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Special Commentary

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Will Fed Tightening Derail Developing Economies?

Executive Summary

Although it is still a bit premature, some analysts are beginning to fret about prospects for economic growth and asset prices in developing economies once the era of extraordinary policy accommodation by the Federal Reserve comes to an end. So what will trigger less accommodative Fed policy? As in the past two major policy tightening cycles (1994-95 and 2004-06), the FOMC will begin to withdraw policy stimulus when there are unmistakable signs that a truly self-sustaining recovery has taken hold in the U.S. economy.

Economic growth remained positive in developing economies and asset prices continued to trend higher long after the Fed began to remove policy accommodation during the past two tightening cycles. What finally derailed economic growth and financial markets in developing economies was the onset of financial crises—the series of crises that swept through the developing world in 1997-98 and the 2007-09 global financial crisis—rather than Fed policy tightening per se. In that regard, decision makers who are concerned about growth prospects and asset prices in developing economies should focus on potential catalysts for a financial crisis in the foreseeable future, such as the ongoing debt problems in the Eurozone and the debt ceiling debate that looms again in the United States, rather than on any near-term policy changes by the Federal Reserve.

Why Does the Fed Tighten Policy?

As we documented in a recent special report, yields on emerging market sovereign debt have declined significantly over the past few years.¹ Not only have prices of sovereign debt in these countries risen sharply, but many other assets in developing countries have also rallied significantly in an environment of ultra-low interest rates in the developed world. Having reached the effective lower bound of zero interest rates some time ago, many major central banks have continued policy accommodation via so-called quantitative easing (QE).

Although it likely will be some time before major central banks begin to raise policy rates, QE will eventually come to an end. At that point, policy will cease to be more accommodative, and speculation will start to mount about the timing of QE reversal and rate hikes. In that regard, attention will be focused on the Federal Reserve. Not only is the United States showing more signs of economic strength relative to other major economies, but the U.S. economy is the largest in the world, making it an engine for the overall global economy. Will asset prices in developing economies fall sharply once Fed policy accommodation starts to reverse? More broadly, will Fed tightening cause economic growth in the developing world to slow sharply?

Over the past two decades, there have been two episodes of major Fed tightening. Between February 1994 and February 1995 the FOMC raised its target for the fed funds rate by 300 bps. The second major tightening episode occurred between July 2004 and June 2006 when the Fed hiked the fed funds rate by 425 bps. In both tightening cycles the Federal Reserve was responding

Many major central banks have continued policy accommodation via so-called quantitative easing.

¹ See “Emerging Market Debt: A Looming Problem?” (Feb. 28, 2013), which is available upon request.

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to a rise in the nominal GDP growth rate that was due largely, at least initially, to stronger real GDP growth rather than rising inflation (Figure 1).² In other words, the FOMC raised its target for the fed funds rate because a self-sustaining recovery had taken hold and the economy no longer needed the added boost from low interest rates.

Similarly, the FOMC likely will not begin to hike rates in the current cycle until there are unmistakable signs that a truly self-sustaining recovery has taken hold in the U.S. economy. Indeed, the Fed has publically stated that it “anticipates that this exceptionally low range for the federal funds rate will be appropriate at least as long as the unemployment rate remains above 6-1/2 percent,” which would represent a 3-1/2 percentage point decline in the unemployment rate from its peak in late 2009/early 2010.³

Figure 1

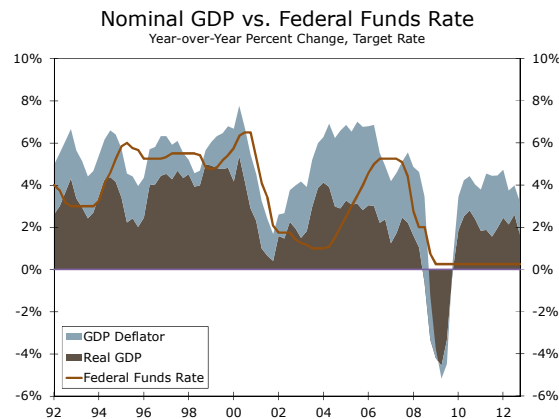


Figure 2



Source: U.S. Department of Commerce, Federal Reserve Board, IMF and Wells Fargo Securities, LLC

Will Fed Tightening Derail Growth in Developing Economies?

There is a fairly high degree of correlation between U.S. real GDP growth and growth in real exports of goods and services in the developing world (Figure 2). That is, as U.S. GDP growth strengthens, real exports of developing economies tend to accelerate, and vice versa. Because the United States accounts for roughly 20 percent of global GDP, fluctuations in American GDP growth are important enough to affect export growth in the developing world. Exports of developing economies crashed in 2009, but so too did the U.S. economy.

