Normalizing Central Banks' Balance Sheets

New York Fed/Columbia SIPA Workshop

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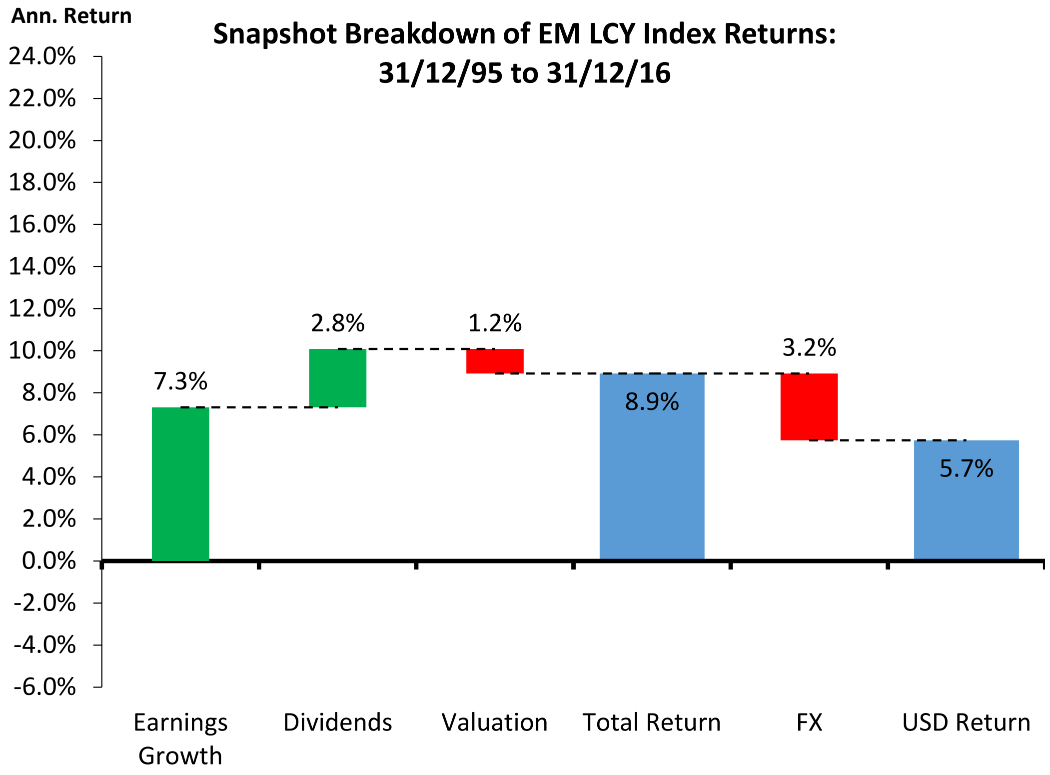
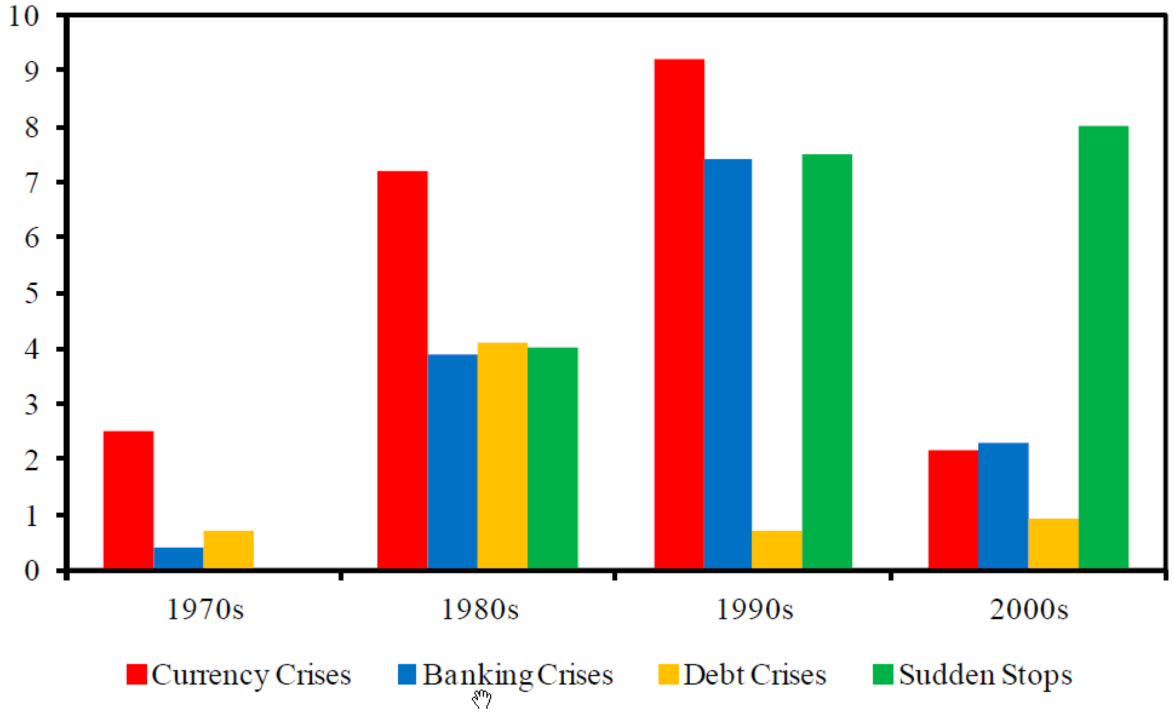
EM assets in the long run

