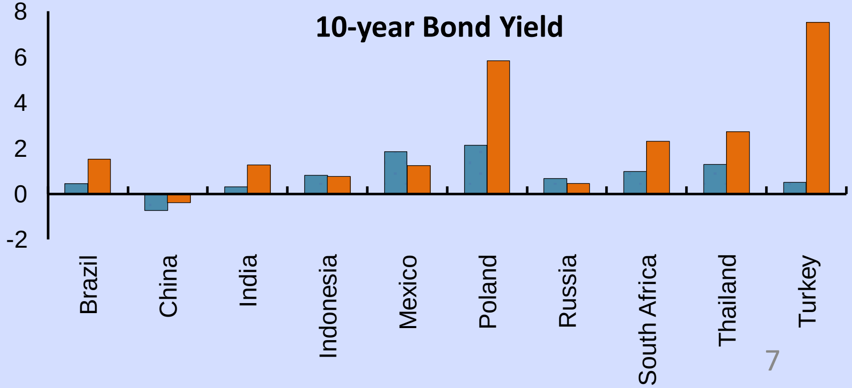
# Taper talk effects clearly differentiated across countries: May-June 2013

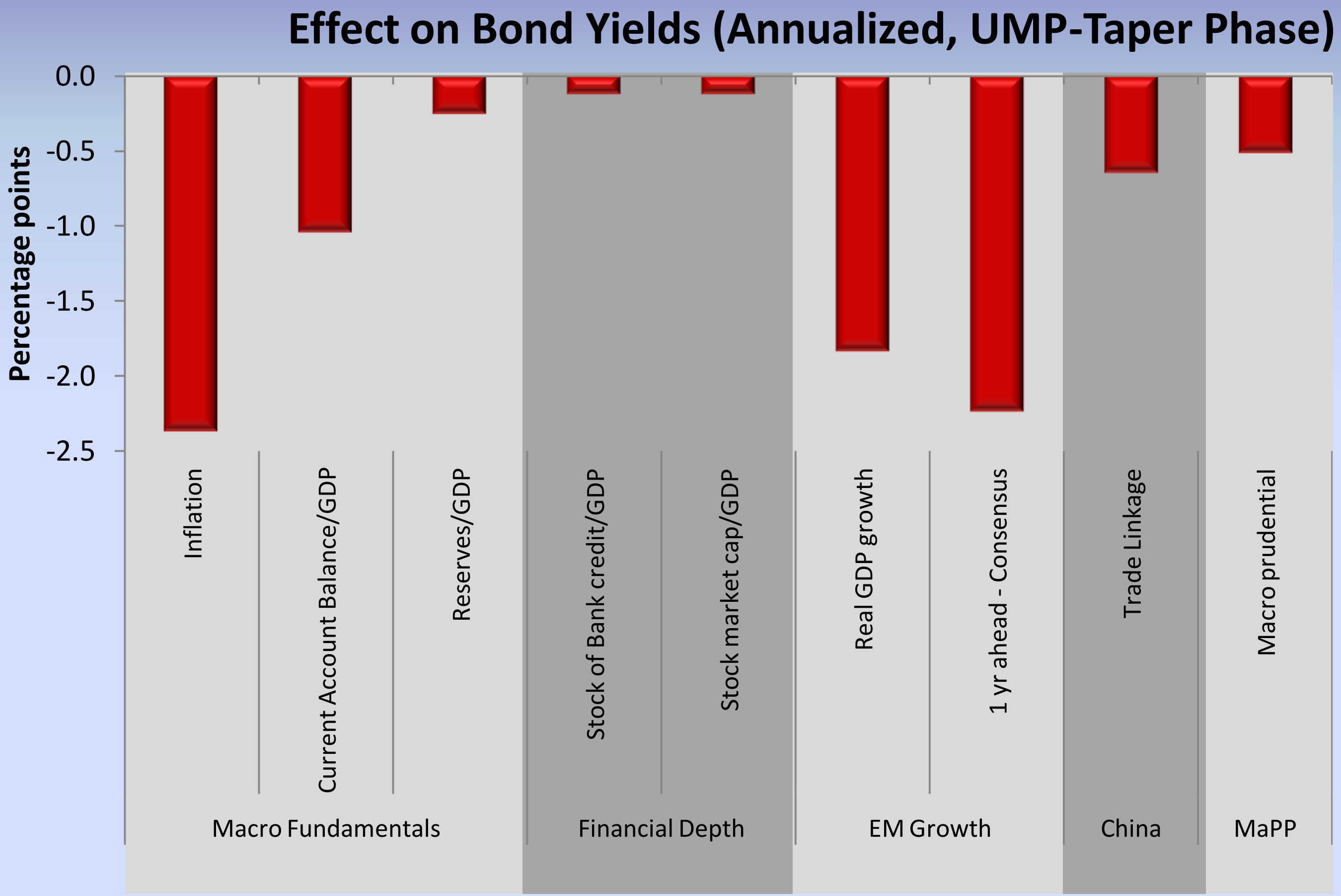


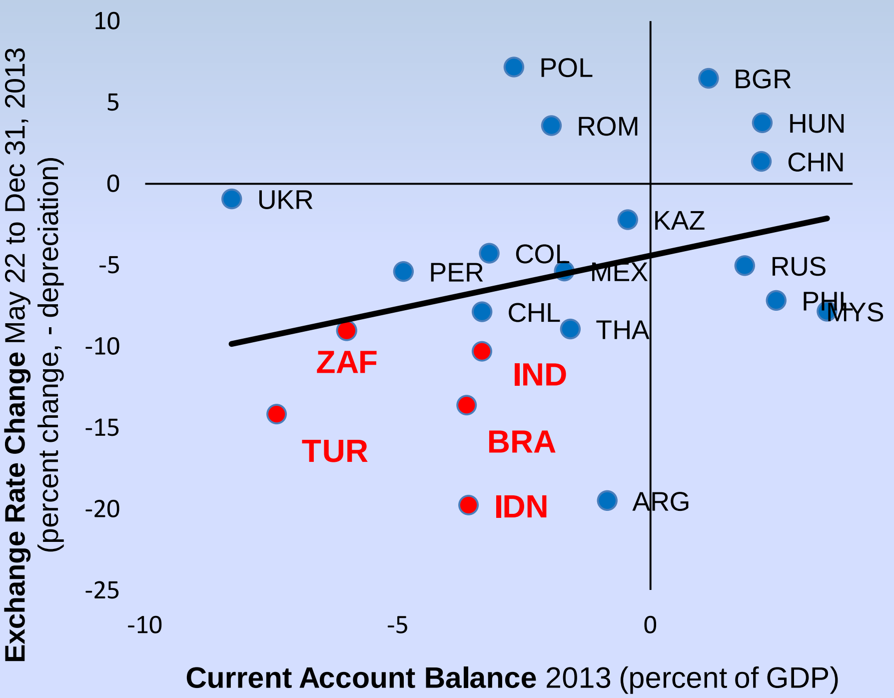



# Macro fundamentals & growth prospects matter most

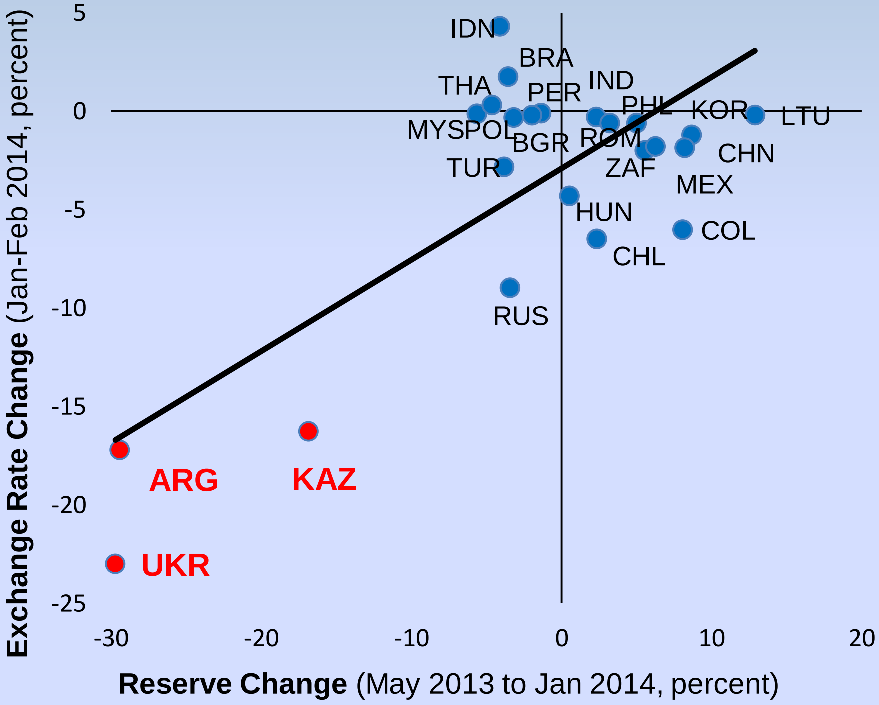


# Differentiation:
# Seems to have shifted from CA deficits to reserve declines?

## Exchange Rate Change vs. Current Account Balance




## Reserves vs. Exchange Rate



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# EMs Response: Range of policy tools

| | Monetary policy | | Fiscal policy | Macroprudential Policy | CFMs | FX Intervention | Liquidity provision measures |
|---|---|---|---|---|---|---|---|
| | Tight | Loose | Tight | Tight | Removal | | |
| **Brazil** | ✓ | | ✓ | | ✓ | ✓ | ✓ |
| **India** | ✓ | | ✓ | ✓ | ✓ | | ✓ |
| **Indonesia** | ✓ | | | ✓ | ✓ | ✓ | ✓ |
| **Russia** | ✓ | | | | | ✓ | |
| **S Africa** | ✓ | | | | | | |
| **Thailand** | | ✓ | | | | | |
| **Turkey** | ✓ | | | ✓ | | ✓ | ✓ |
| **Poland** | | ✓ | | | | ✓ | |

.Source: Based on IMF Discussion Note 14/09

# EM policy announcements are having a stabilizing effect

## Effect of Policy Announcement 1/

| | Pace of FX Depreciation | Equity Prices | Bond Yields |
