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Taper Tantrum 2.0 appears unlikely

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In 2020 the coronavirus pandemic led to a sharp drop in economic output – including in the US. However, that country surpassed the pre-crisis output level already in the second quarter of 2021. The advancing economic recovery has now prompted the US Federal Reserve to initiate a monetary policy reversal. The asset purchase programme will end in March 2022, and the Fed will start a cycle of key interest rate rises. It will also begin to reduce its balance sheet in the course of the year.

The monetary policy reversal in the world's largest economy will have repercussions for the global financial markets. It will place emerging economies at risk of capital outflows, as happened in 2013, with the possible consequence of a spike in volatility in the bond and currency markets.

However, the macroeconomic conditions of many emerging economies have improved significantly since 2013. Current-account deficits have been reduced and foreign currency reserves built up. Reductions in short-term foreign debt and credit growth have also made them less vulnerable. Nevertheless, the sharp rise in sovereign debt in some of the emerging economies reviewed here is cause for concern. Data on the fight against high inflation rates also paints a mixed picture.

Overall, however, in the past nine years the macroeconomic indicators examined in this study were found to have evolved overwhelmingly positively in five of the six economies surveyed. The only exception is Turkey, a country that appears to be significantly more vulnerable today than in 2013. The monetary policy reversal in the US has the potential to further exacerbate the already extremely tense macroeconomic situation there by driving further capital outflows from that country.

US initiates monetary policy reversal

The outbreak of the coronavirus pandemic led to a sharp drop in economic output in the US as well. But US gross domestic product started to expand again from mid-2020. The recovery was bolstered by an expansionary monetary and fiscal policy. US economic output exceeded the pre-crisis level already in the second quarter of 2021. The economy can be expected to be back on the pre-crisis growth path by the end of 2022. The economic recovery has led to rising employment levels and inflation rates well over the Fed's two-per cent target. Significant progress towards fulfilling the Fed's mandate of price stability and maximum employment have prompted it to initiate the monetary policy reversal. The asset purchase programme will end in March 2022, and the Fed will start a cycle of key interest rate rises. It will also begin to reduce its balance sheet in the course of the year.

Memories of the 2013 taper tantrum are returning

The monetary policy reversal in the world's largest economy will have repercussions for the global financial markets. The taper tantrum of the year 2013 remains unforgotten. At the time, the unexpected announcement by then Fed Chairman Ben Bernanke that he might soon reduce the bond purchases led to sharply rising yields on US government bonds. Capital flows to the US and an appreciation of the US dollar were the consequence. By contrast, the currencies as well as the stock and bond markets of emerging and developing countries came under pressure.

The current tapering (reduction of bond purchases) is nearly completed, but concerns remain that the subsequent interest rate reversal and reduction in the Fed balance sheet could lead to similar distortions in the financial markets of developing and emerging economies as those that were observed in 2013.

Assessing the situation using macroeconomic indicators

Following the distortions nine years ago, the US Federal Reserve examined a range of macroeconomic indicators to find out which of them were best suited for assessing the vulnerabilities of individual emerging economies.[1] The six indicators identified as being particularly predictive include current account balance, foreign currency reserves, short-term foreign debt, sovereign debt, inflation and credit growth. In a study from the year 2014 the IMF listed very similar macroeconomic indicators that help to demonstrate vulnerabilities in the course of a US monetary policy reversal. [2] In this study we examine the indicators identified by the Fed for six selected countries.