- Over a long horizon, the biggest driver of returns is the compounding of earnings
- Stability of institutions and predictability of policy frameworks more important in the long run



Crises are a prevalent feature of EM

- Price controls, leverage buildups, currency and maturity mismatches, thin markets and reliance on external financing introduce non-linearities in macro and market responses to shocks



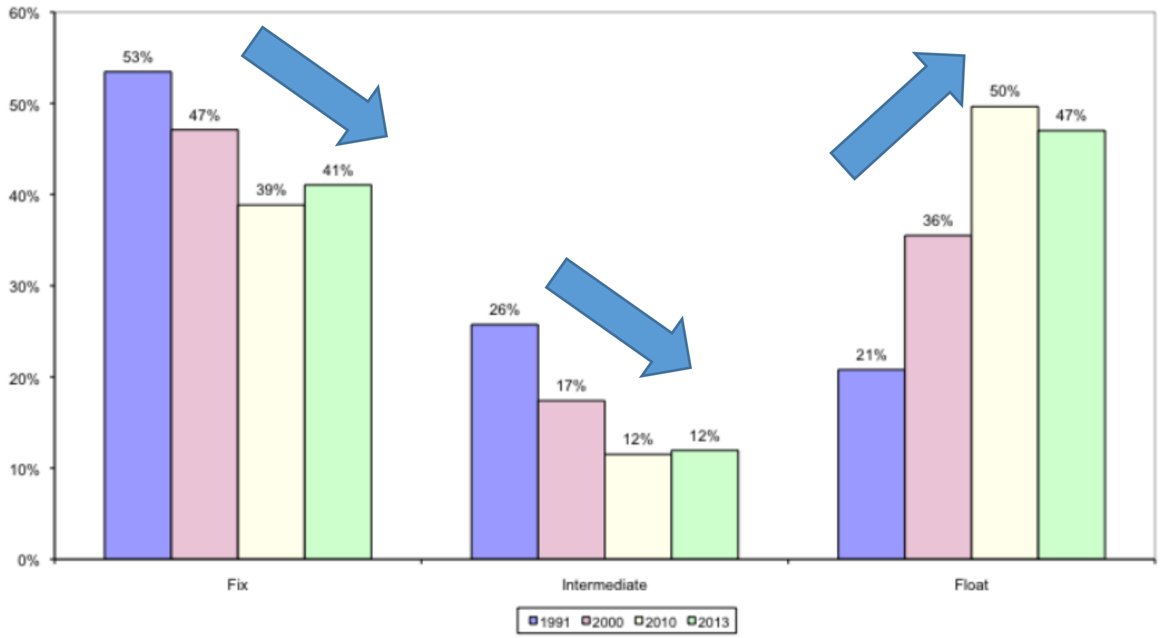
Notes : This graph shows the average number of financial crises in respective decades.