|---|---|---|---|
| Liquidity Provision Measures | ✓ | ✗ | ✓ |
| Interest Rate Hike | ✓ | ✓ | ✓ |
| Tighter Fiscal Policy | ✓ | ✓ | ✓ |
| Removal of CFM on Inflows | ✓ | ✓ | ✓ |
| Macroprudential Policies | ✓ | ✓ | ✓ |

1/ Figures highlighted in yellow are not statistically significant.
Period May 2013-January 2014. Green check marks represent instances where policy actions had a dampening effect on the selected asset price. Red cross represent instances where policy actions did not have or had a worsening impact on the selected asset price.

# Conditions for effectiveness of FX intervention

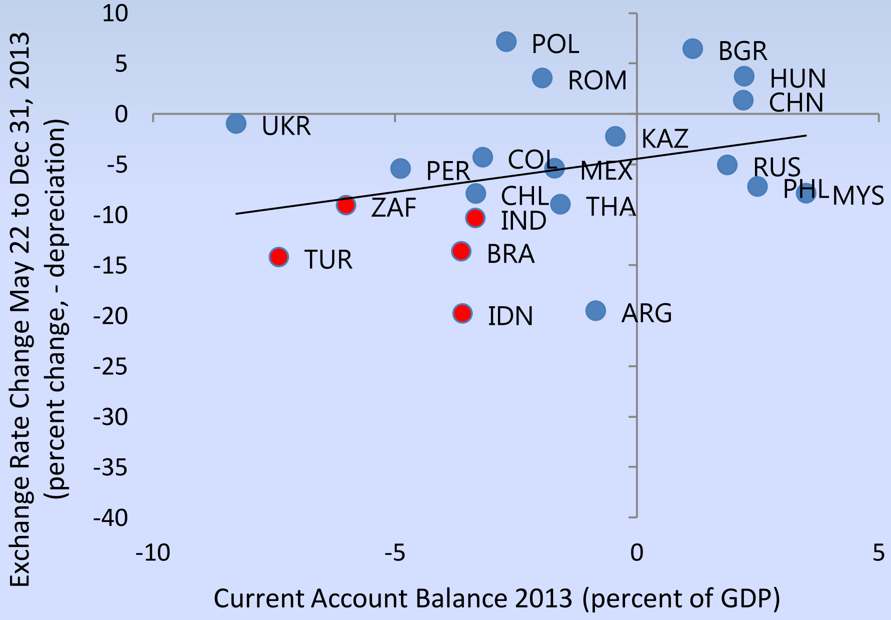
**FX intervention** helps slow the pace of depreciation when

- Low inflation
- Currency not overvalued
- Adequate reserves

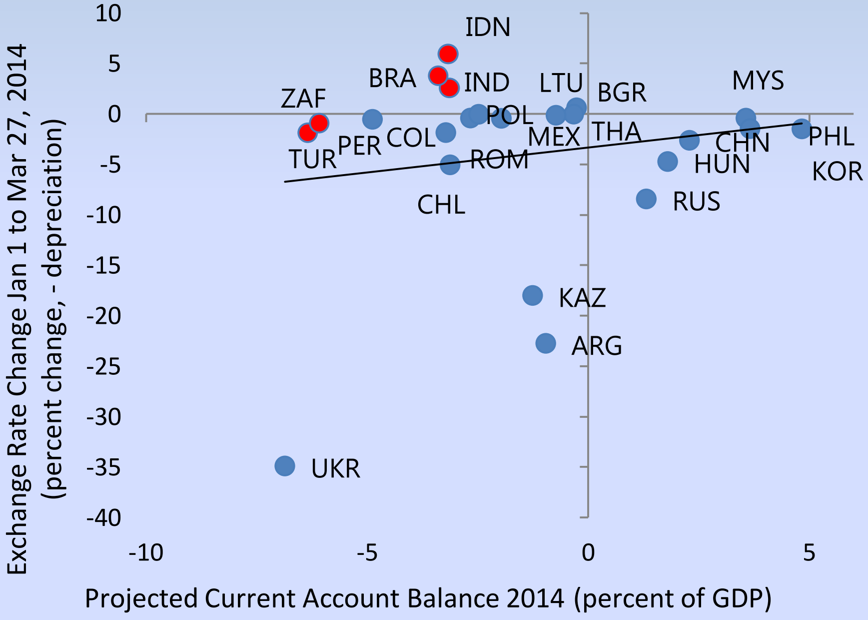
**Greater capital account openness** reduces effectiveness of FX intervention

# Strengthening macro-fundamentals matter

**Exchange Rate Change (May-Dec 2013) vs. CA Balance 2013**




**Exchange Rate Change (Jan-end-March 2014) vs. CA Balance 2014**



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# EMs: Lessons from current analysis (1)

