Economist Insights

Catching cold

With the Fed set to raise interest rates later this year, will that lead to contagion and higher rates in the rest of the world? Emerging markets may be worried as they are potentially the most exposed to US monetary policy. The taper tantrum in 2013 showed how disruptive a US tightening could be for some emerging markets. Will a Fed hike lead to a repeat of those tensions?

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It is said that when the US sneezes, the rest of the world catches a cold. So with the Federal Reserve set to raise interest rates later this year, will the rest of the world catch tighter monetary policy? Once upon a time that would have been true; historically the Bank of England (BOE) and the European Central Bank (ECB) always tightened monetary policy after the Fed did. This was because of the flip-side of the cold-catching argument: when the Fed feels better, the rest of the world gets out of their sick bed.

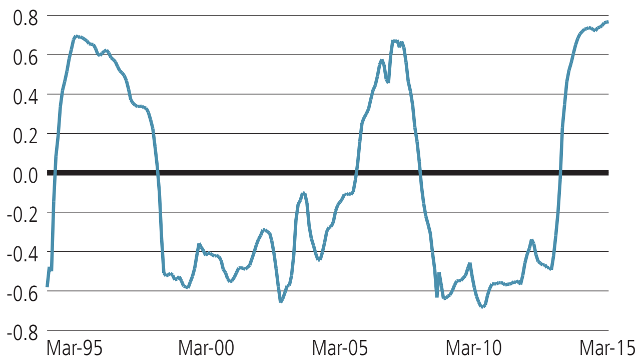
The old relationship may well hold true for the BOE in this cycle, but clearly it won't for the ECB. The Eurozone has its own ailments that are independent of the US (and for which the doctors came close to prescribing amputation). So the ECB is currently undertaking quantitative easing and is more likely to loosen monetary policy further than to tighten. This first great divergence in policy rates between the two largest economic areas shows that the Eurozone will be on medication for some time to come.

Emerging markets (EM) should probably be more worried. The Eurozone is big enough to move independently, while the UK is in the same stage of the cycle as the US. But emerging markets know how exposed they are to US monetary policy. The experience of the 'taper tantrum' in 2013 showed how disruptive a tightening stance in the US could be for EM. And the taper tantrum was not even a tightening, just a shift from further loosening to a neutral stance. In that context, an outright hike sounds positively scary.

Most of the time when US treasuries (USTs) are doing badly, EM sovereign bonds do better. This is fairly intuitive: USTs are viewed as a safe asset, while EM sovereign bonds are seen as risky: when times are good and people want to take risk they usually sell USTs and switch into EM and other risky assets. So most of the time there is a negative correlation between the return on the EM sovereign benchmark and the return on the UST 7-10y benchmark (chart 1).

Chart 1: In-step, out of step

Three-year rolling correlation between total return of EM sovereign benchmark and US 7-10y sovereign benchmark



Source: Bank of America/Merrill Lynch, Bloomberg Finance LP

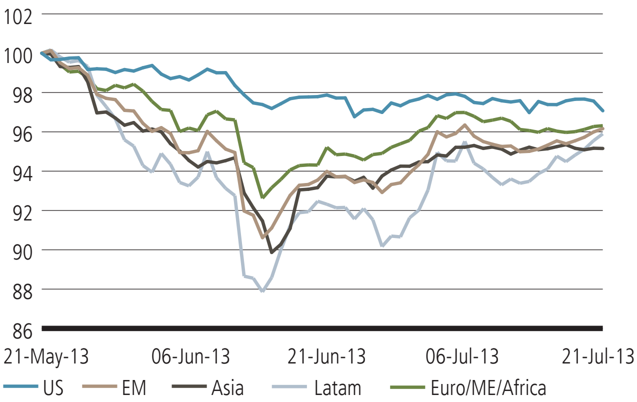
Yet the correlation only holds most of the time. There have been some quite marked episodes when USTs and EM sovereigns moved in the same direction. The first episode of this strongly positive correlation was in 2007-2008, driven by the so-called 'global savings glut'. During this time many EM countries had pegged their currencies at the low rate to the USD, so they ended up running large current account surpluses, especially against the US (which of course was running a big deficit). This trade imbalance created upward pressure on their currency against the USD, so the only way to maintain the peg was to recycle the income from the current account back into the US. In other words, they bought lots of safe USTs for their foreign reserves. So even though EM sovereigns were doing well because their economies were doing well and so people wanted to take risk, USTs were also doing well because of all the buying by EM central banks.

The other two exceptions (the peaks shown in chart 1) were different, but had something in common with each other: both were caused by a monetary policy shock. Surprises to monetary policy are one of the very few factors that can lead to a positive correlation between sovereign bonds and risky assets. The 1994 episode was a negative policy shock, when the Fed surprised markets with an aggressive rate hike at the beginning of the year. This completely caught the markets offside, so there was a sell-off in both USTs (to match the new path of the Fed Funds rate) but also in riskier assets globally.

The more recent episode was another negative surprise shock, the aforementioned taper tantrum. Before the announcement the market had been happily pricing in ongoing QE for ever, so it came as a shock when then Fed Chair Ben Bernanke announced that the Fed would be likely to taper off purchases to zero. Not only did this mean fewer buyers of USTs (causing a sell-off) but it also raised the possibility of rate hikes. Once again risky assets (such as equity and EM sovereign bonds) took a hit. In fact, both the UST Treasury index and the EM sovereign bond index recorded substantial losses (chart 2).

Chart 2: Emerging and developed pain

Total return of US, EM, Asia, Latam, Euro/Middle-East/Africa sovereign benchmark (21 May 2013 = 100)



Source: Bank of America/Merrill Lynch, Bloomberg Finance LP

However, in many EM countries (namely Brazil, India, Indonesia, Turkey and South Africa) the tensions that followed the announcement of the tapering were more persistent and went beyond financial markets. These countries all had severe external and internal imbalances that had built up on the back of the many years of ultra-loose global monetary policy conditions. In short, they had been using that easy money to live beyond their means, and now that it was going into reverse they faced a painful adjustment. And it was not just painful for foreign investors, it was also painful for the domestic economy.

Now that the Fed is likely to raise rates, does this mean things will get worse for those exposed EM economies? Possibly not. The next Fed rate hike is about as far away from a surprise as you can get: it has been discussed so much that it should already be priced in. This does not mean there might not be a surprise in either direction, but the surprise is likely to be small (such as slightly faster or slower hikes).

Nonetheless, the current economic and financial environment is not one that is well situated to face a Fed rate hike. Financial conditions in many EM have already tightened substantially in the past year, especially for those who have pegged to the USD while it appreciated relative to the JPY and EUR. Lower inflation also meant that real interest rates have moved higher. Some countries have eased monetary policy since the beginning of the year, but not enough to completely offset the tightening in financial conditions. Perhaps as a result we are seeing the first signs of weaker economic activity (see last week's *Economist Insight*).

So, why are EM central banks not being more aggressive in loosening monetary policy? For some the reason is financial stability (especially in Asia) and for others it is external imbalances (such as Brazil and Turkey). For instance, the excessive leverage in the Asian (shadow) banking sector and recent developments in the Chinese equity market confirm that further liquidity injections could just push up leverage and mispricing.

If monetary policy is not really an option to counterbalance the effects of a Fed hike then all the adjustment has to come from the exchange rate. In the current environment this seems the most viable option. It would help to restore some of the lost competitiveness while at the same time pushing down real interest rates by reinforcing inflationary pressures. Yet many are reluctant to abandon or alter pegs that they have had for so long. They want their lunch but don't want to pay for it; however, economics has something to say about the availability of free lunches.