Source: Claessens and Kose

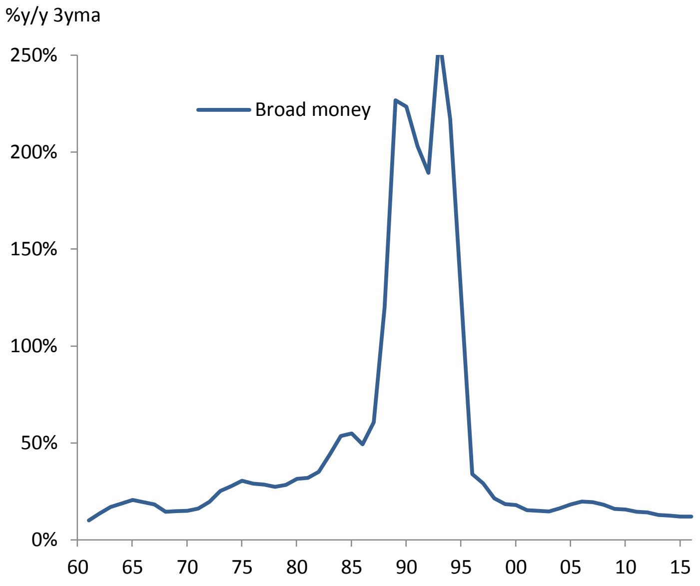
Policy frameworks have been changing

- Price flexibility provides some buffers
- Investors are more discerning across EMs

Exchange Rate Classification



EM: Broad Money Growth

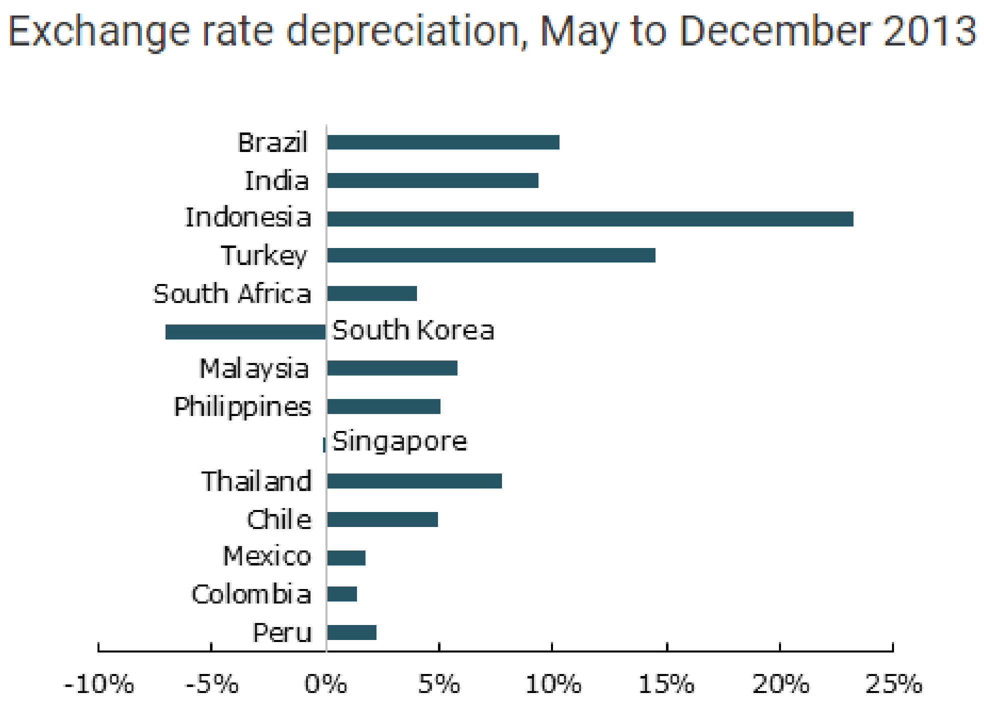


Source: Levy-Yeyati and Sturzenegger (2016)

Taper Tantrum 2013

- Impact was large, but did not lead to traditional “crises”