As noted above, the FOMC is not likely to hike rates until the U.S. economy is strong enough to withstand the effects of higher interest rates. If, as we expect, monetary tightening does not derail the U.S. economy, at least not initially, then the early stages of Fed rate hiking should not cause economic growth in the developing world to swoon via declining exports to the United States.

Will Capital Leave the Developing World When the Fed Hikes Rates?

Another way in which Fed tightening could impart a negative shock to developing economies is via capital flows. The Institute of International Finance estimates that developing countries have attracted more than \$1 trillion in gross capital inflows in each of the past three years. Arguably, ultra-low rates of return in most advanced economies have caused some investors to send capital to developing economies in search of higher rates of return. Therefore, higher interest rates in the United States could cause capital to flow out of developing countries, potentially leading to slower, if not negative, rates of economic growth in those countries.

² Nominal GDP growth is the sum of real GDP growth and the change in the GDP deflator, which is the broadest measure of inflation.

³ The unemployment rate at present is 7.7 percent. In the previous two tightening cycles, the unemployment rate had declined by a bit more than 1 percentage point before the Fed started to hike rates.

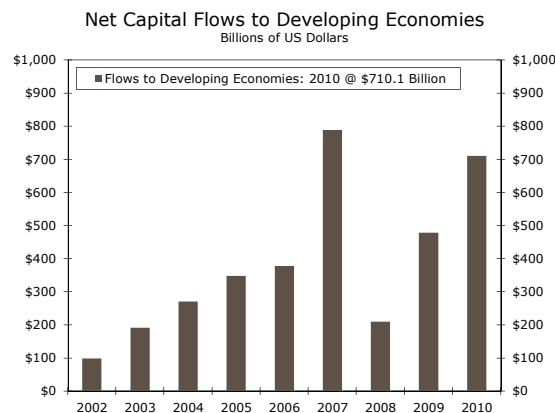
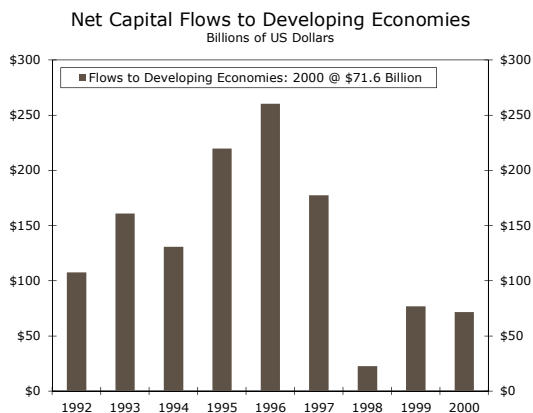
As U.S. GDP growth strengthens, real exports in developing economies tend to accelerate.

However, net capital inflows to the developing world did not crash in the previous two tightening cycles referenced previously. For example, net capital inflows in developing economies doubled between 1994 and 1996, and they did not turn down until 1997, which marked the advent of the Asian financial crisis (Figure 3). It was the looming financial train wrecks in Asia, Russia, and Latin America that finally caused capital to flow out of developing economies in 1997 and 1998, not higher U.S. interest rates. More recently, net capital inflows in the developing world shot up from less than \$300 billion in 2004 to nearly \$800 billion in 2007 (Figure 4). Again, it was the onset of a financial crisis (i.e., the global financial crisis of 2007-09), not Fed rates hikes per se, which caused net capital inflows in developing economies to weaken significantly in 2008. Assuming that another financial crisis is not lurking around the corner, a topic to which we will return subsequently, capital flows to developing economies should not weaken, at least not significantly, when the Fed initially begins to lift its target for the fed fund rate.

Net capital inflows to the developing world did not crash in the previous two tightening cycles.

Figure 3

Figure 4



Source: Institute of International Finance and Wells Fargo Securities, LLC

Will Financial Markets in Developing Economies Melt Down?

Related to the subject of capital inflows is the behavior of financial markets in emerging economies. As measured by the MSCI EM Free index, emerging market stock markets have doubled in value relative to their October 2008 low, and emerging market bonds have outperformed equities over the past four years.⁴ Solid economic fundamentals in most developing economies undoubtedly have played a role in these financial market rallies, but accommodative monetary policy in the developed world likely has played a role in pushing asset prices higher as well. Will these financial markets go into a tailspin when the Fed begins to tighten monetary policy?

Emerging market stocks rose about 25 percent between February 1994 and September 1994.

Like the case of net capital flows, the historical record casts doubt on the notation that the initial stages of Fed tightening lead to deleterious economic and financial effects in developing economies. Emerging market stocks rose about 25 percent between February 1994 and September 1994, even though the Fed had hiked rates by 175 bps during that period (Figure 5). After a selloff in late 1994/early 1995, emerging market stocks climbed 60 percent until the onset of the Asian financial crisis in July 1997 brought the bull run to an end. As previously noted, the Fed hiked the fed funds rate by 425 bps between July 2004 and June 2006, but emerging market stocks rose about 60 percent during this two-year period. Equity markets in most developing countries did not decline precipitously until the global financial crisis was in full fury. By then, the FOMC was slashing rates drastically.

