Fears of a New Era*

C.P. Chandrasekhar

The near relentless bull run on India's stock markets seems to be faltering, with signs of a descent from recent peaks. These signs of investor reticence are visible across emerging markets, with India being one of the better performers. While short-term international and domestic developments are blamed for that reticence, there is a more serious fear keeping policy makers and central bankers awake in these emerging market economies. That is the prospect of an exit of foreign investors from their equity and bond markets, consequent to a readjustment of monetary policy in the advanced economies.

Across the world, there is a sense of apprehension about the near- and medium-term economic future. The proximate cause is inflation in the advanced countries. The US index of consumer prices rose 6.2 per cent in October relative to a year ago. The figure for the UK was 4.2 per cent, the highest in a decade. In Europe, German inflation of 4.6 per cent in October was at a 28-year high and Spanish inflation of 5.5 per cent is the highest in 37 years.

When prices first started moving upwards, central bankers either dismissed or ignored the tendency. The dominant view was the price rise was 'transitory', influenced by pandemic-related supply bottle necks and buoyant energy prices. Neither would last was the assessment, and central banks continued with their focus on feeding the recovery with large volumes of cheap money—a policy that should be abjured if there is any danger of inflation.

There are indications of a change of minds, led by the Federal Reserve. After promising not to retreat till well into next year from its "unconventional monetary policies"—injecting liquidity by buying bonds and keeping interest rates near zero—adopted since the 2008 financial crisis, the Fed has shifted gears. Starting November 2021, the Fed planned to reduce its monthly purchases of $120 billion worth of Treasuries and mortgage-backed securities by $15 billion every month. That would bring "quantitative easing" or large scale liquidity injection to an end latest by the middle of next year. However, Richard Clarida, the vice-chair of the Fed went public saying that the December meeting of the Federal Open Market Committee would have another look at the pace of the planned "taper" to assess whether changed economic circumstances warranted acceleration. Sending a signal of a possible hastening of the pace, he referred to the "upside risk" of inflation and the prospect of strong growth in the fourth quarter of 2021.

This has implications for interest rates. Earlier, Jay Powell, who has been nominated by President Biden for a second term as Fed chief, had said that the Federal Reserve was unlikely to begin raising interest rates while it is still purchasing bonds. But if those purchases are phased out faster, the hike in rates could come sooner.

Since the inflationary trend seems generalised across the advanced economies, the question arises whether bond buying would be tapered and interest rates raised in all of them. The Bank of England has signalled it is on the verge of raising rates, though it held back doing so at its November meeting. But Christine Lagarde, who presides over the European Central Bank (ECB), seems to be holding out. She said that, following what she described as "soul-searching" over its view that inflation would subside, the ECB does think that that position still holds and is unlikely to raise rates before the end of 2022, and would continue its bond-buying programme, even if at a "moderately lower" pace than the Euro 80 billion-a-month it currently clocks. There is no unanimity though. Jens Weidmann, whose tenure as President of the Bundesbank and member of the ECB's governing council is coming to an end, believes that given the inflation outlook, "monetary policy should not commit to its current very expansionary stance for too long." Moreover, the ECB President's adamance is beginning to hurt, with the euro sliding vis-à-vis the dollar. Capital movements influenced by expectations of a widening of interest and inflation rate differentials is driving that relative decline. The currency's value touched $1.13 in mid-November, which was the lowest it has been since July of 2019. That could encourage investors to move to assets denominated in the stronger dollar, aggravating the problem. So, the ECB may have to relent. Soon, a retreat from the era of "unconventional monetary policies", involving a taper of bond buying and a hike in interest rates may be the position adopted by all developed country central banks.

If that happens, and for long, the turn would mark the end of an era when global financial markets were awash with cheap money. From the point of view of emerging markets like India that is a serious problem. A chunk of that cheap money flowed into equity and bond markets in developing countries. If such money dries up and rates rise, foreign investors may chose to move out of these emerging markets. That is what happened in 2013, when then Fed Chairman Ben Bernanke announced that at some future date the US central bank could begin a taper of its bond buying programme. The result was turmoil in developing country financial markets including India's as foreign investors chose to exit. Bernanke's threat was not implemented and action by central banks managed to stabilise markets, and the world returned to business as usual as growth and inflation remained weak, and even collapsed when the Covid pandemic struck.

The fear is that all that could change. As of now there are signs of a lull. Bloomberg's Emerging Markets Capital Flow Proxy Index, which tracks the combined movement of commodity, equity, bond and foreign exchange market indices, which together appear to mimic the flow of money into and out of emerging markets, having risen from a low of close to 102 when the pandemic's effects were felt in March 2020 to a high of 170 in early May 2021, has since fallen to around 157. Though India's equity markets received $7.1 billion over the first 10 months of 2021, October saw an outflow of $1.8 billion. So, India too may be feeling the heat, though its substantial reserves give it some room for manoeuvre.

But weaker economies with balance of payments difficulties and limited foreign exchange reserves, have much cause to worry. Reza Baqir, Pakistan's central bank governor, has in an interview to the Financial Times warned that developing countries are vulnerable to a shock like the "taper tantrum". "If there's volatility in financial markets because there is a somewhat sudden realignment of expectations of interest rate changes in advanced economies, that volatility will impact emerging markets with high debt and moderate or low levels of reserves more than otherwise," he reportedly said.

But the problem need not be restricted to emerging markets and poor countries. Financial markets worldwide have been riding on large volumes of cheap money, addicted to seeing indices rise most of the time. If a taper and higher interest rates trigger an investor retreat that sets off a more sustained decline, panic could ensue. Given the intertwined nature of financial institutions, turmoil in bond and equity markets that hurts some financial institutions can soon spread to other segments of the financial structure and even the banks. In fact, before the onset of the Covid-19 pandemic, the principal reason why advanced country central banks stayed with quantitative easing and low interest rates for a decade after the financial crisis was the uncertainty about what the fallout of any unwinding of those unconventional policies would be. But at that time, inflation was low and the recovery moderate, so such policies could be justified. The concern today is whether we are entering a period when that justification does not hold, forcing central bankers to open the doors to a new era the transition to which could be destabilising.

Not surprisingly, there is a strong body of opinion that goes with Lagarde in arguing that the time for retreat has not yet arrived. And, there are others who argue that the retreat is not possible. Thus, Ruchir Sharma, the chief global strategist of Morgan Stanley Investment Management, has argued in the Financial Times that, if despite the return of inflation long term interest rates have not moved, it is not because of fears that another wave of the pandemic would end recovery or the belief that the inflationary spike is transitory, but because the period of unconventional monetary policies has resulted in a huge spike in debt and put the world in a debt trap. Given the mountain of debt, bond markets are convinced that any significant rise in interest rates is not sustainable. Inflation, which in Sharma's view does not appear to be transitory, may force central banks to raise short term rates, but long term rates would remain stable even if below the rate of inflation, because even mild tightening will spell trouble. The world being caught in a debt trap, will remain in a mode where debt only keeps rising. Convenient, but there must be some force that can keep those rates stable and some end to the story!

*** This article was originally published in the Frontline Print edition: December 17, 2021.**