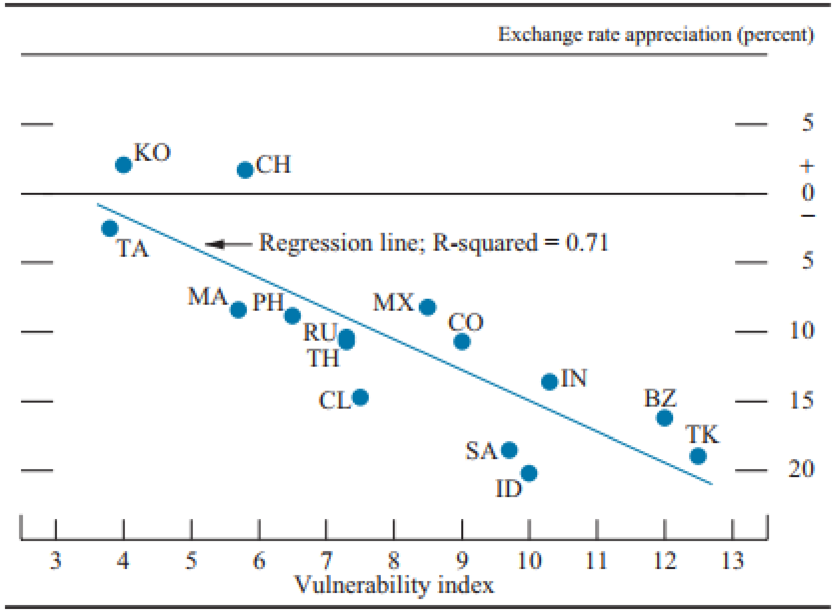
- Two main drivers:
  1. EM Fundamentals
  2. Policy signalling channel



Source: Federal reserve Bank of San Francisco (2014)

FX moves were in line with fundamentals

- Vulnerability Index:
  - Current Account to GDP ratio
  - Gross Govt Debt to GDP
  - Average inflation over past 3 years
  - Ratio of external debt to exports
  - Ratio of FX reserves to GDP



NOTE: Exchange rate appreciation of emerging market currencies against the U.S. dollar is measured from April 30, 2013, to February 6, 2014. BZ is Brazil; CH is China; CL is Chile; CO is Colombia; ID is Indonesia; IN is India; KO is Korea; MA is Malaysia; MX is Mexico; PH is the Philippines; RU is Russia; SA is South Africa; TA is Taiwan; TH is Thailand; TK is Turkey.

SOURCE: CEIC; Haver Analytics; International Monetary Fund (IMF) International Financial Statistics and World Economic Outlook; IMF Fiscal Monitor; Joint BIS-IMF-OECD-WB External Debt Hub; Federal Reserve Board staff calculations.