Fragile five plus one

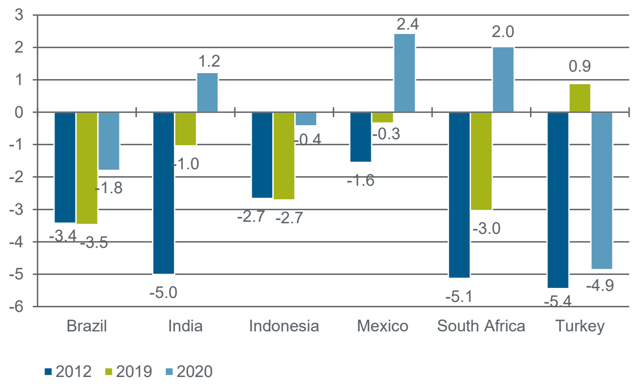
In 2013 Morgan Stanley coined the term 'Fragile Five', which stands for those economies that had proven particularly vulnerable in the course of the Taper Tantrum. These are India, Indonesia, Turkey, Brazil and South Africa. The list was updated in 2016, with Mexico added to the group of vulnerable countries. This study therefore examines the macroeconomic situation of the original 'Fragile Five' plus Mexico.

Current accounts are now more balanced than in 2012

Countries that depend heavily on international capital inflows are particularly vulnerable in episodes of large capital outflows. The current account balance demonstrates such dependence. A current account deficit reflects a net inflow of foreign capital. The higher the deficit, the greater the risk of uncontrolled depreciation of the local currency in the event of a reversal of capital flows. In the lead-up to the Taper Tantrum of 2013 all six economies examined in this study had a current account deficit (Figure 1). In 2012 the deficit in India was 5.0% of GDP, and in Turkey and South Africa it was as high as 5.4% and 5.1% respectively. All six countries have been able to reduce their deficits in the past years. In 2020 India, Mexico and South Africa even had a current account surplus. Turkey was the only country with a 4.9% deficit two years ago. It must be kept in mind, however, that the current account balances were heavily influenced by the coronavirus pandemic in 2020. Declining domestic demand has reduced imports in many emerging economies, resulting in a lower current account deficit. The variation between 2012 and the pre-crisis year 2019 shows that net foreign capital inflows were still reduced for India, Mexico and South Africa. Brazil and Indonesia, on the other hand, did not experience any significant change between 2012 and 2019. In 2019 Turkey recorded its first current account surplus in 18 years, but it was short-lived. On average, the situation in the countries under review stabilised. The average current-account deficit of the six economies decreased from 3.9% in 2012 to 1.6% in 2019 and 0.2% in 2020. That means they have become less dependent on foreign capital inflows.

Figure 1: Current account balances

In per cent of GDP



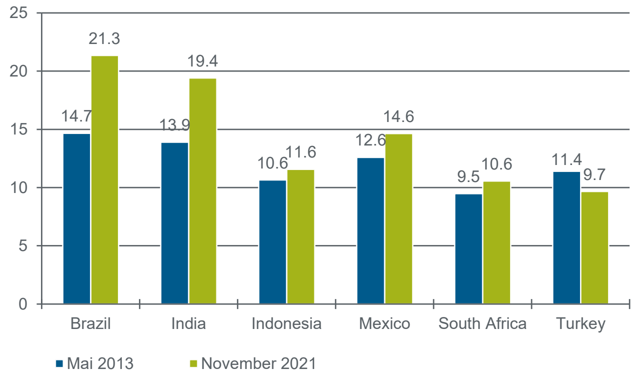
Source: World Bank

Currency reserves were expanded

A further indicator used to assess the vulnerabilities of the emerging economies is their foreign currency reserves. Higher reserves enable the central bank to intervene in the market more comprehensively in times of crisis in order to stabilise the domestic currency. In May 2013 the reserves in the six countries under review were between 9.5% and 14.7% of GDP (Figure 2). They have grown significantly in the past nine years. Brazil and India have expanded their reserves particularly strongly. Foreign currency reserves have also been increased in Indonesia, Mexico and South Africa. Turkey is once again the sole exception. Its reserves fell from 11.4% in May 2013 to 9.7% in November 2021. How high a central bank's foreign currency reserves should be in a best-case scenario depends upon, among other things, the foreign debt level of the relevant economy.

