EMERGING MARKETS AT CROSSROADS

- Abhimanyu Gupta[1]

I. INTRODUCTION

If Earth is Gods' canvas, he took a white brush and painted the canvas blank to draw a fresh picture anew, a much better version of the former.

Businesses will reshape, skill sets will drift to the new demand landscape post crisis. Every crisis has changed the way we work, travel and evolve, this will be just more severe and prolonged in terms of ripples that would follow in the coming years. To put things in perspective, with just some days under mandatory work from home, companies and governments have started rethinking operational capacities and business models.

It will be a tough ride for the Emerging Markets, quick and strong revival is all they hope for. Lack of proper medical infrastructure and paucity of resources makes them vulnerable to financial and economic dislocations. With dollar strengthening, their dollar borrowings become expensive in times when they need maximum foreign financing. Colossal capital outflows and hostile foreign takeovers is another hanging sword. But the light at the end of the tunnel, is the latest positive growth

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projections made by IMF for India and China, the outliers to the negative growth world in 2020. There have been widespread and frantic efforts by Central Banks to rescue economies and prevent or delay an economic recession. With a large pie of the population engaged in the MSME and unorganized sector, government fears the fallout of this segment and thus steps have been taken to fund their businesses and keep them afloat.

We assess the implications of the unprecedented foray into the Quantitative Easing (QE) by the EM Central Banks (CB). The COVID-19 shock led to significant tightening in global financial conditions, which could not be offset by rate cuts and liquidity-easing measures in EM. With concerns also growing about the funding of fiscal deficits, this pulled EM central banks into the world of QE.

II. THE DEVELOPED MARKET (DM) EXPERIENCE

A. What can we learn from QE in developed markets?

When the US first did QE in 2009, there were two big concerns: ‘currency debasement and runaway inflation’. Neither materialized in the long term. The Euro area and Japan also had similar experiences with QE. In fact, the common denominator across DM has been the “Japanification” of yields. Currency debasement is the key concern, and EM currencies are at a disadvantage since they are not used in FX reserves, unlike the major DMs. Moreover, FX losses might occur even without a pickup in inflation. We believe EM central banks will have to unwind QE before their DM counterparts. This could require global policy coordination, and might only by possible if the public-health crisis remains contained in EM.

Exhibit 1: Unconventional monetary policy in emerging markets

B. COVID brings QE to emerging markets

The shock from the COVID-19 outbreak has been so large that outflows from EM Asia (ex-China) have surpassed global financial crisis (GFC) outflows (Chart 1). This has led to a tightening in financial conditions. In response, emerging Asia central banks have gone into overdrive, adopting strong liquidity easing measures coupled with monetary easing. The urgent need for fiscal stimulus has also significantly strained government balance sheets, leading to “unthinkable” widening in fiscal deficits. For example, Indonesia relaxed its budget deficit cap of 3% of GDP for 2020-22 and is now looking at a potential deficit of 5.1% of GDP deficit this year. EM central banks have responded by attempting to fund their governments’ expenditures to manage the health and economic crisis. In this note, we discuss: (1) what EM central banks have announced in terms of funding government deficits, with a focus on EM Asia, (2) how their plans compare to DM central bank actions, i.e. traditional QE, and (3) the potential implications for markets, including the end game.

III. EM ANNOUNCEMENTS ON LIQUIDITY SUPPORT

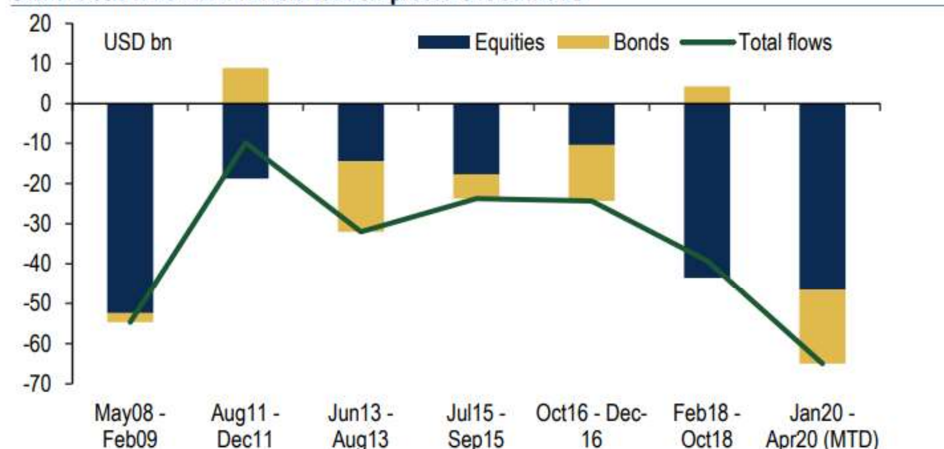

Chart 1: Outflows from EM Asia have surpassed GFC outflows

Source: Bloomberg. Note: Equity flows include data on India, Indonesia, Korea, Philippines, Taiwan and Thailand. Bond flows include data on India, Indonesia, Malaysia, Philippines, Thailand and Korea (only KTB).