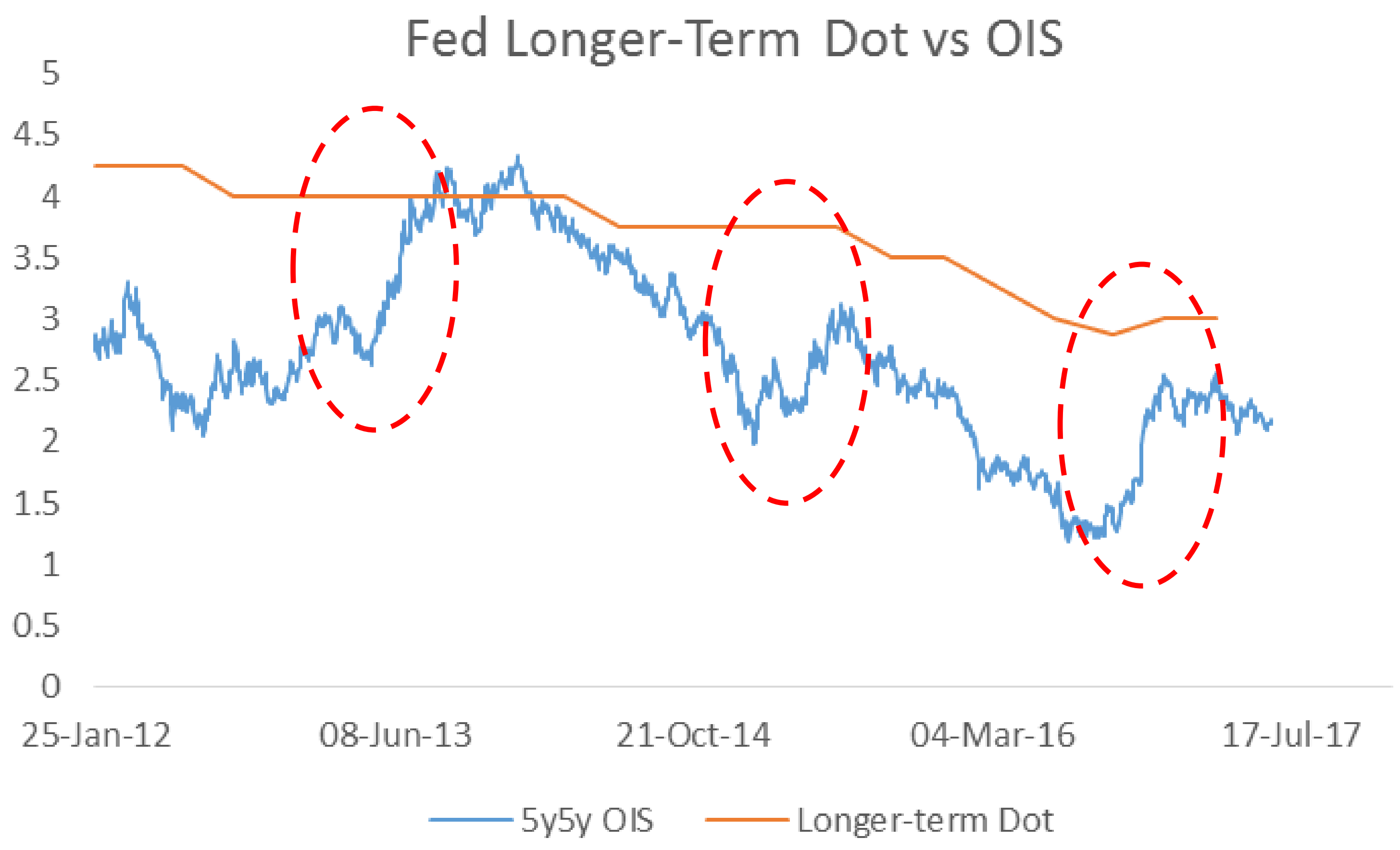
Source: Monetary Policy Report, February 2014

Policy signalling also mattered

- Fed policy = *f(r*, output gap, inflation vs target, "X"*)

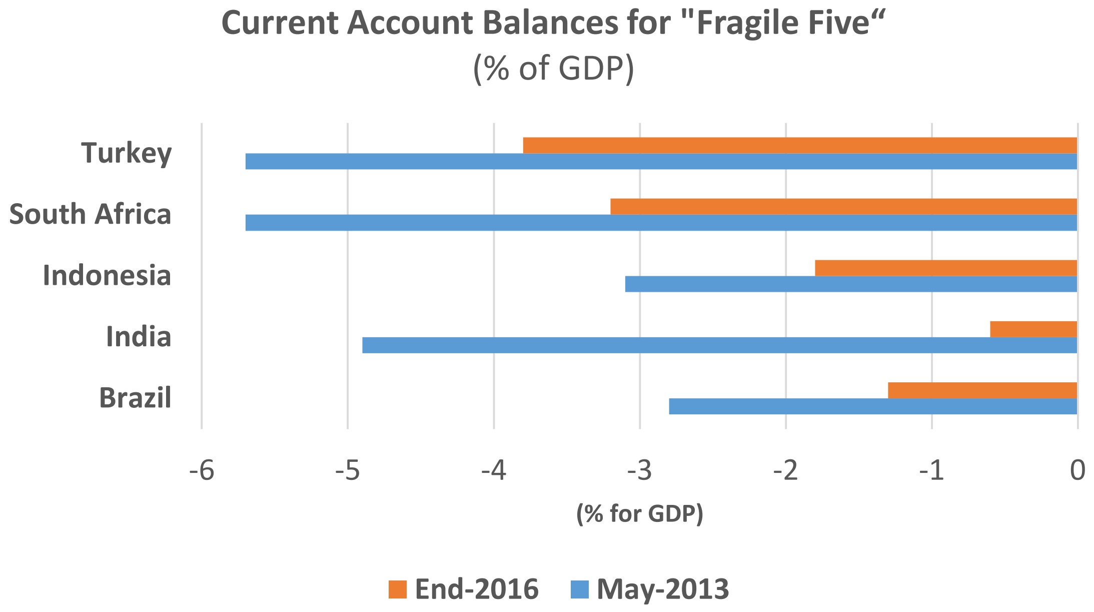
- Uncertainty over "*X*" factor:
    - Asset prices?
    - Financial stability?
    - Credit growth?
    - Change in preferences or reaction function?