**Volatility in EMs has reflected both domestic and external factors**:

- *Domestic factors: inflation, domestic GDP growth, foreign reserves, current account, fiscal balance, financial depth, Macro Prudential.*
- *External factors: normalization of U.S. monetary policy, EM growth slowdown, global market uncertainty.*

**Markets are differentiating across EMs, not only based on macroeconomic fundamentals and structural factors, but also policy frameworks**:

- *FX intervention can be stabilizing if fundamentals are good/reserves adequate.*
- *A deeper financial sector helps dampen shocks, though this could be partly offset by a larger share of foreign investor holdings.*
- *A more credible monetary framework may require smaller interest rate hikes.*



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# EMs: Lessons from current analysis (2)

**Policy responses by EMs in many cases appeared to be effective**:

- ⟹ *Liquidity provision in stressed markets is associated with lower volatility.*
- ⟹ *Monetary tightening tended to calm markets when inflation was high and above target.*
- ⟹ *Early policy action and reduction of imbalances helped dampen market reaction.*

# Korea: implications of QE exit (1)

- Limited direct impact from QE operations/announcements.
- Capital flows to Korean bonds have demonstrated a safe-haven behavior
- A growth-driven smooth QE exit, which leaves long-term US rates anchored and does not hurt investor confidence, is unlikely to cause capital outflows for Korea
  - It could even cause inflows to Korean equity and bank debt through positive signaling effects associated with an orderly steepening of the yield curve.

# Korea: implications of QE exit (2)

- Assessment points to Korea's possible graduation from a high capital flow beta country,
  - corroborated by impressive resilience of the won and asset prices to recent QE exit related global turmoil.
- While there is a need for continued vigilance,
  - Korea's sound macroeconomic fundamentals/policies should enable Korea to weather external shocks now much better than other countries.

# International Community: A Collaborative Approach

## UMP Countries:

- ✓ Clear communication and market guidance
- ✓ Minimize excess volatility in longer-term rates

## Enhance policy dialogue

- ➢Cooperation to mitigate policy spillovers
- ➢Greater dialogue between AE/EM financial regulators/supervisors to address cross border issues
- ➢Shared assessment of UMP unwinding implications.

## Enhance financing options

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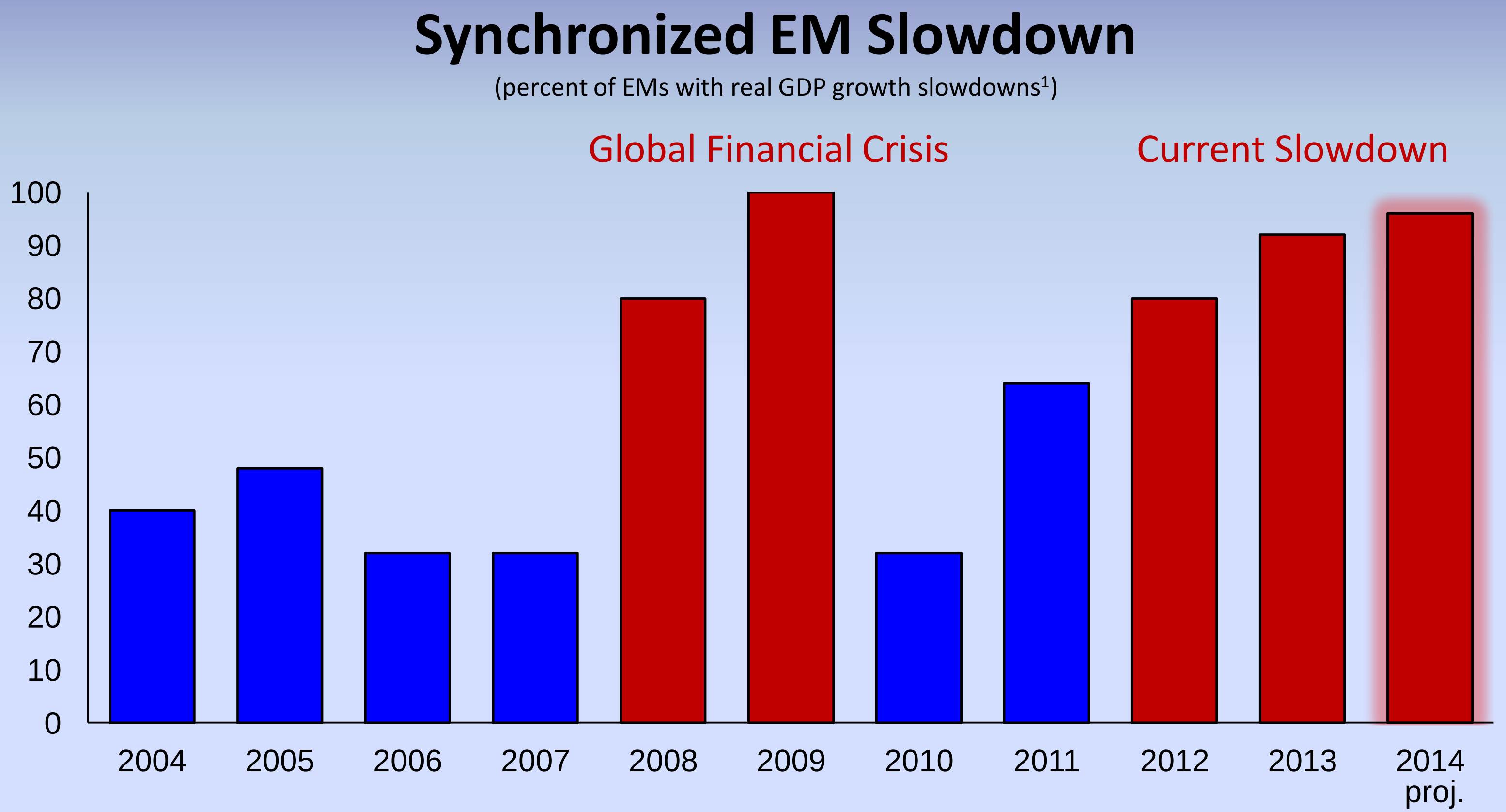
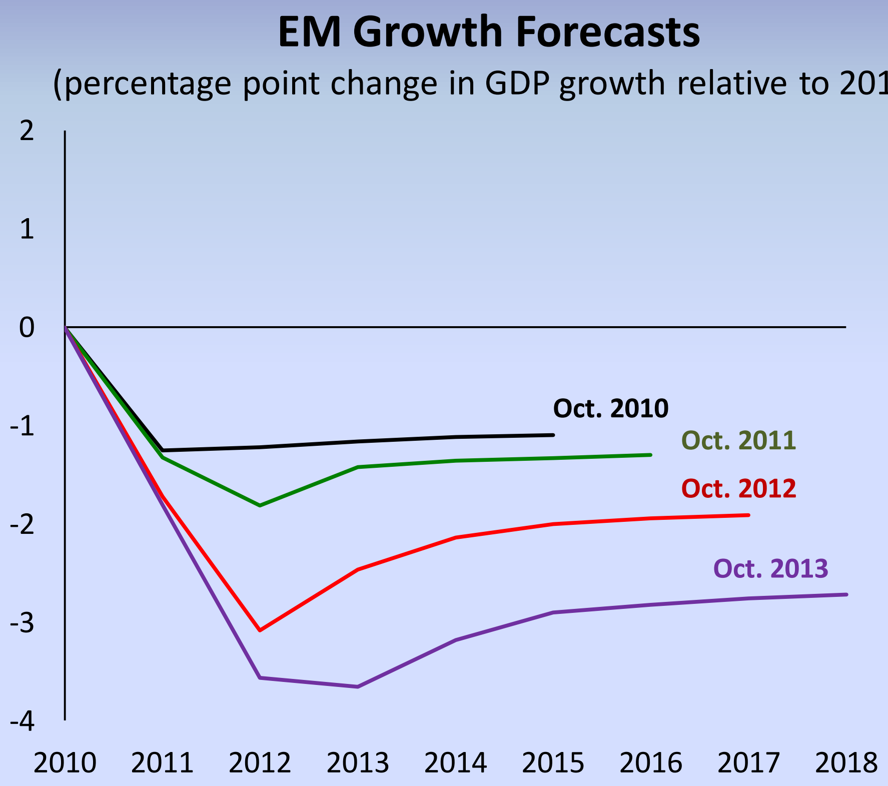
# EMs: Has there been a synchronized slowdown?