⁴ The J.P. Morgan EMBI Plus index, which is an index of emerging market bonds, has risen 120 percent since October 2008.

Between April 2004 and mid-May 2004, bond markets in developing countries lost more than 10 percent of their value.

Data on emerging market bond prices during the 1990's tightening cycle are not readily available, but bond markets in developing countries do not appear to have been adversely affected, at least not in a lasting sense, by Fed rate hikes in the past decade. Between April 2004, when expectations of eventual Fed tightening started to ramp up, and mid-May 2004, bond markets in developing countries lost more than 10 percent of their value (Figure 6). However, values had recovered to their previous peak by the end of that summer, and thereafter they continued to trend higher until the global financial crisis caused a 30 percent decline in value.

Figure 5

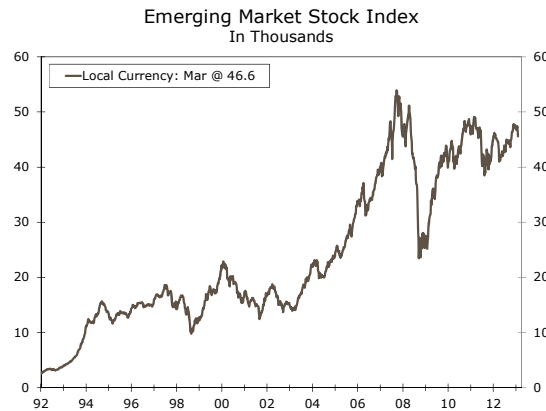
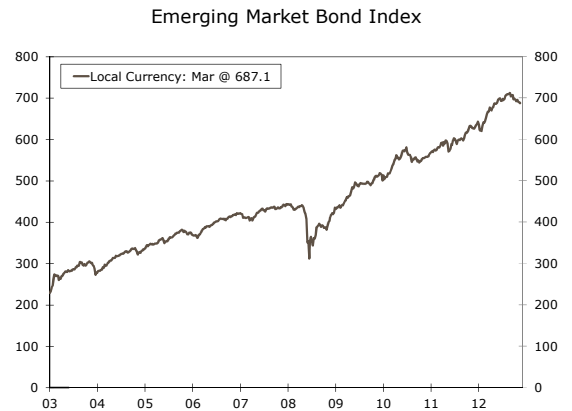


Figure 6



Source: Bloomberg LP and Wells Fargo Securities, LLC

Emerging market currencies showed little reaction to the two previous Fed tightening cycles.

Likewise, emerging market currencies showed little reaction to the two previous Fed tightening cycles. Currencies of many developing countries were fixed vis-à-vis the U.S. dollar in the mid-1990's. Therefore, signs of downward pressure on emerging market currencies would have been manifested by declining foreign exchange reserves.⁵ However, total foreign exchange reserves in the developing world rose by \$20 billion in the twelve months following June 1994 (when the Fed hiked rates by 300 bps), suggesting little downward pressure on emerging market currencies (Figure 7). Foreign exchange reserves among developing countries did not dip markedly until the Asian financial crisis was in full swing in the summer of 1998.

Figure 7

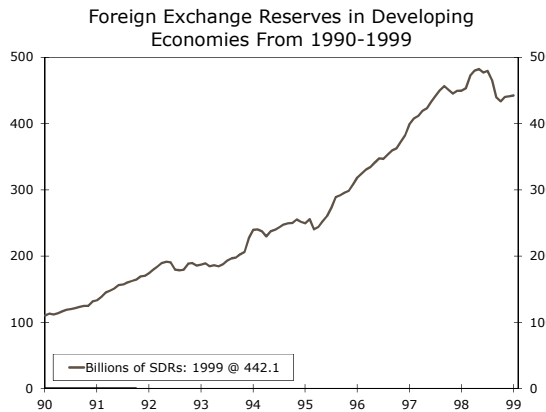
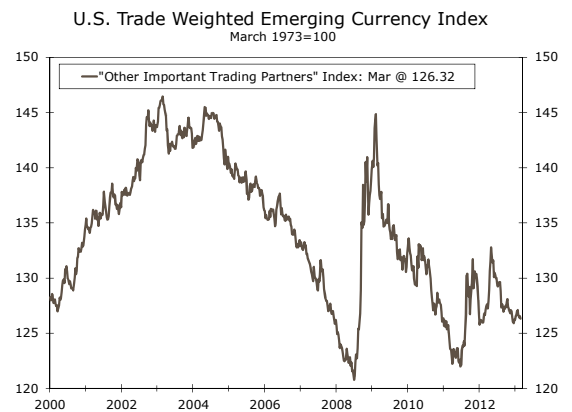


Figure 8



Source: International Monetary Fund, Federal Reserve Board and Wells Fargo Securities, LLC

⁵ If foreign investors are pulling out, they will sell their local-currency assets, and convert the proceeds into foreign currencies like U.S. dollars. In a flexible exchange rate regime, the transaction in the foreign exchange market causes the local currency to depreciate against the dollar. Under a fixed exchange rate regime, the central bank must sell U.S. dollars in the foreign exchange market to keep the value of the local currency fixed vis-à-vis the greenback. The transaction causes the foreign exchange reserves of the central bank to decline.