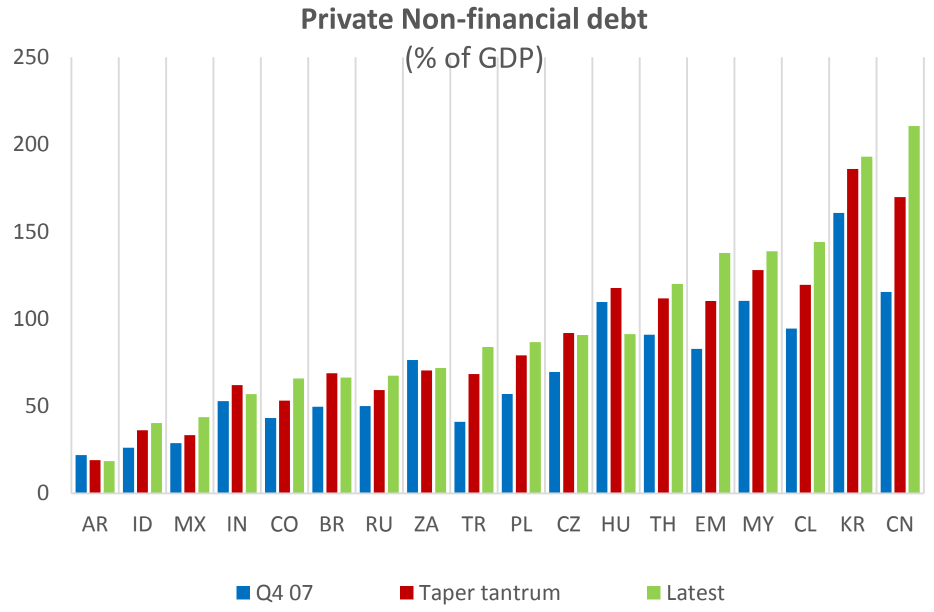
Managing expectations



The situation today (1)

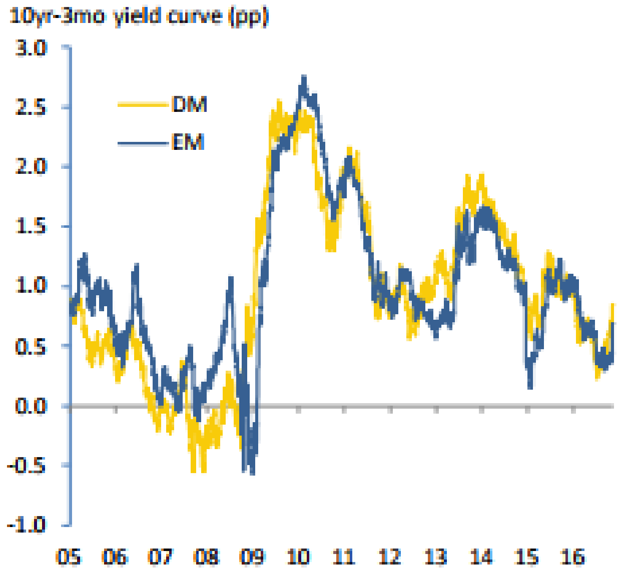
- Vulnerabilities have fallen for “Fragile 5”, but risen elsewhere