Sources: Based on successive IMF, World Economic Outlook Reports

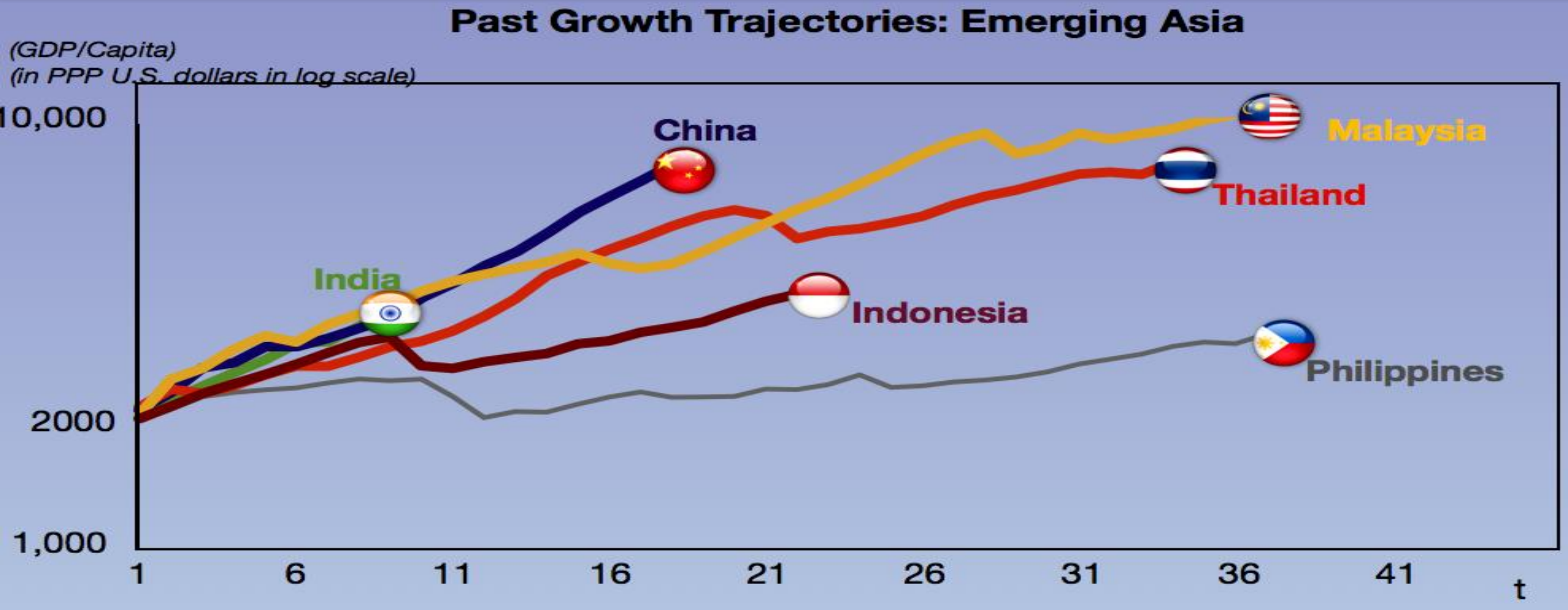
[1] Red bar denotes more than 70% of sample of emerging economies with real GDP growth below the 2003-2007 average.

