Finance: The US Federal Reserve System (Fed) is destabilizing emerging market economies

Friday 5 September 2014, by TOUSSAINT Éric (Date first published: 27 August 2014).

Since the US Federal Reserve System (the Fed) hinted in May 2013 that it would gradually normalize its policy, the negative impact on the so-called "emerging" economies immediately triggered off. What were the proposed changes?

1. Reducing purchases of toxic assets [1] from the US banks in order to relieve them of this burden.

2. Reducing the acquisitions of US Treasury Securities from these banks which the Fed does in order to inject them with liquidity. [2]

3. Raising interest rates (0.25% as of now).

This announcement itself was enough to lead major financial companies in the US and other countries (banks and their satellites in the shadow banking system, mutual funds, etc.) to pack-off some of their liquid investments from the emerging market economies (EMEs). This destabilized those economies: plunge in stock markets and currency depreciation (Indonesia, Turkey, Brazil, India, South Africa ...) [3]. In fact, the low interest rates prevailing in the US and Europe, combined with the central banks' massive cash infusions in the economy, have always set financial companies on the trail of maximum profit by investing in the EMEs which offer better returns than the North. The outflow of financial investment from the EMEs towards the most industrialized economies can be explained by the fact that the financial companies expected attractive returns in the North as soon as the Fed hiked interest rates [4]. These companies thought that other "investors" would withdraw their capital from these countries and it was better to act first. A herd mentality response resulted in a self-fulfilling prophecy.

Finally, the Fed did not raise interest rates and waited till end-2013 to reduce purchases of structured securities and treasury bills from banks. The dust almost settled.

The situation in June 2013 gives some idea of what might happen if the Fed increases interest rates significantly. This is what the Bank for International Settlements (BIS), the central banks' central bank, says "Capital flows could reverse quickly when interest rates in the advanced economies eventually go up or when perceived domestic conditions in the host economies deteriorate. In May and June 2013, the mere possibility that the Federal Reserve would begin tapering its asset purchases led to rapid outflows from funds investing in EME securities" (BIS, 84th Annual Report, 2014, p. 76, http://www.bis.org/publ/arpdf/ar2014e.htm)

The BIS brings to light a worrying trend: financial companies that invest a part of their assets in EMEs do so in the short term. They can swiftly withdraw their funds if they discover other profitable avenues. Here is what the BIS says: "A higher proportion of investors with short-term horizons in EME debt could amplify shocks when global conditions deteriorate. Highly volatile fund flows to EMEs indicate that some investors view their investments in these markets as short-term positions

rather than long-term holdings. This is in line with the gradual shift from traditional open or close-end funds to exchange- traded funds (ETFs), which now account for around a fifth of all net assets of dedicated EME bond and equity funds, up from around 2% 10 years ago… ETFs can be bought and sold on exchanges at low cost, at least in normal times, and have been used by investors to convert illiquid securities into liquid instruments”. (BIS, 84th Annual Report, 2014, p. 77, http://www.bis.org/publ/arpdf/ar2014e.htm)

In short, the wellbeing of the EMEs depends a great deal on the policy followed by the most industrialized economies (especially the US, Europe and Japan). A hike in interest rates in the US may result in a significant outflow of volatile capital invested in EMEs with higher returns in mind.

“In addition, roughly 10% of the debt securities maturing from 2020 or later are callable, and an unknown proportion have covenants that allow investors to demand accelerated repayment if the borrower’s conditions deteriorate.” (BIS, 84th Annual Report, 2014, p. 76. http://www.bis.org/publ/arpdf/ar2014e.htm) This means that financial companies that purchased debt securities maturing in a relatively distant future (2020 or later) can demand accelerated and full repayment from a crisis-hit country. Obviously, this can only aggravate the situation of an indebted country: all inflows will stop simultaneously. This is another reason why the populations of developing nations need to be aware of the serious dangers posed by their country’s public debt. Payment of the illegitimate portion of the debt must be challenged immediately.

The decline in revenues from raw material exports is another factor that might lead to a fresh nd acute debt crisis in developing countries, since China – a major consumer of raw materials for her manufacturing industry – has reduced her huge imports. A drop in the price of raw materials can be fatal to the economic health of developing countries which depend mainly on exports. In this respect prices for raw materials might also drop if the Fed increases interest rates, as this reduces speculation responsible for high prices. The combined effect of a hike in interest rates and a decline in raw material prices could produce a situation similar to what happened in the early 1980s, when the debt crisis exploded in the developing countries. It is imperative to learn from that crisis and to act, so that the Southern people do not have to foot the bill once more.

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P.S.

* http://cadtm.org/The-Fed-is-destabilizing-emerging

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Footnotes

[1] The Fed has bought huge amounts of Mortgage-Backed Securities (MBS) from the US banks. Its purchases of such assets between 2008 and early 2014 were worth more than $1,500 billion. During 2012-2013, it purchased toxic assets for $ 40 billion per month from banks and real estate agencies that guarantee mortgages, to reduce their burden. By end-2013, it started to make fewer purchases which went up to $ 35 billion per month by March 2014. By October 2014, the Fed will hold $1, 700 billion of MBS, or about 21% of the total volume of such assets, an enormous sum.

[2] By October 2014, the Fed will hold US Treasury Securities worth $ 2,450 billion. Please note, contrary to popular belief, the Fed does not buy Treasury Securities directly from the Treasury, it buys them through open market operations from private banks which had acquired them previously. See the US laws on this matter:
http://www.federalreserve.gov/aboutthefed/section14.htm

[3] The Bank for International Settlements (BIS) describes this situation as follows: - "The first episode was abrupt and generalised in nature, with sharp asset price movements ending a period of fairly stable interest and exchange rates. As the sell-off spilled over from advanced economies, EMEs experienced a sharp reversal of portfolio flows, especially in June 2013. . . EME equities fell by 16% before stabilising in July, and sovereign bond yields jumped more than 100 basis points, driven by rising concerns over sovereign risk… At first, the indiscriminate retrenchment from EMEs affected many currencies simultaneously, leading to correlated depreciations amid high volatility. The currencies of Brazil, India, Indonesia, South Africa and Turkey depreciated by more than 10% against the US dollar during the first episode…. Brazil, India, Indonesia and Russia each lost more than $10 billion in reserves. Countries with rapid credit growth, high inflation or large current account deficits were seen as more vulnerable and experienced sharper depreciations". (BIS, 84th Annual Report, 2014, pp. 27-28)
http://www.bis.org/publ/arpdf/ar2014e.htm

[4] For an analysis of what happened in 2013, please read Daniel Munevar's "Inestabilidad en los mercados emergentes: El fin de un ciclo?" available only in Spanish here :
http://cadtm.org/Inestabilidad-en-los-mercados (1st part) and
http://cadtm.org/Inestabilidad-en-los-mercados,10117 (2nd part)