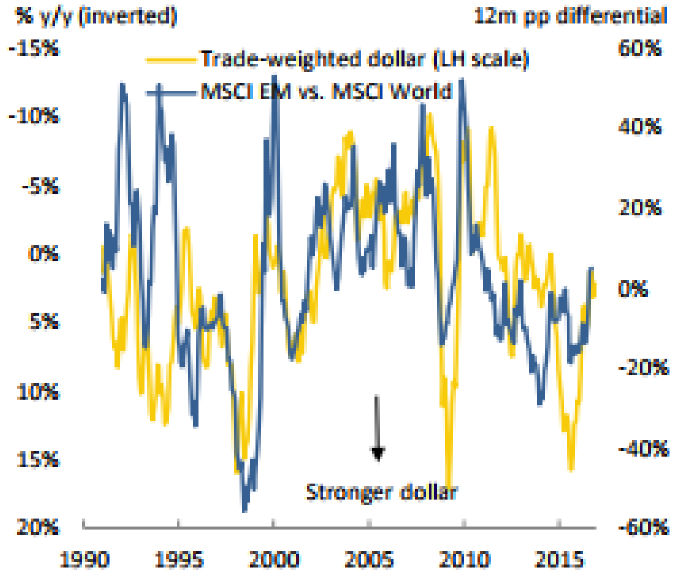


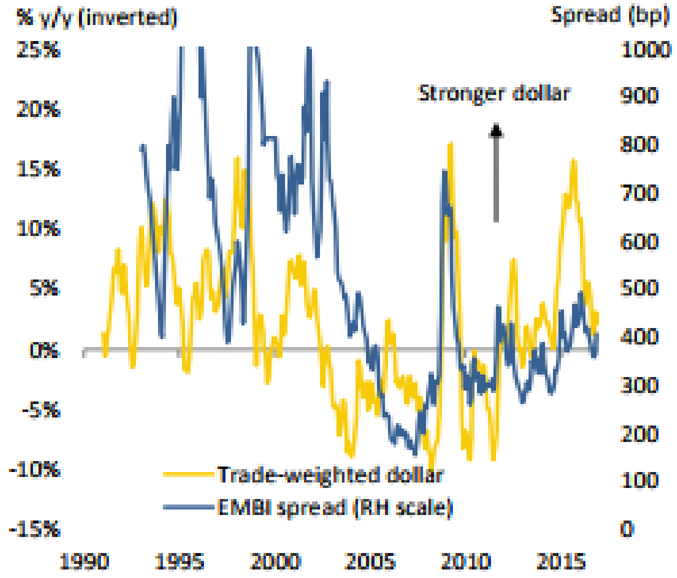


The situation today (2)

- EMs remain vulnerable to the global risk environment, DM interest rates, and the US dollar