# EMs growth projections: There has been successive markdowns



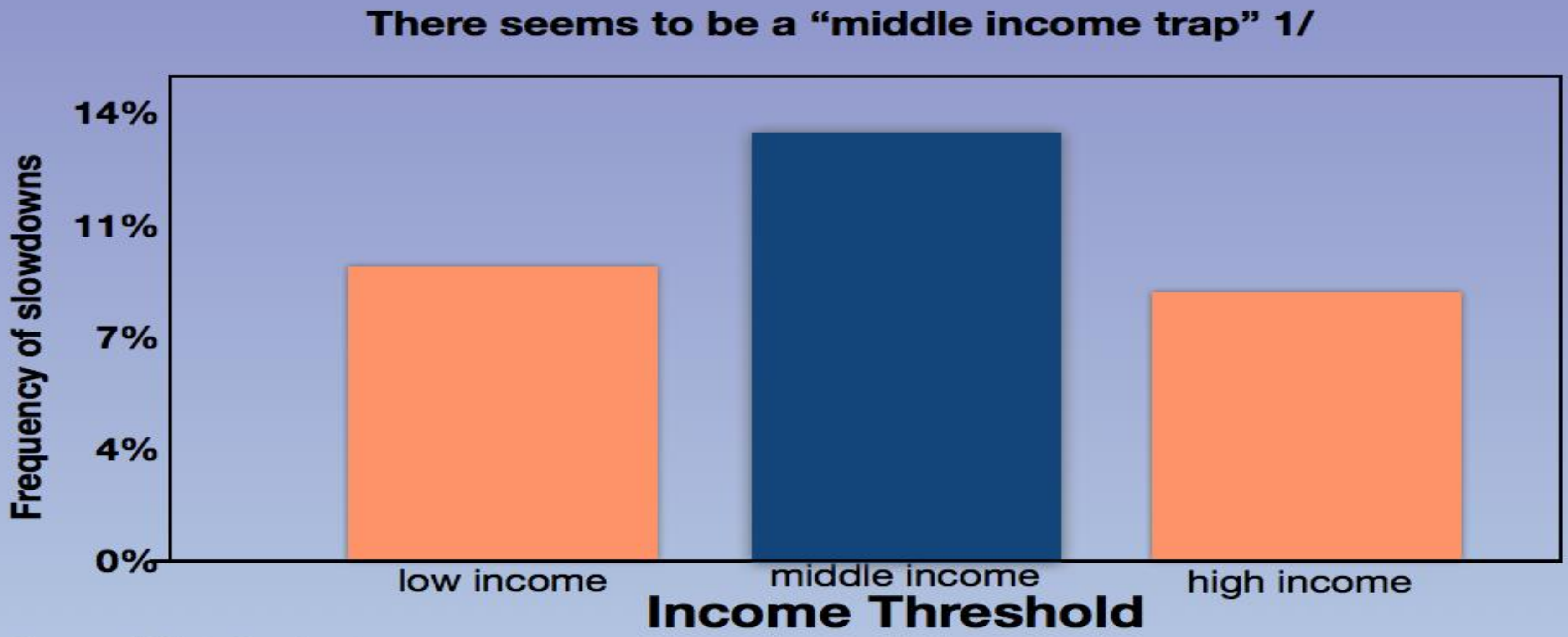

Source: Successive IMF World Economic Outlook Reports

# Have Asian EMs begun to face middle-income challenges?



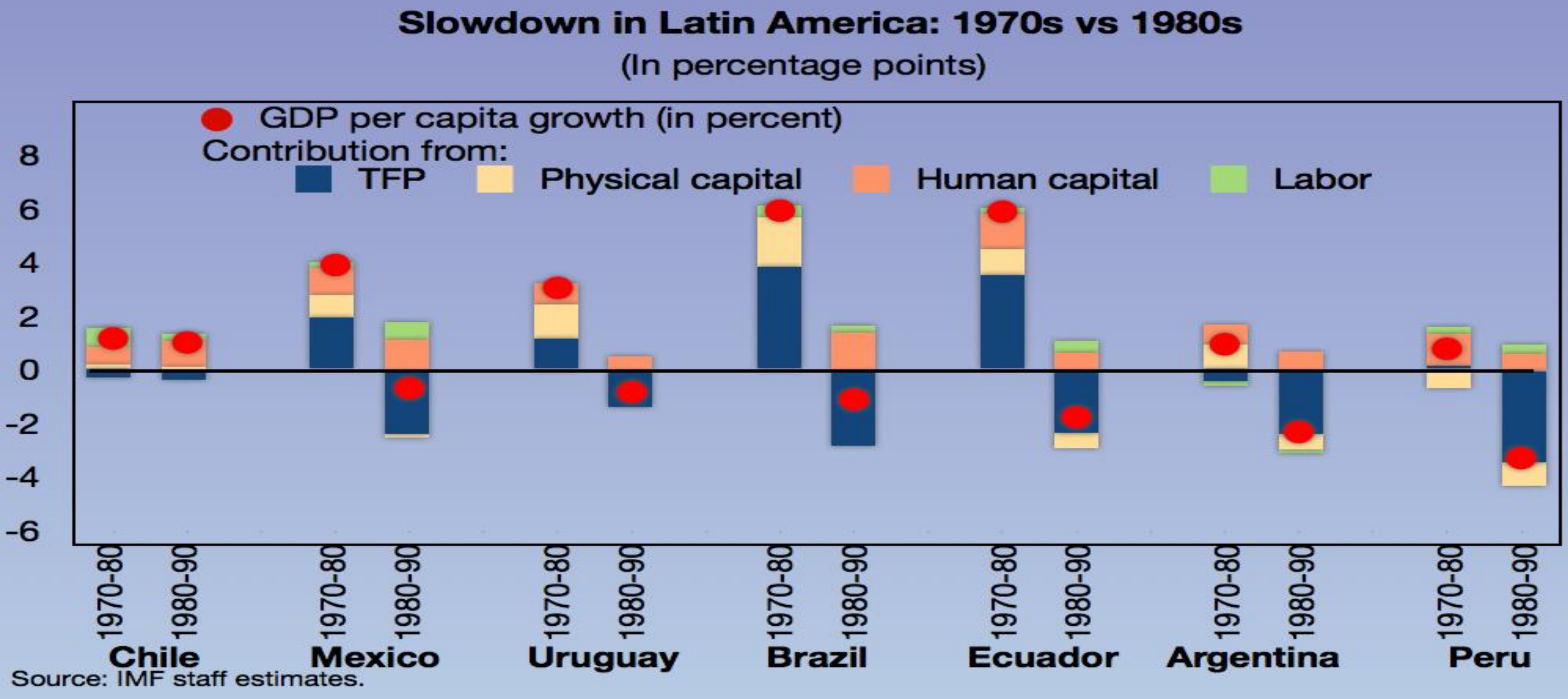

Sources: Penn World Table Version 7.1; IMF staff estimates.
Note: t=1 is defined as the year when the GDP/capita for a particular country reached US$ 2000 in PPP terms.

# Slowdowns are more frequent in middle-income economies

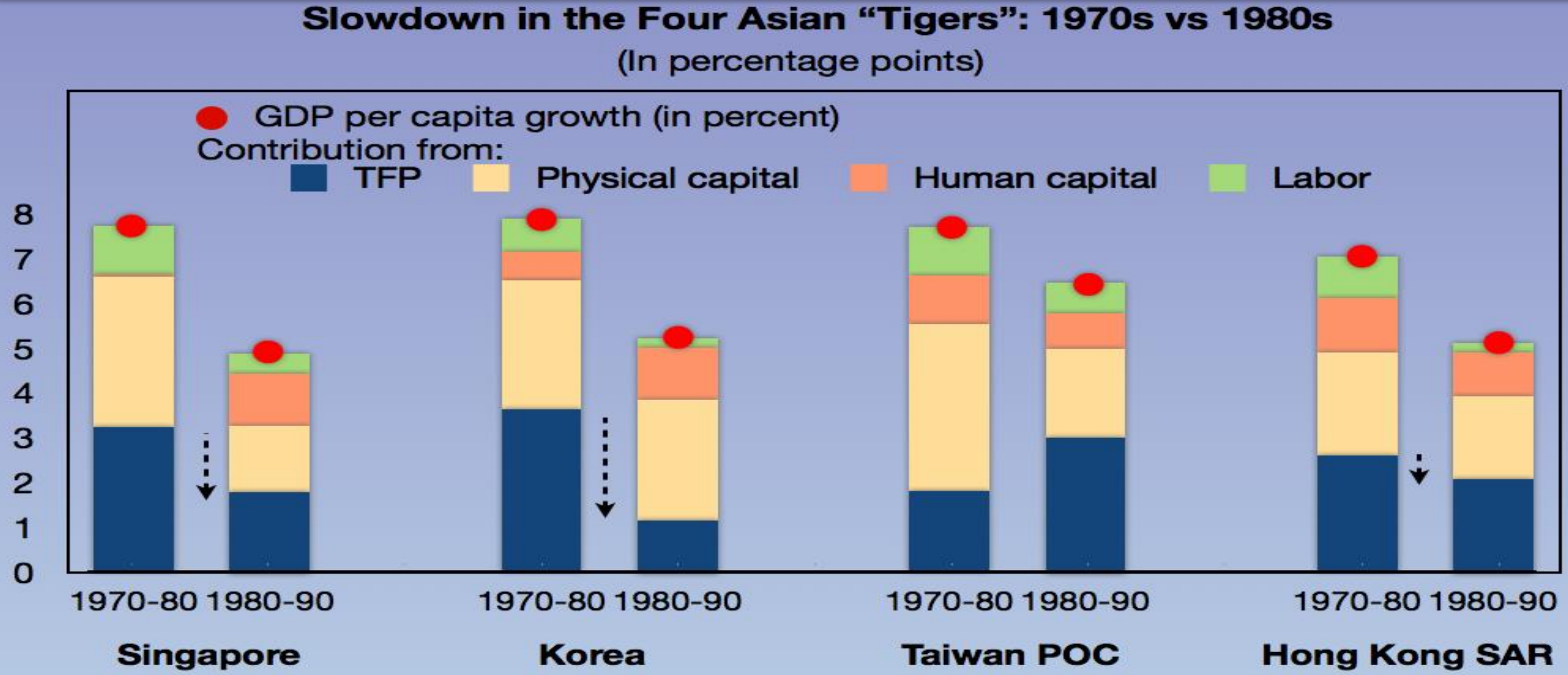



Source: IMF staff estimates.
1/ The figure considers a low income threshold of US$ 2,000 and a high income threshold of US$ 15,000 in PPP terms, but is robust to a range of alternative thresholds.

