Global Economic Prospects

HIGHLIGHTS from Chapter 4:

Asset Purchases in Emerging Markets: Unconventional Policies, Unconventional Times

Key Points

- *Amid financial market stress in the early months of the global recession of 2020, central banks in some emerging market and developing economies (EMDEs) announced and implemented asset purchase programs, in many cases for the first time.*
- *These programs, along with spillovers from accommodative monetary policy in advanced economies, appear to have helped stabilize EMDE financial markets.*
- *In EMDEs where asset purchases continue to expand and are perceived to finance unsustainable fiscal deficits, these programs may erode hard-won central bank operational independence and risk de-anchoring inflation expectations.*

Asset purchase programs in EMDEs. In 2020, 18 EMDEs have announced or implemented asset purchase programs. Asset purchases have been focused on local currency government bonds. The size of asset purchases has varied from less than 1 to 6 percent of GDP. Many EMDE central banks have not announced the scale or duration of purchases. While most have been purchasing only in secondary markets, some have purchased bonds directly from governments.

Impact of EMDE asset purchase programs. Announcements of asset purchase programs appear to have helped stabilize bond markets and boost equity prices while avoiding putting pressure on currencies. The effects on long-term bond yields and equity prices have been on average greater than the effects of announcements of monetary policy rate cuts in response to COVID-19. In addition, the announcement effect of EMDE asset purchases on government bond yields appears to have been larger than the announcement effects of advanced-economy asset purchases. The broader macroeconomic implications, however, remain to be seen.

Risks to central bank credibility and perceptions of debt monetization. In the 1980s and 1990s, some EMDE central banks bought government bonds to finance fiscal deficits. These past episodes of debt monetization differed from the recent experience in being preceded by long periods of high inflation, less credible fiscal and monetary frameworks, external debt defaults, and stubbornly high fiscal deficits. For now, macroeconomic conditions in EMDEs are more benign than in these historical episodes. However, the earlier episodes are a reminder of the risks to central bank credibility if asset purchase programs are used for prolonged monetary financing of fiscal deficits.

The recent experience of EMDE asset purchase programs may overstate their future effectiveness. First, they were set against the backdrop of uniquely accommodative macro-economic policies in advanced economies. Second, they were an unanticipated departure from earlier policy guidance of EMDE central banks that had focused on buttressing their independence. Third, fragile liquidity conditions in EMDE financial markets are conducive to volatile movements in asset prices, possibly leading to unintended consequences.

Need for policy action. Embedding asset purchase programs in a transparent framework that is consistent with financial stability and inflation objectives reduces the risk that asset purchases are perceived as monetary financing that might de-anchor inflation expectations. The need for enhanced frameworks and medium-term fiscal strategies may increase in the absence of the uniquely accommodative global monetary conditions enacted in response to COVID-19.

Figure 1. Asset purchase programs in emerging markets

In 2020, 18 EMDEs have announced or implemented asset purchase programs. Announced and implemented asset purchases by EMDE central banks have been smaller than those in advanced economies. The announcement of asset purchase programs in EMDEs helped stabilize domestic financial markets. Case studies of EMDEs in the 1980s and 1990s illustrate the severe macroeconomic instability that can follow sustained and large-scale debt monetization. The crises were preceded by a decade of large fiscal deficits financed by central banks and high inflation.
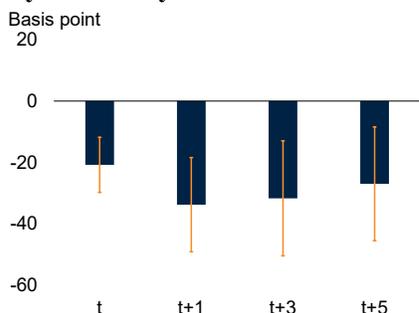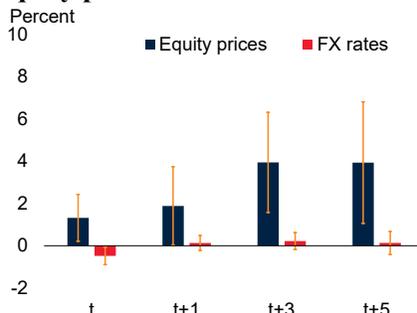
A. Advanced economy asset purchases
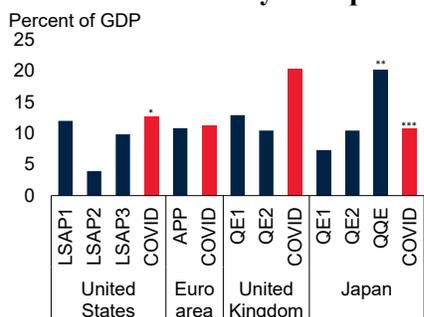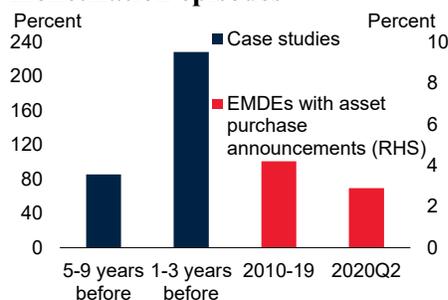
B. EMDE announced or completed purchases
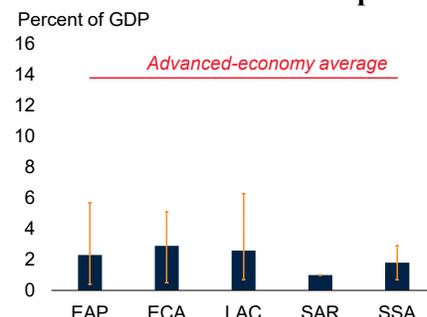
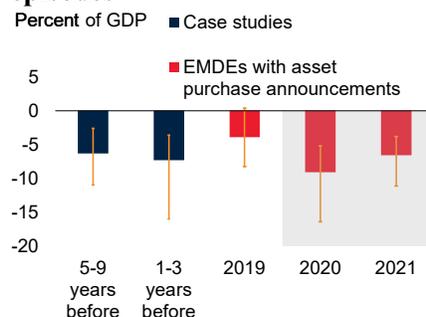**C. Impact of EMDE asset purchases: EMDE 10-year bond yields**