Figure 2: Currency reserves

In per cent of GDP



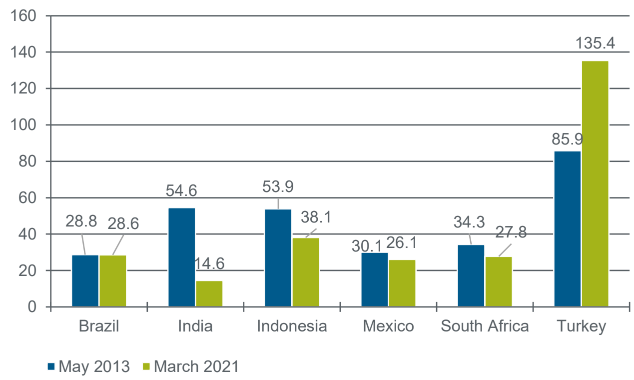
Sources: World Bank, IMF

Foreign debt is a particular problem in Turkey

The volume of debt repayments due to non-residents in the next 12 months is a useful measure for assessing how quickly an economy can run into trouble when external borrowing options deteriorate. Foreign lenders quickly with-draw capital in times of crisis, and debts are often denomi-nated in foreign currency. Short-term foreign debt is measured against the foreign currency reserves that could be used to service foreign debt in an emergency. According to the 'Greenspan-Guidotti rule'[3] the currency reserves should be at least equivalent to the sum of all foreign debt payable within a year. While Brazil, India, Indonesia, Mexico and South Africa have been able to reduce the short-term foreign debt in relation to their reserves since 2013, dependencies in Turkey have grown very substantially (Figure 3). According to the 'Greenspan-Guidotti rule', Turkey's short-term foreign debt is currently 135% of its foreign currency reserves, which is much too high.

Figure 3: Short-term foreign debt

In per cent of currency reserves



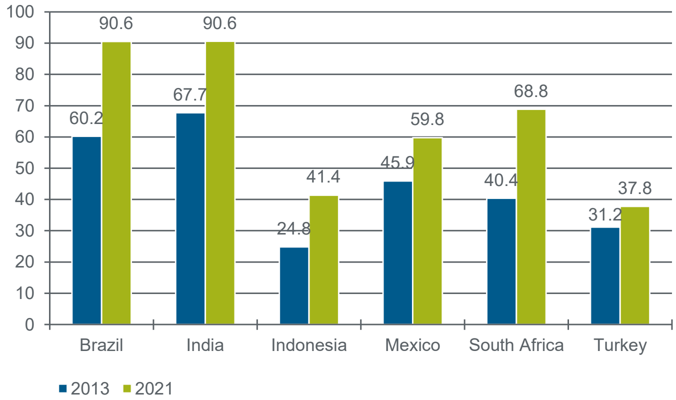
Sources: Joint External Hub, IMF

Sovereign debt was high already before the crisis

Rising interest rates make it more difficult to service existing debt. Interest rate rises due to capital outflows therefore tend to lead to greater problems in countries with a higher degree of indebtedness. Sovereign debt levels as a percentage of GDP have grown significantly in all six countries under review. Average sovereign debt as a percentage of GDP grew from 45% to 65% for the countries under review between January 2013 and April 2021 (Figure 4). The coronavirus pandemic and the fiscal policy support measures have accelerated this trend even more. Not only did the pandemic require higher public expenditure; the difficult economic situation also led to lower tax revenues. This development has negatively influenced debt sustainability.