# Sustained slowdowns typically reflect slower TFP growth: Latin America during 1980s….



# Slowdown in TFP growth was much milder for Asian Tigers, after reaching middle-income status

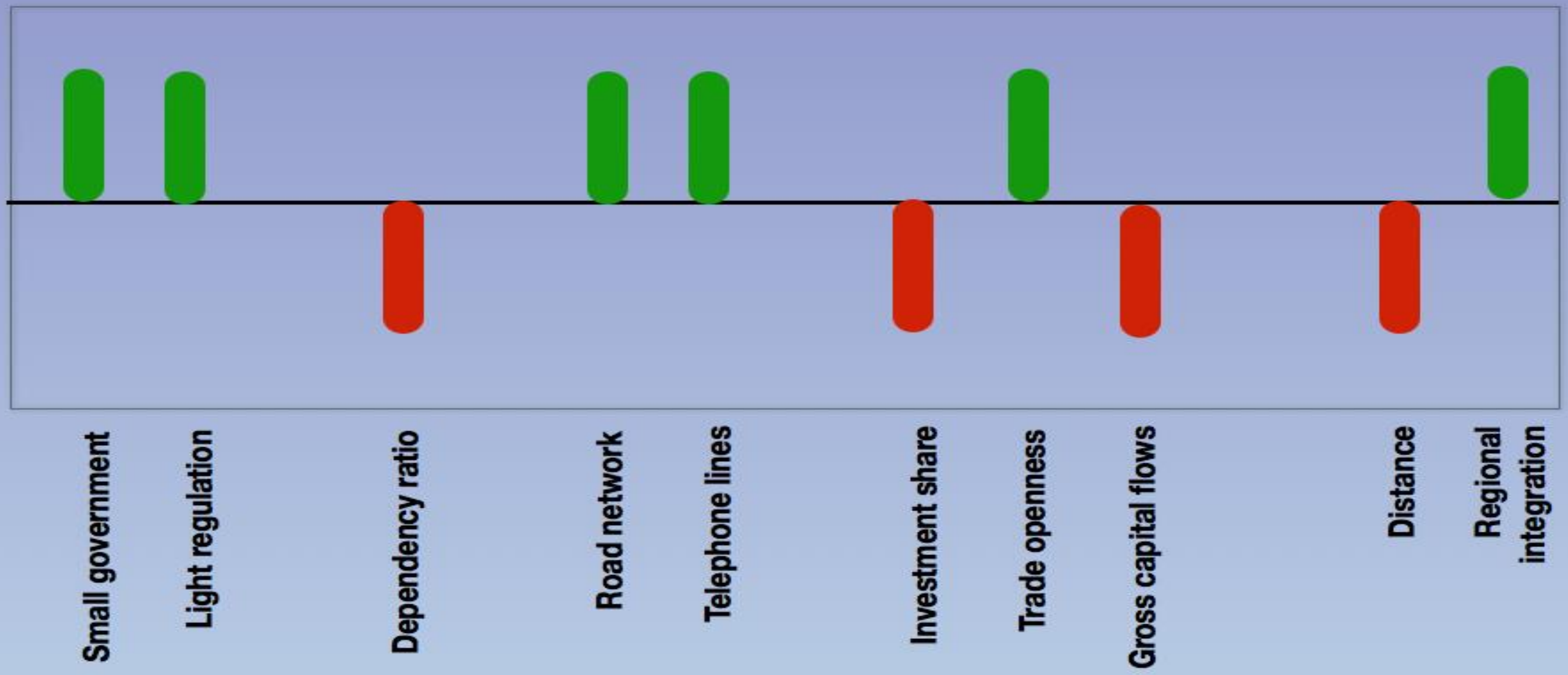


Source: IMF staff estimates.

# Drivers of trap: Institutions, demography, infrastructure, macro factors, trade structure…

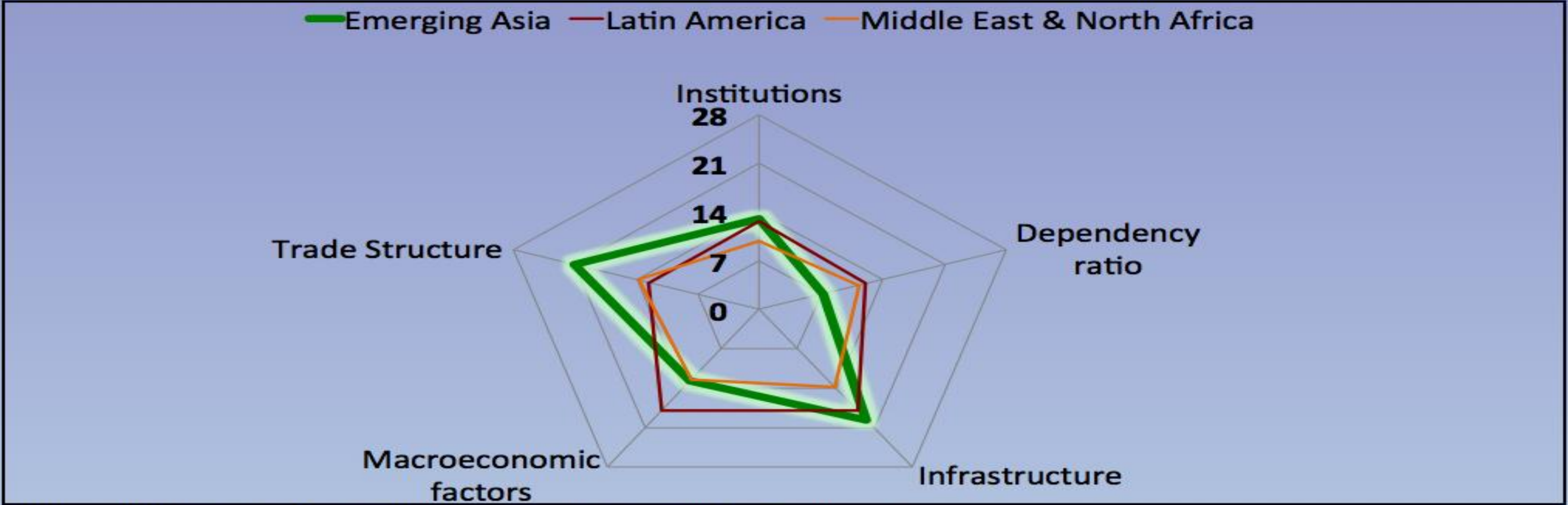
**The Impact of Changes in Fundamentals on the Probability of a Sustained Slowdown**

(Middle income sample; positive=significantly reducing the likelihood of a sustained slowdown)



# …and Asian MIEs fare on average somewhat better than in other regions…

**Strengths and Weaknesses of Asian MIEs Relative to other Emerging Regions**
(A higher rank indicates a lower risk of growth slowdown stemming from the examined category)