Most central banks have eased reserve requirements, initiated bond buyback operations in the secondary market and unveiled long-term repo operations. Some have announced QE. Others could seek ways to directly buy bonds from the government in the primary market. Below we detail the measures taken by the major EM Asia central banks.

A. India – Been there, done that. But no explicit announcement

The Reserve Bank of India (RBI) bought bonds directly from the government in 2002. Since the FRBM (Fiscal Responsibility and Budget Management) Act came into effect in 2003, the RBI has not bought bonds directly from the government even though it has undertaken large-scale open-market operations involving bonds for many years. Even though the RBI has not made any explicit announcement, partial funding of the fiscal deficit through the RBI is almost inevitable, in our view. A clause in the FRBM Act allows the RBI to do this without seeking special approval from the government.

B. Korea, Thailand – Will do if needed

The Bank of Korea has so far conducted one open-market operation (about USD 1.2bn) in the last month and announced another in the last policy meeting. Both involve bond purchases in the secondary market. The Bank of Thailand (BoT) has bought over USD 6bn worth of bonds (exceeding outflows worth USD 2-3bn) since the beginning of March to prevent bond yields from rising. So far, neither of these banks has said anything about buying bonds directly from the government if needed. That said, there are currently no laws in place that prohibit the BoT from buying bonds in the primary market.

C. China – No need to do it

The People's Bank of China (PBoC) is not allowed to purchase government bonds in the primary market. The PBoC conducted cash bond transactions in the secondary market during the early 2000s to manage liquidity, but this measure has become less popular in recent years as more liquidity management tools have been created. However, the PBoC does actively facilitate absorption of high government bond issuance through liquidity injections (for instance, reserve ratio requirement [RRR] cuts) and window guidance.

IV. HOW THINGS FARED IN DMS?

QE typically includes government bonds but it can cover other instruments as well. For example, agency mortgage-backed securities (MBS) have been included in both the Fed's current package and its measures after the financial crisis. European Central Bank (ECB) QE covers corporate bonds. The Bank of Japan (BoJ) has gone the furthest,

purchasing equity exchange traded funds (ETFs). QE does not include measures to support market liquidity. For example, the Fed is using its Section 13(3) emergency powers to purchase investment grade corporate-bond ETFs, some high-yield bonds, commercial paper, municipal bonds and other assets. These actions are NOT considered part of QE. The dynamics of QE in DMs are debated over its long seen impact on the inflation and currency valuations. The lessons are similar from other developed markets. Inflation continues to undershoot in the Euro area and Japan despite aggressive central bank asset purchases. Currency weakness has not been a major concern in either region. The BoJ has even instituted yield curve control, which is similar to QE except that the central bank targets prices rather than purchase quantities. Even this measure has not created a surge in inflation. In summary, the cost of QE in developed markets has somewhat counterintuitively been a step closer to "Japanification": sustained zero or negative policy rates, flat yield curves, falling inflation expectations and depletion of central bank ammunition.

V. WHAT MOTIVATED THE EM CENTRAL BANKS FOR QE?

In our view, the main motivation behind the QE announcements by EM central banks was to prevent tightening of financial conditions, which was due to (1) portfolio outflows (have surpassed those during the GFC) and (2) expectations of significant widening of fiscal deficits to fund the healthcare crisis. With governments announcing measures to support their economies, financial conditions would likely have tightened further had the central banks not either injected liquidity or announced some form of QE.

VI. IMPLICATIONS FOR MARKETS

A. EM at a disadvantage:

If an emerging economy doing QE does see a big pickup in inflation, markets could quickly lose faith in the central bank's willingness or ability to respond. The result would be FX depreciation. Another disadvantage for EM central banks is that their currencies are not reserve currencies. This removes a source of demand that tends to prop up the major DM currencies.

B. Don't focus on Inflation:

We are likely facing the worst economic shock in nearly a century. As much as central banks might attempt to ease supply conditions, demand could remain very weak. This could suppress credit growth and keep a lid on inflation. As a result, domestic banks are likely to park surplus liquidity in government bonds for lack of better investment opportunities.

C. Raising the Stakes:

If there are sustained currency losses in EM, inflation and capital-flight risks would rise. This would prompt central banks to tighten policy abruptly, weakening their economies further. One way this scenario could play out is if COVID-19 continues to spread in EM after the US and Europe have brought it under control and re-opened their economies. Inadequate healthcare resources in emerging economies make this a serious concern.

VII. FINAL REMARKS: WHAT IS THE END GAME?

A. How will this massive policy experiment end?

EM central banks would need to tighten prematurely, which would be messy and painful. Avoiding such an outcome could require some policy coordination. If one of the big three central banks is eyeing the exit, it would have to warn its EM counterparts before signalling to the markets. In other words, the global surge in QE has been synchronized but not coordinated. The unwind will need to be coordinated but not synchronized to avoid another crisis.

Countries that have negative NIIP or current account deficits are likely to be more prone to financial crises when expectations of policy normalization pick up. Putting everything together, the risks are again to the downside. Stepping back, given the unprecedented nature of the COVID-19 shock, it is hard to fault EM central bankers for their unprecedented response. But such aggressive easing comes with a wide range of risks that we are only beginning to understand.