Figure 4: Sovereign debt

In per cent of GDP



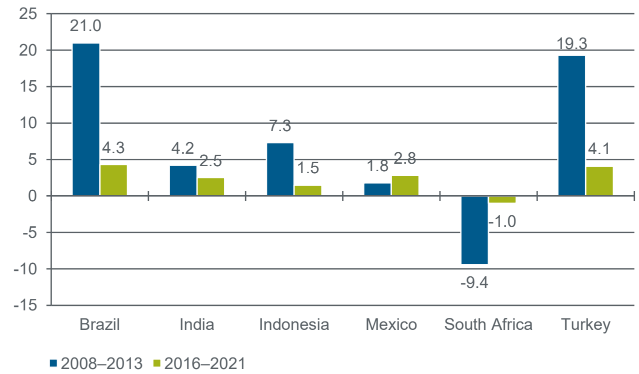
Sources: IMF

Credit growth has weakened

In order to assess the financial vulnerabilities of an economy we must consider not just sovereign debt but private sector debt as well. The Fed therefore uses the ratio of credit growth to GDP as a further indicator. In the five years preceding the Taper Tantrum (January 2008 to January 2013) the volume of bank loans in relation to GDP grew by just under 20 percentage points in Brazil and Turkey (Figure 5). Between early 2016 and early 2021, however, credit growth turned out significantly lower, and in South Africa the borrowing to GDP ratio even contracted during that period. Only Mexico experienced a minor increase. In January 2021 bank loans made up 21% of GDP, which was still on quite a low level. Among the six countries under review, bank loans as a percentage of GDP were highest in Brazil, at just under 70%, followed by South Africa and Turkey with just over 60% each.

Figure 5: Credit growth

Variation of loans extended to the private sector as a percentage of GDP



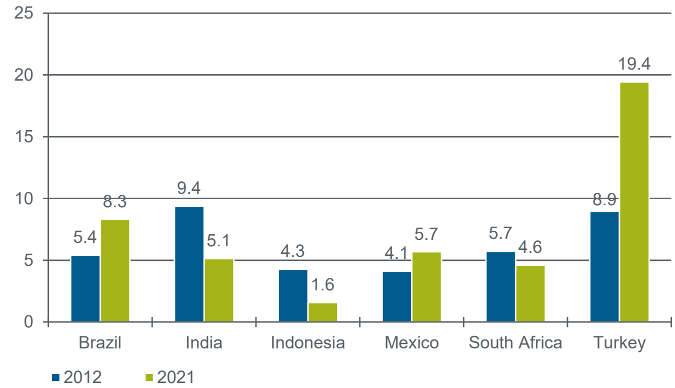
Sources: BIS

Inflation has grown, particularly in Turkey

Rising interest rates in the US could lead to capital outflows from emerging economies and weaker domestic currencies. A currency weakness makes imports more costly and drives inflation. This may lead to problems particularly in countries that are already facing a possible crisis and struggling with a high inflation rate. The average inflation rate in the six countries under review was 6.3% in 2012 and 7.4% in 2021. Whereas price increases in India, Indonesia and South Africa ended up being more moderate in 2021 than in 2012, they have accelerated again in Brazil and Mexico and, most notably, in Turkey. The inflation rate there was nearly 20% in 2021, more than twice as high as in the other five countries examined.

Figure 6: Inflation

In per cent



Source: IMF

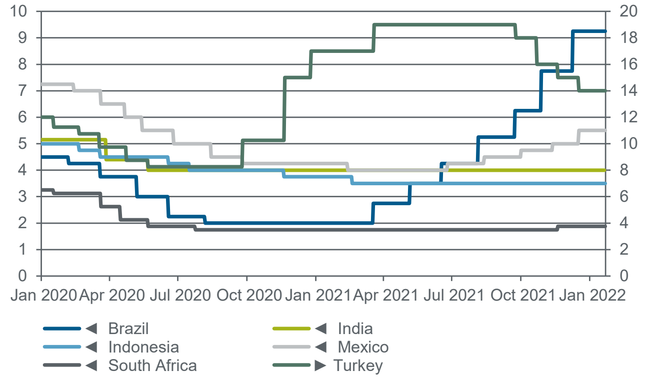
Access to COVID-19 vaccines would help synchronise the global economic recovery

Capital outflows from emerging economies are driven by an interest rate differential vis-a-vis the US. The central banks of emerging economies therefore have the possibility to preempt key interest rate hikes in the US to prop up the local currency. The monetary policy reversal has already been initiated in countries such as Mexico, Brazil and South Africa (Figure 7). Turkey's central bank, however, implemented multiple key interest rate reductions even though inflation recently hit 35% and the currency depreciated sharply last year. That has even exacerbated the risk of a balance of payments crisis and a further devaluation of the Turkish lira.

