Pathfinder Economic Flash

US Federal Reserve Tapering: A Soft Landing?

The US Federal Reserve Bank (Fed) announced a tapering of its bond buying program (QE3) following a meeting of its Federal Open Markets Committee (FOMC) last week. Its purchase of US bonds ($40 billion) and mortgage-backed securities ($35 billion) has been reduced by $10 billion from $85 billion to $75 billion a month. The announcement, while anticipated in the near future by markets, came earlier than expected. Only 37% of economists polled by Bloomberg expected the Fed to announce the commencement of its tapering program at its December 2013 FOMC meeting.

Why Now?

The Fed's decision to initiate tapering is based on an increasing flow of positive data on the US economy over the last few months. Growth, unemployment, housing, consumer sentiment, exports and stock markets have all recorded an upturn signifying a steady, if unspectacular recovery in the US economy. The Fed has signaled that the tapering will take place in "baby-steps". The extent and pace of its glide path will be driven by the flow of data on the strength of the US economy going forward. The consensus expectation is that the process is likely to be completed by the end of 2014, given the increasing signs of the underlying strength of the US economy, not least the reduction in energy costs and the strength of corporate balance sheets.

Fed: Unemployment to Inflation Targeting

In announcing the commencement of its tapering program, the Fed also signaled a qualitative shift in its forward guidance. Up till now, it has focused primarily on the unemployment rate. It had previously signaled that the unemployment rate would need to decline to 6.5% before it considered reviewing its accommodative monetary policy. Last week, Ben Bernanke's forward guidance shifted the focus to the inflation rate which at 1.2% is currently well below the target of 2%. This gives the Fed significant room to maneuver in continuing its accommodative monetary policy. It is also important to note that the Fed has reverted to the bread and butter of Central Bank activity i.e. inflation targeting.

The significance of this shift is that it reinforces the Fed's "dovish" stance on monetary policy for some time to come, as the 6.5% unemployment target is expected to be met well before inflation rises to 2% i.e. the Fed is guiding that its accommodating monetary policy stance will

continue for longer and that the policy interest rates will not be increased anytime soon – not until 2015 at the earliest.

International Reaction Then

When Ben Bernanke first spoke about tapering in May 2013, it triggered gyrations in global markets. The US bond yields increased sharply and stock markets around the world took a hit. Most significantly, the reduction in the differentials in the yields between US securities and emerging market instruments led to an outflow of money from emerging markets with adverse consequences for their currencies and share markets. Countries like India and Indonesia were most severely affected due to economic vulnerability created by their twin deficits: the current account of the balance of payments and the budget. Some money also flowed out of Sri Lankan government securities and the Colombo stock exchange. However, the level of outflow was manageable.

International Reaction Now

This time around markets have been far less skittish. The increase in US bond yields has been moderate so far. Stock markets in advanced countries experienced a "tapering pop". While there has been some outflow of money from emerging markets, the impact has been far more muted than earlier this year. The less extreme reaction this time around seems to reflect not only that emerging markets are better insulated but also that the Fed has been successful in making a clear distinction between tapering QE3 gradually and monetary tightening i.e. an increase in policy interest rates. As mentioned above, the shift in forward guidance from unemployment to inflation has reinforced he credibility of the Fed's continued commitment to accommodating monetary policy. The nomination of Janet Yellen as Ben Bernanke's successor has given further credence to the Fed's "dovish" credentials.

One may conclude that the Fed seems to have engineered "a soft landing" for its tapering program, which is very much uncharted territory in the realm of macroeconomic management. The implications so far for the US and the rest of the world have been manageable. However, at the time of writing it is still early days and vigilance and caution are necessary. Going forward, one needs to monitor the US inflation rate to understand the direction of US policy interest rates. In addition, the key transmission mechanism for the impact on emerging economies will be the US bond yields – more significantly the trends in yield differentials. These will inevitably decline. However, the more gradual the increase in US bond yields, the less disruptive it will be for emerging markets. The strength of their macroeconomic fundamentals will be the key determinant of their vulnerability/resilience to declining yield differentials.

Implications for Sri Lanka

For Sri Lanka, as well as the other emerging markets, the costs of borrowing abroad will be higher as yield differentials decline with the inevitable eventual rise in US bonds. The extent of

the risk premium demanded by international capital markets from these countries will depend on the strength of each country's macroeconomic fundamentals, particularly the current account and budget deficits. It is encouraging, therefore, that the Sri Lankan authorities have anticipated the changing global financial landscape by attaching priority to fiscal consolidation, in particular. As pointed out by the Pathfinder Foundation on numerous occasions, the budget deficit lies at the heart of the macroeconomic stability of the Sri Lankan economy. Going forward, the premium attached to fiscal consolidation will only increase, particularly if foreign borrowing (by the government, banks and corporates) is to play a role in supporting growth by funding the twin fiscal and external financing gaps.

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