D. Impact of EMDE asset purchases: EMDE equity prices and currencies

E. Inflation developments prior to debt monetization episodes

F. Government deficits prior to debt monetization episodes

Sources: Haver; IMF; National Sources; World Bank.

Note: EMDE = emerging market and developing economies; EAP = East Asia and Pacific, ECA =Europe and Central Asia, LAC = Latin America and the Caribbean, SAR = South Asia, SSA = Sub-Saharan Africa. All asset purchase and balance sheet figures are estimates based on published data.

A. Announced purchases of sovereign and private sector bonds in percent of nominal GDP. In the U.S., the large scale asset purchase (LSAP) programs began in 2008 (LSAP1), 2010 (LSAP2), and 2012 (LSAP3). The European Central Bank's 2015 Asset Purchase Program (APP) is given as the original announced program size. U.K. programs include QE1, launched in 2009, QE2, launched in 2010 and expanded in 2011, and the COVID program launched in March 2020. The Bank of Japan's first QE program during 2001-06 is given as "QE1," while the second QE program launched in 2010 is given as QE2. The "Quantitative and Qualitative" program launched in 2013 is given as QQE. * The "COVID" package launched in March 2020 is not specified in scale, so purchases are only shown from the start of the program to November 2020. ** QQE program reflects initially announced purchases in March 2013. Subsequent expansions of the program increased liquidity by 72 percent of GDP between March 2013

and January 2020. *** Bank of Japan COVID support package is not limited. Purchases to November are provided.

B. Announced or completed purchases (where no announcement exists) relative to 2019 nominal GDP as of November 2020. Bar shows average in each region. Orange whiskers show regional range. Red line shows average of advanced economy programs in 2020.

C.D. Based on panel regression with daily financial asset prices in 26 EMDEs. Twenty-five asset purchase announcements in 14 EMDEs are studied. Horizontal axes indicate days after the announcements of asset purchases ($t = 0$). Standard errors are clustered by countries. Blue and red bars indicate point estimates and orange whiskers indicate 90 percent confidence intervals.

D. FX rates indicate foreign exchange rates of EMDE currencies vis-à-vis the U.S. dollar. An increase in the exchange rate denotes a depreciation of EMDE currencies.

E.F. Country case studies include Argentina (1989), Bolivia (1985), Brazil (1990), Peru (1990), and Turkey (1994). Years listed are the year in which inflation and debt-monetization rates were at their peak. Historical episodes are reported in the blue bars as the average of the five episodes ahead of the peak rate of inflation or debt monetization in the case study economies. Inflation takes the median of these episodes in order to reduce the influence of outliers. Red bars indicate the average of those EMDEs undertaking asset purchase programs since the emergence of the COVID-19 pandemic in the years indicated.

F. The shaded region indicates the average of the fiscal deficit projected in the IMF's October 2020 World Economic Outlook for those EMDEs undertaking asset purchase programs. Orange whiskers show the range.