

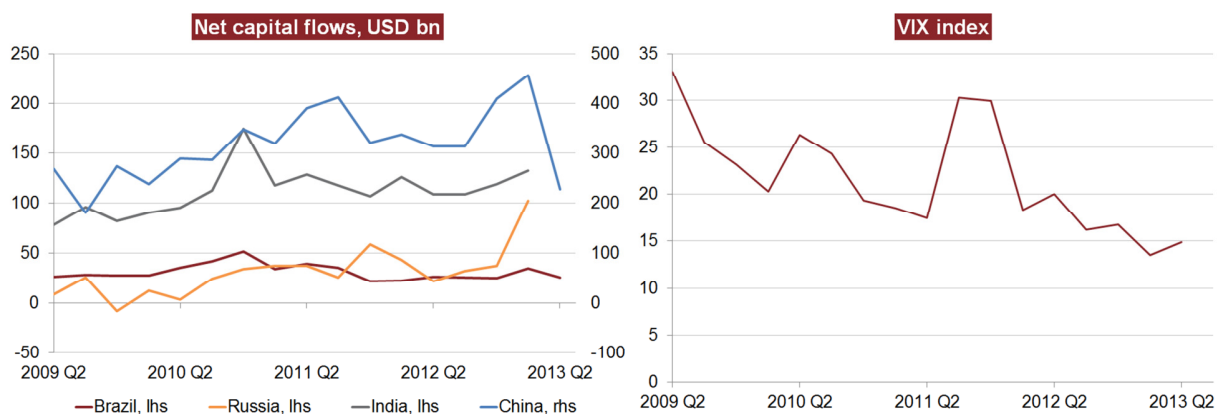
## Taper is not the key question for EMs

- **The postponement of Fed tapering is positive for EMs but likely to be short-lived**
- **Global risk aversion is a key driver for the moment**
- **Risks of capital flow volatility to remain high in the short to medium term**

The Fed's September decision – no action on QE – was not only a surprise to many but also a much welcome relief, particularly for emerging markets (EMs). The relief was increased by Ben Bernanke's comment that the Fed was watching emerging markets "very carefully".

The Fed inaction should be seen as a positive for EMs; but the optimism is likely to be short-lived as underlying weaknesses in key EM economies are unchanged and expected to persist. Growth in emerging economies has lost its momentum, while at the same time growth prospects in developed economies look somewhat less negative. This, combined with the need for deeper structural reforms and fiscal consolidation, makes EMs look relatively less attractive. The prospects for a reacceleration in overall EM growth remain constrained in the short-to-medium term although activity may benefit from an increase in domestic demand, supported by significant past monetary policy stimulus. In addition, many EMs are facing significant country-specific policy challenges to reach faster rates of growth.

Rather than focusing on the Fed, those concerned about further capital outflows, should concentrate on how well policy makers in EMs are handling structural reforms in their economies. While unconventional US monetary policies have had measurable effects on net inflows into emerging markets in the past few years, these effects have been relatively muted compared to three other factors – growth in emerging markets, interest rate differentials and global risk sentiment.



During 2009-10 there was a surge in capital flows into EMs. Improved global risk sentiment, indicated by a fall in the VIX index, exerted a significant effect on capital flows. After a temporary spike in the second half of 2011, the further fall in the VIX index contributed to an increase of capital flow into EMs. However, country

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specific factors such as the quality of domestic institutions and macroeconomic fundamentals explain the heterogeneity of capital flows into EMs. A few things to note:

- The Fed's unconventional monetary policy measures over the past few years account for only a small portion of the large volatility of capital flows, but they exacerbated the pro-cyclicality of capital flows to emerging market.
- QE1 in late 2008 and early 2009 contributed significantly to net capital outflows from EMs. The Fed's liquidity operations and the drop in Treasury yields that they led to, caused a rebalancing out of emerging market assets into US bonds, but also into equities, leading to an initial strengthening of the dollar.
- By contrast, QE2 in 2010 caused a shift out of US equities and bonds into EM equities. The Fed's Treasury purchases triggered a higher risk-taking by investors, especially in regard to investing in EM equities.
- QE3 in 2012 was initially greeted with dismay in emerging markets, who feared that this was the start of a US currency war. Capital flowed into EMs, strengthening their currencies and driving up asset prices. However, once the Fed began to make noises about tapering and eventually ending its quantitative easing, the flows reversed – accompanied by further EM criticism.

Hence, the delay in tapering was generally welcomed. But, it only affords a temporary reprieve and – potentially worse – takes some of the immediate pressure off more vulnerable countries with big current account deficits, such as India or Turkey.

While an increase in policy rates by the Fed still is some time away, a normalization of US monetary policy will eventually happen over the next few years. The first step in this will still be a taper and eventual end of QE3, most likely by mid-2014.

More importantly, since the crisis, global risk aversion has been a more important factor than global interest rates or liquidity in terms of affecting capital flows. Although tapering is put on hold for now, the risks remain high given the overall weaknesses of emerging economies. This issue will be revisited in a future Comment.

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