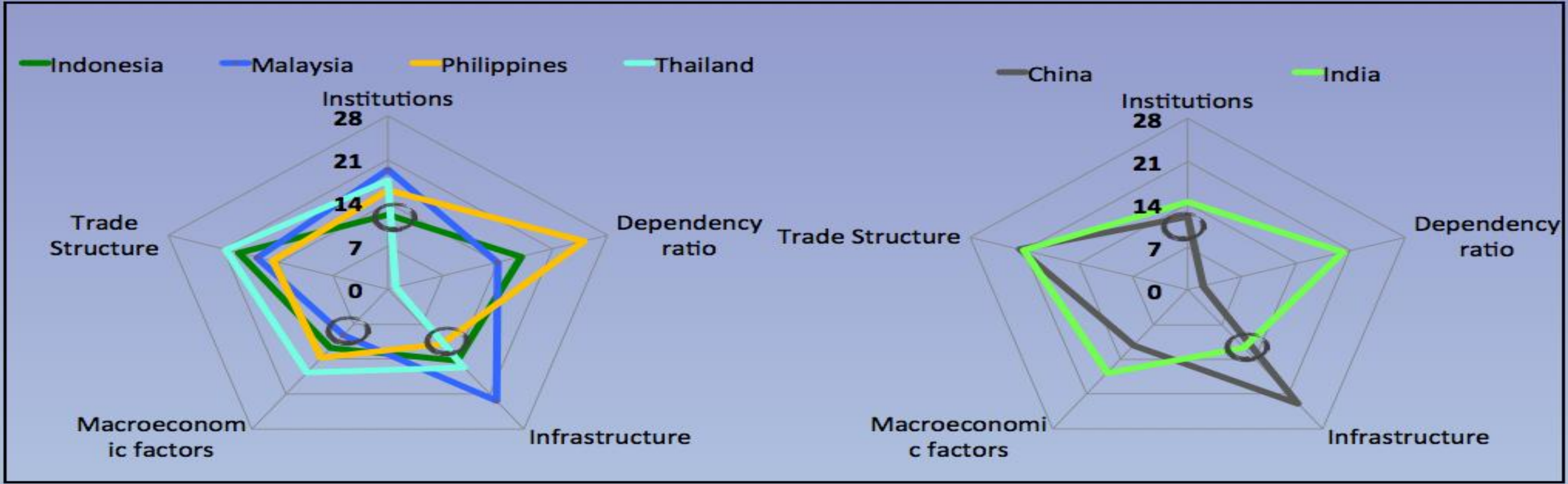

Sources: World Bank, World Development Indicators; IMF staff estimates.

*Institutions* includes small government involvement in the economy, strong rule of law and light regulation; Infrastructure includes telephone lines, power generating capacity, and road networks; *Macroeconomic factors* includes low gross capital inflows, the change over 2008-2012 in capital inflows and trade openness, and the (negative of the) change in the investment-to-GDP ratio; *Trade structure* includes strong regional integration and low GDP-weighted distance. Dependency ratio is the change between 2010 and 2050.

# …but strengths and weaknesses (and therefore risks of sustained slowdown) vary

**Strengths and Weaknesses of Asian MIEs**

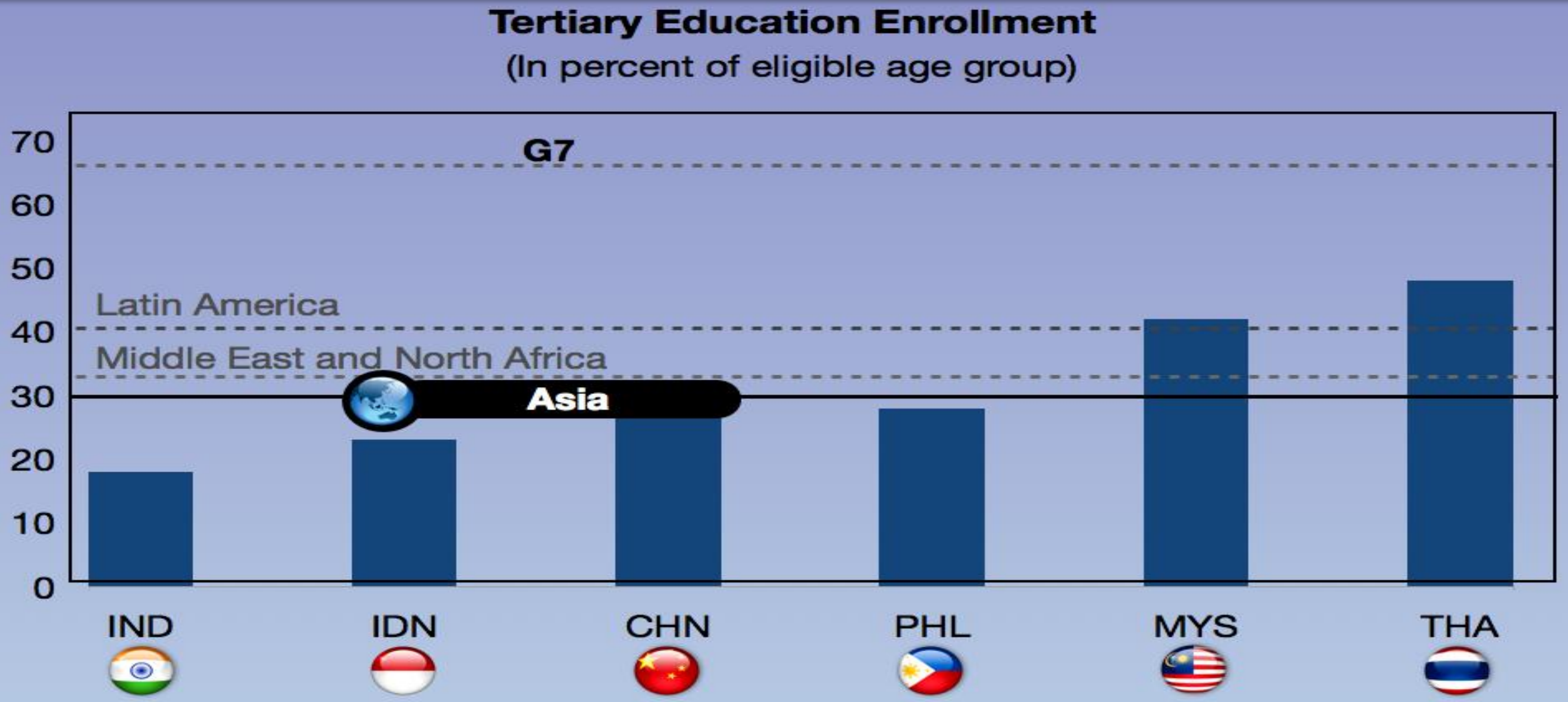
(A higher rank indicates a lower risk of growth slowdown stemming from the examined category)




Sources: World Bank, World Development Indicators; IMF staff estimates.

