

Box 4

CHANGING EXPECTATIONS OF US MONETARY POLICY AND GLOBAL ASSET PRICES: WHAT CAN WE LEARN FROM THE 1994 EPISODE?

The global asset market volatility that accompanied changing expectations regarding a tapering-off of the Federal Reserve's asset purchases since May resembled previous episodes when the withdrawal of accommodative US monetary policy was associated with significant global market sell-offs. From a financial stability perspective, one past episode stands out, namely that of developments in 1993-94. During this period, an abrupt change in US monetary policy caught financial markets by surprise, resulting in sharp adjustments to expectations regarding the US monetary policy stance that led to considerable bond market turbulence.¹ Although much has changed since 1994 – central bank communication has improved significantly and monetary policy tools have become more complex – an examination of the mechanics of the 1993-94 episode, and a comparison with recent events, can provide some useful insights into potential vulnerabilities associated with changing expectations regarding the US monetary policy stance.

The US economic recovery gained strength in late 1993, triggering a tightening of monetary policy that went hand in hand with spikes in volatility and significant price corrections in global bond markets. The Federal Reserve's policy rate rose by 300 basis points in seven steps from

¹ See also Box 1, entitled "Interest rate risk and the Federal Reserve's tightening cycle: comparison with the events of 1994", *Financial Stability Review*, ECB, June 2010.

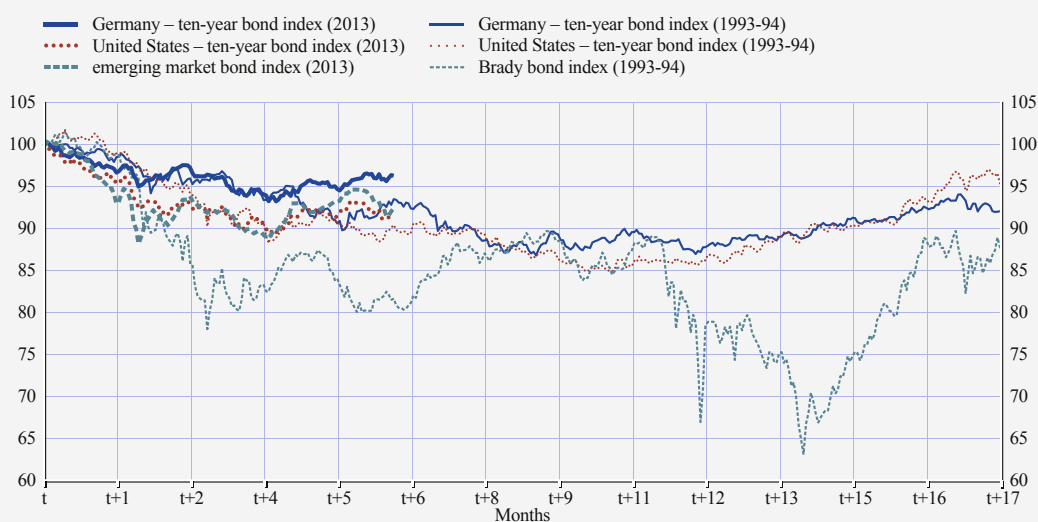
early 1994 to early 1995, and US Treasuries followed suit: yields on one-year and ten-year US government bonds increased by 320 basis points and 200 basis points respectively. The ten-year US Treasury benchmark lost 15% of its value between the end of 1993 and mid-1994. Developments in US Treasuries quickly spilled over to other bond markets, in particular US corporate bond markets, as well as to advanced and emerging market government bond markets (see the chart).

Between the end of 1993 and mid-1994, the price of the ten-year gilt had fallen by almost 20%, while prices of ten-year German, Swiss and Japanese government bonds had declined by around 10%. Similar to recent developments, the most marked price corrections were observed in emerging markets. US dollar-denominated bonds in Latin America (so-called “Brady bonds”) had lost almost 25% of their value by March 1994, and tighter financial conditions linked to the Mexican crisis brought the total price decline to 35% by early 1995.

Although recent developments have been more muted than those observed in 1994, there appear to be some parallels between the two events (see the chart below). In May 2013, a change in expectations regarding a tapering of the Federal Reserve’s bond purchase programme was associated with large-scale sales of assets across the globe, particularly of emerging market assets. Similar to events in 1994, developments in the United States appear to have been a catalyst for bond market corrections, although the magnitude of the adjustment was clearly linked to underlying domestic vulnerabilities, in particular a deteriorating growth outlook, combined with large current account deficits. Price adjustments in emerging bond and equity markets in the period from late May to early July amplified those of advanced markets. In particular, the euro area emerged relatively unscathed from the recent financial market turbulence. While a deteriorating growth outlook for emerging markets has amplified adjustment challenges,

Sovereign bond indices during the 1993-94 and 2013 market turbulences

(indices: Dec. 1993 = 100; May 2013 = 100)



Sources: Thomson Reuters Datastream and ECB calculations.

Note: With respect to the period 1993-94, t refers to December 1993, while it refers to May 2013 in the case of the year 2013.

improving growth prospects have mitigated the impact of global financial turbulence on the advanced economies.

These episodes illustrate how reassessments of the US monetary policy stance can have significant global consequences, particularly for regions where domestic vulnerabilities are high. While the exit from quantitative easing may lead to some volatility and investor portfolio shifts at the global level, determining the extent of these shifts and their impact on yields remains an arduous task. Estimates by some market participants that point to a low impact of a tapering of the Federal Reserve's asset purchase programme on asset prices seem to contrast with the sharp interest rate movements observed over last summer, perhaps indicating that recent fluctuations embedded in expectations regarding rate increases (conventional policy) may have been equally or even more important for markets than those regarding the tapering (unconventional policies). It should be noted that history suggests that the strength of global spillovers from changing US monetary policy expectations depend on country-specific vulnerabilities, notably unsustainable external positions.