Several central banks in the emerging countries are still reluctant to tighten monetary policy as they do not want to risk choking off their economic recovery. A cycle of key interest rate increases therefore cannot be synchronised between the industrialised and emerging economies unless their economic recovery also runs simultaneously. But that is currently not the case. Greater availability of vaccines in the industrialised countries is instrumental to overcoming the coronavirus crisis more quickly. This uneven global economic recovery is increasing the risk of capital flows to the industrialised countries. Providing sufficient access to COVID-19 vaccines for emerging and developing countries would thus contribute to preventing further disparities in economic recovery rates and, consequently, possible distortions in the emerging economies' financial markets.

Figure 7: Key interest rates

In per cent



Source: Central bank of relevant country

Macroeconomic situation generally more stable than in 2013

In summary, the emerging economies under review are today in a more stable macroeconomic position than they were in the lead-up to the Taper Tantrum in 2013. The sole exception is Turkey, which has deteriorated in the past nine years in almost all the indicators examined. By contrast, India and Indonesia have proven to be significantly less vulnerable, having been able to make progress in most indicators. The only cause for concern in all economies under review is sovereign debt, which has grown very significantly in some cases. That development has been exacerbated even more by the coronavirus crisis.

Conclusion: 2022 is not 2013

Apart from an improved macroeconomic position, there are other reasons that currently make a surge in volatility in the global financial markets such as that observed in 2013 appear unlikely. The Fed has learned from its past mistakes. The current monetary policy reversal was initiated with great caution. The market stakeholders were gradually prepared for the beginning of the tapering. The announcement to stop net bond purchases from March 2022 has therefore only led to a subdued response from the markets. The approach of the US Federal Reserve has so far been communicated very clearly and early. This is likely to remain the case in 2022 as well. This year's key interest rate increases and the reduction of the Fed balance sheet will lead to rising interest rates in the US, with the likely consequence of capital outflows from emerging economies. However, all economies examined in this study with the exception of Turkey appear to be better prepared for such a case than in 2013. It must also be noted that the monetary policy reversal in the US is driven by a return to strength in the world's largest economy after the coronavirus crisis. The advancing economic recovery also brings positive aspects for emerging and developing countries in the form of improved sales opportunities. Of the countries examined in this study, Mexico in particular maintains very close trade relations with the US. Besides, the economic recovery of the industrialised nations also benefits the commodities exporters among the emerging economies such as Brazil and South Africa. But there is another side to this coin. The recent sharp oil price increase driven by the recovery in the industrialised countries will significantly weigh on the current account balances of Turkey, South Africa and India, for example.

[1] Cf. Ahmed, S. (2017): International Financial Spillovers to Emerging Market Economies: How Important Are Economic Fundamentals? https://www.bostonfed.org/publications/risk-and-policy-analysis/2017/international-financial-spillovers.aspx

[2] Cf. Sahay, R., Arora, V. B., Arvanitis, T., Faruqee, H., N'Diaye, P., and Griffoli, T. M.. (2014): Emerging Market Volatility: Lessons from the Taper Tantrum. IMF Staff Discussion Notes No. 14/9. https://www.imf.org/external/pubs/ft/sdn/2014/sdn1409.pdf

[3] Cf. Greenspan, A. (1999):Currency Reserves and Debt. The Federal Reserve Board. https://www.federalreserve.gov/BoardDocs/Speeches/1999/19990429.htm