The market implications of financial repression in EMs

- Policymakers in a few emerging markets have turned to unconventional monetary policies to combat the economic fallout from the coronavirus pandemic, and some may go further into outright financial repression. This note sets out some of the potential implications for financial markets.

- What do we mean by “financial repression”? We use the term to cover a host of different policies aimed at keeping down borrowing costs that go beyond standard monetary policy. Historically, these have included interest rates caps, creating a captive domestic audience for government debt (e.g. via capital controls or financial regulation), and institutional structures (e.g. state banks) that channel cheap loans to favoured sectors. Unconventional monetary policy tools such as quantitative easing, credit easing, and yield curve control can also be seen as financial repression, given that they result in similar outcomes – cheaper loans for debtors and lower returns for creditors, in effect transferring resources from savers to borrowers.

- Which of the main emerging markets are taking steps in that direction? Most major EM central banks have cut interest rates in response to the pandemic. In addition, during the market panic in March, several bought local currency government bonds in order to stabilise their bond markets. While some argue that constitutes QE, in our view such steps are better understood as emergency liquidity measures, since they are mainly aimed at restoring market functioning and are not intended to continue for a prolonged period.

- That said, many EM central banks are now at, or approaching, the effective lower bound for interest rates and, as a result, some have started to turn to unconventional tools to provide further long-term support to their economies. In both Chile and Hungary, central banks have announced asset purchase programmes with the explicit aim of bringing down long-term interest rates (though Chile’s is yet to be implemented because it requires a change in legislation). In Poland, the central bank has continued to buy government bonds even as market conditions have normalised, though it has shied away from formalising this into a QE programme. We think that others will follow with similar measures in the coming months, including Korea, Thailand, and Peru.

- In addition, the central bank of Indonesia, where the policy rate is still some way above the lower bound, has bought bonds directly from the government to help finance fiscal deficits resulting from the pandemic. And several countries, including Indonesia and Turkey, have tightened capital controls to support their currencies. But, as yet, steps towards more severe forms of financial repression have been limited to countries like Argentina and Lebanon, which were already in distress before the pandemic hit.

- What are the likely implications for EM financial markets? In our view, the effects of unconventional monetary policy in emerging markets are less straightforward than in DMs and could differ significantly from country to country. In some countries with solid fundamentals, they are likely to be similar to those in DMs – lower bond yields and some downward pressure on currencies. But in others, unconventional policies could easily trigger a rise in risk premia and sustained currency weakness. We think that three key features will determine which EMs are likely to be able to pursue such policies successfully:

- The first is their external positions and the depth of their domestic financial markets. Countries with current account surpluses, positive net foreign assets, and large pools of domestic savings are better placed to pursue unorthodox policies successfully. They can rely on domestic investors for financing – many, including pension funds and insurers, have little choice but to hold much of their portfolios in domestic bonds. But countries which do not have sufficient domestic savings and rely on foreign investors to finance external deficits and roll over existing debt are less likely to get away with unorthodox steps. If yields there were lowered significantly, foreigners may put their money elsewhere, which would push up risk premia and lead to significant currency depreciation.

- The second is their history with inflation. Countries with low and stable inflation, and where inflation expectations are well-anchored, are less likely to trigger instability by pursuing financial repression.

- The third factor is the strength of institutions, both monetary and fiscal, and political systems. After all, unorthodox policies rely on investors’ willingness to accept policymakers’ reassurance that they will only be used as long as is necessary and would be withdrawn before triggering runaway inflation – the recent experiences of Argentina and Venezuela provide cautionary examples of what can happen when they are not.

- Those countries that have started long-term asset purchases, as well as those we think will soon, all score fairly well on all or most of those metrics. (See Charts 1-3.) Their government bond yields, which were already lower than those of most EMs, have fallen a bit further over recent months (see Chart 4), and we think they will edge down further. Others, such as South Africa and Brazil look more vulnerable on these metrics, and are more likely to turn to austerity, at least initially, to address their public debt issues and avoid spooking investors.
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