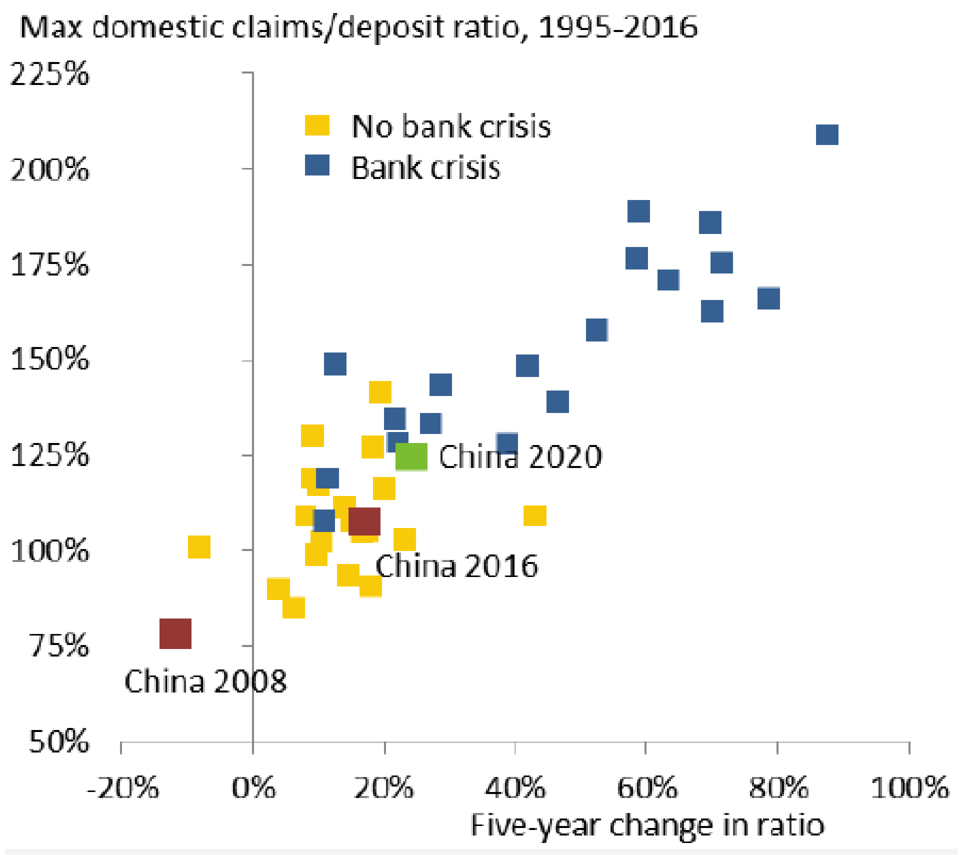


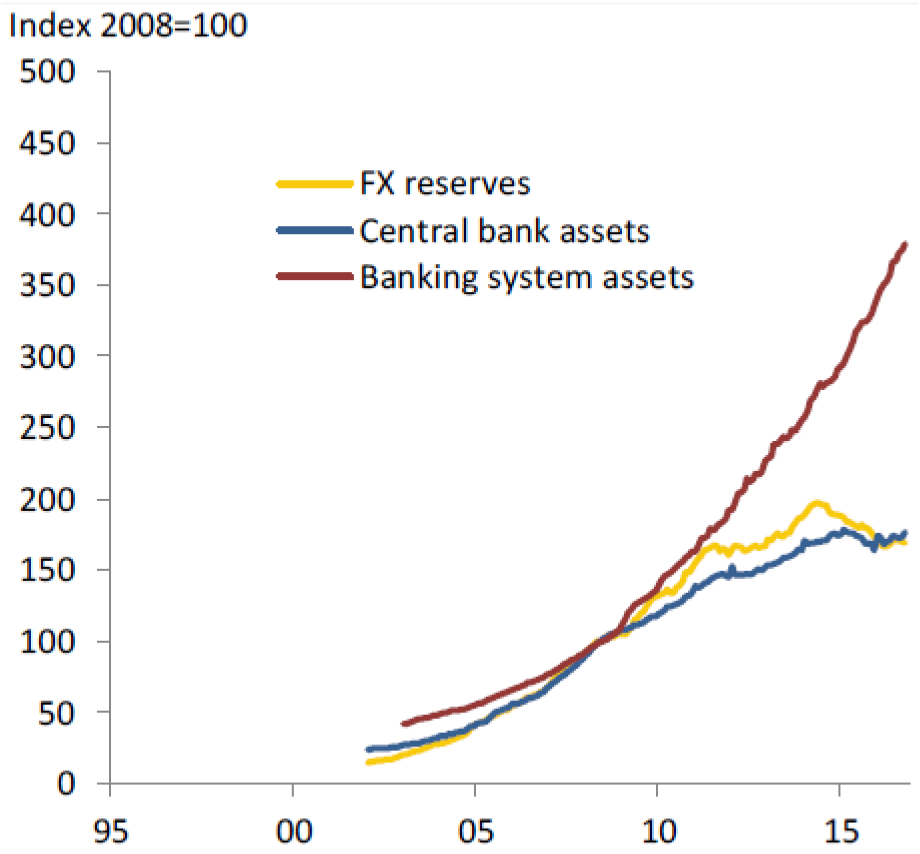




Source: Jon Anderson, EM Advisors

China remains a key risk factor for EMs





Source: Jon Anderson, EM Advisors

Conclusion

- EMs have undergone structural changes over the past 20 years that have resulted in more robust policy frameworks

- But, EMs remain vulnerable to the global risk environment. Issue is not so much about interest rate increases per se but a spike in global risk aversion and a sharp moves in the USD

- China remains a source of risk. Will it amplify or dampen Fed shocks?