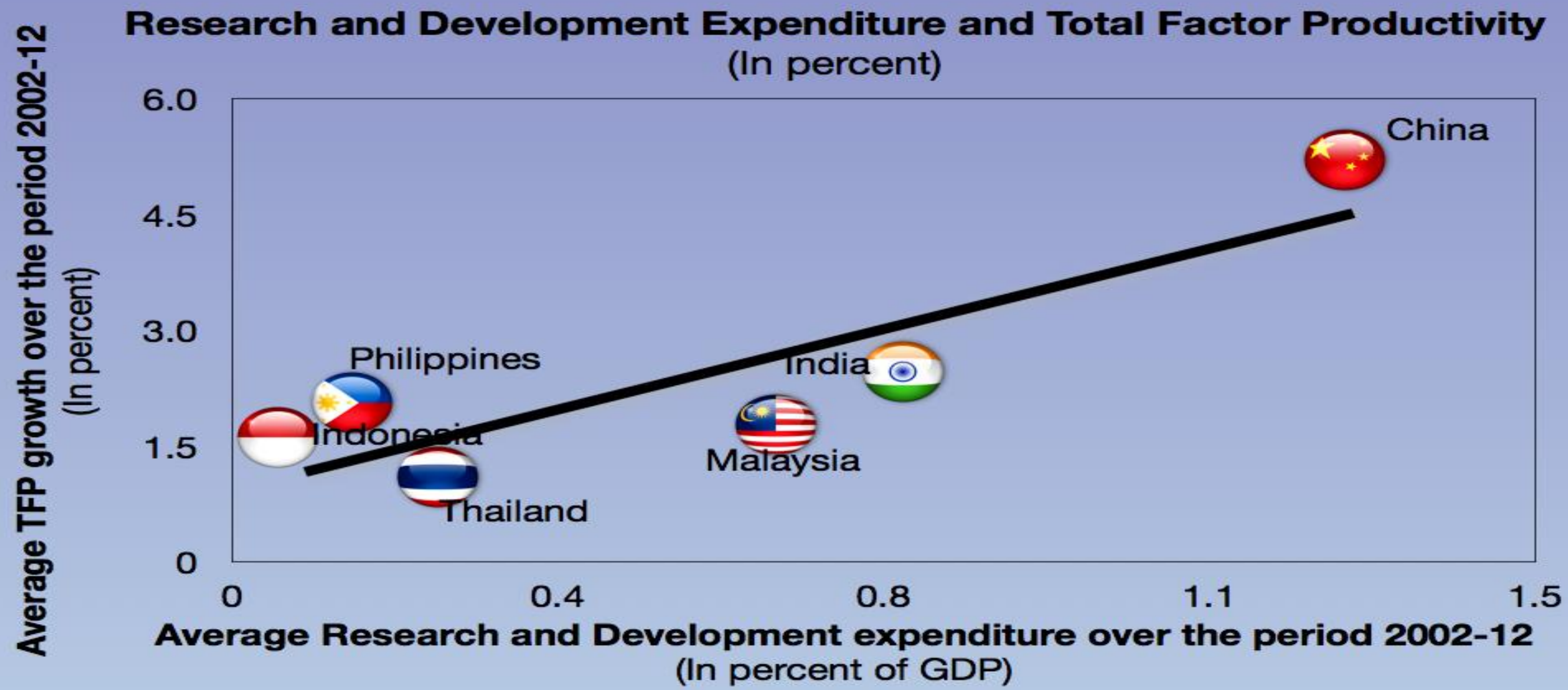
*Institutions* includes small government involvement in the economy, strong rule of law and light regulation; Infrastructure includes telephone lines, power generating capacity, and road networks; *Macroeconomic factors* includes low gross capital inflows, the change over 2008-2012 in capital inflows and trade openness, and the (negative of the) change in the investment-to-GDP ratio; *Trade structure* includes strong regional integration and low GDP-weighted distance.Dependency ratio is the change between 2010 and 2050.

# Other key growth drivers for middle-income economies: tertiary education…



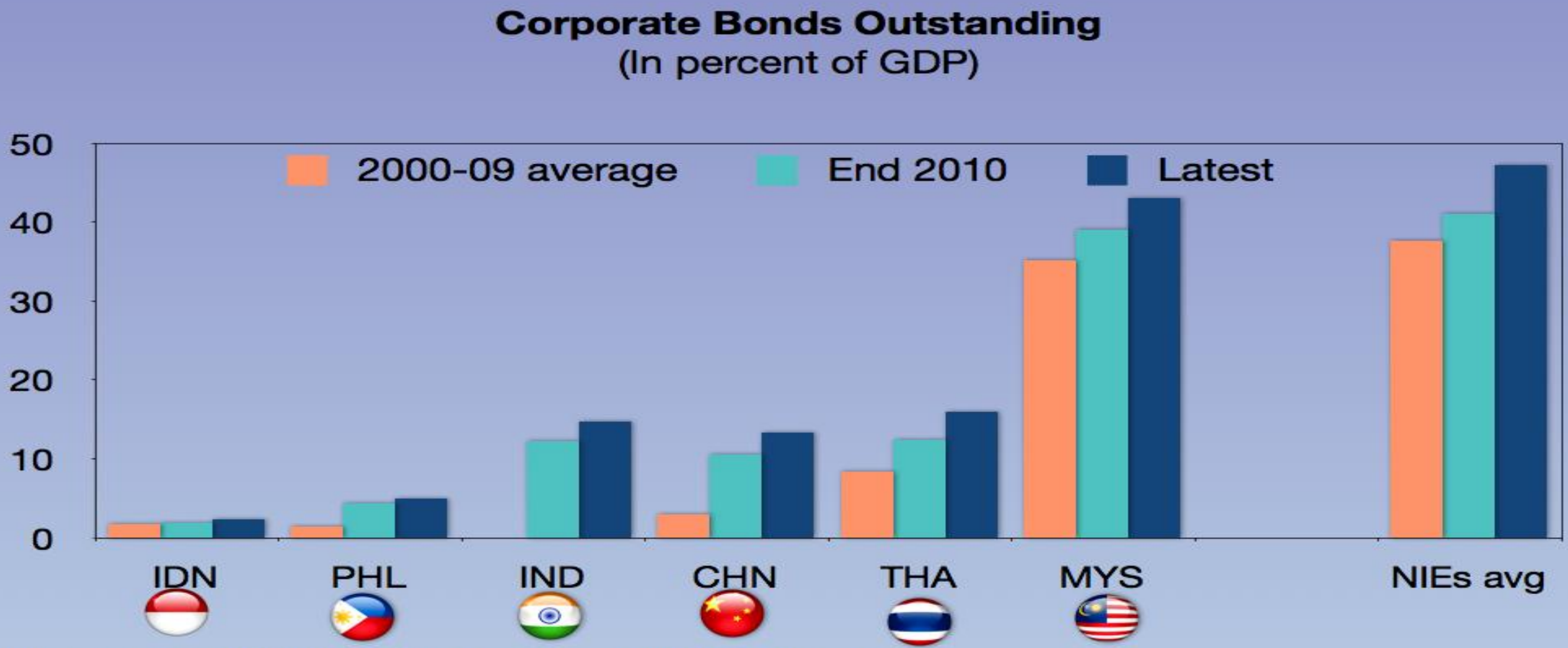

Sources: UNESCO databases; and IMF staff calculations.

# …and R&D expenditure.




Sources: World Bank, *World Development Indicators;* UNESCO databases; and IMF staff calculations.

# Financial deepening needed:
# To further spur growth and productivity




Sources: AsiaBondsOnline; CEIC data co. ltd; and IMF staff calculations.
Note: For India, the original source for amount outstanding is the Securities and Exchange Board of India.

# Key Implications for some Asian Reform Agendas

| Country | |
|---|---|
| **China** | Broad institutional reforms, some of which (e.g. financial reform) will rebalance the economy and reduce macro-economic risks. |
| **India** | Enhance infrastructure and improve economic institutions. |
| **Indonesia** | Improve economic institutions and infrastructure. |
| **Malaysia** | Macro-economic and structural policies need to remain geared towards stability given size and volatility of capital flows. |
| **Philippines** | Improve economic institutions including rule of law, as well as infrastructure. |
| **Thailand** | Still room for improvement on a broad front, including on infrastructure and institutions. |

# References


- Bowman David, Juan M. Londono, and Horacio Sapriza, 2014, ”U.S. Unconventional Monetary Policy and Transmission to Emerging Market Economies,” International Finance Discussion Papers, No. 1109, Board of Governors of the Federal Reserve System.
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