The financial crises that swept through the developing world in the late 1990's forced many countries to abandon their dollar pegs. By the commencement of the next Fed tightening cycle in 2004, most developing economies had adopted flexible or semi-flexible exchange rates. Despite 425 bps of Fed rate hikes, the Federal Reserve's "Other Important Trading Partners" index fell more than 15 percent between mid-2004 and mid-2008 (Figure 8). That is, the U.S. dollar depreciated more than 15 percent against a trade-weighted index of emerging market currencies. The greenback did not strengthen against most emerging market currencies until the summer of 2008, when the acute phase of the global financial crisis started.

Fundamentals Generally Strong in Developing Economies

The above discussion makes clear that developing economies have not been derailed by Fed rate hikes during the past two tightening cycles. Generally, the amount of tightening that the Fed undertook in its past two cycle was not enough to bring the U.S. economy, let alone the global economy, to its knees. Asset prices in developing countries may have wobbled a bit in the initial phases of the tightening cycle, but they quickly recovered and resumed their upward trend. In an environment of continued global expansion, investors ultimately had little reason to turn extremely risk averse. Rather, it was the onset of financial crises—the Asian financial crisis of 1997-98 and the global financial crisis of 2007-09—that led to derailment of developing economies and their financial markets. Therefore, decision makers should really be focused on the potential for financial crisis, not on the potential for Fed rate hikes per se.

Is there another financial crisis lurking right around the corner? As we argued in our Feb. 28 special report on sovereign debt in emerging markets, economic fundamentals in many developing economies are generally solid at present. Many countries have current account surpluses or modest deficits, fiscal positions are generally strong, and inflation is largely under control. In general, the developing world does not look like an accident waiting to happen, at least not in the foreseeable future.

If there are catalysts that could trigger another financial crisis at present, they reside in advanced economies rather than in the developing world. As the recent bailout of Cyprus demonstrates, the European sovereign debt crisis continues to fester. Although the topic is beyond the scope of this report, the Eurozone is far from being "fixed" and, therefore, represents a potential source of global financial instability.⁶ In the United States, Congress must raise or suspend the debt ceiling by summer or risk defaulting on the debt. Although the probability that Congress defaults on the debt is rather low, an actual default by the U.S. government surely would lead to another global financial crisis.

Conclusion

The FOMC has maintained its target range for the fed funds rate at 0 to ¼ percent for more than four years, and a rate hike in the near term does not seem likely. The FOMC has publicly said that it will not hike rates until the unemployment rate drops to 6-½ percent, and it probably will be some time before that threshold is approached. However, if the U.S. economy continues to show signs of strength, the FOMC may decide to scale back, if not discontinue altogether, its QE program. We have no doubt that stock markets in most countries will drop on the expectation that Fed policy will cease to become more accommodative. We also believe that bond yields in most countries will rise on the news, and that emerging market currencies probably will weaken. Given the extraordinary policy accommodation that has been put in place over the past few years, news that the easing cycle is coming to an end could provoke a more significant decline in asset prices than previous cycles of policy tightening have provoked.

However, we also believe that the effects will not be long lasting. After all, the FOMC will judge that further policy accommodation is no longer appropriate because the U.S. economy is strong enough to stand on its own. As long as U.S. economic growth remains solid, economic growth in the developing world likely will remain positive as well. In an environment of global economic

The FOMC has maintained its target rate for the fed funds rate at 0 to ¼ percent for more than four years.

⁶ We have written extensively about the Eurozone sovereign debt crisis over the past few years. Our most recent report, "European Debt Dynamics: An Update" (Feb. 7, 2013), is available upon request.

expansion, ongoing selloffs in asset markets do not seem likely. Even when the FOMC actually begins to hike its target for the fed funds rate, it likely will be some time before monetary policy in the United States becomes so tight as to choke off the U.S. economic expansion. With economic fundamentals in most developing countries generally solid at present, decision makers who are concerned about growth prospects and asset prices in those economies should worry about potential catalysts for financial crises, like the debt issues in the Eurozone and the United States, rather than less Fed policy accommodation in the near term.

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