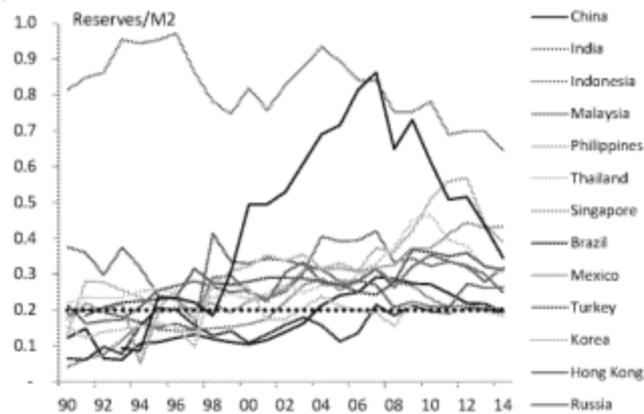




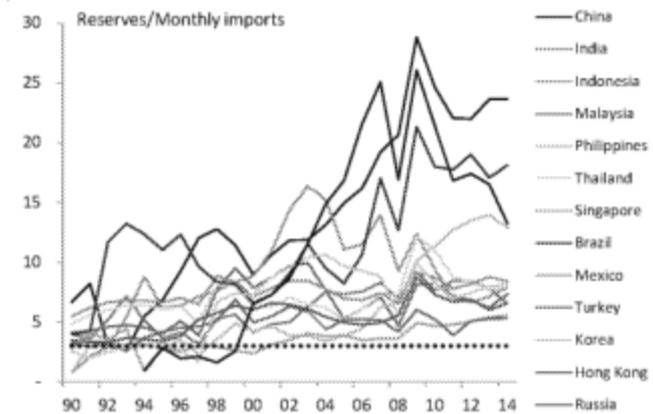
remain more accommodative than feared. The less constructive view is that the Fed balance sheet simply matters far more for EM, with liquidity provided by the ECB and BoJ a poor compensation for the Fed's retrenchment. Indeed, Figure 16 suggests this to be the case, with EM flows tracking the fall in Fed balance sheet growth closely of late. The hawkish scenario of Fed stopping reinvestment next year would suggest that EM flows can get weaker, while even a more dovish scenario of a constant Fed balance sheet would not be enough to lift inflows again.

Figure 17: Reserve-to-M2 ratios were unnecessarily high in some countries even as reserves are now drawn on heavily



Source: Deutsche Bank, IMF WDI

Figure 18: Import cover is similarly excessive in some core EM economies



Source: Deutsche Bank, IMF WDI

Some central banks are in uncomfortable positions and are increasingly concerned about reserves adequacy. In Malaysia, reserves now only just match short term external debt liabilities. Indonesia has been more tentative about drawing down reserves since the taper tantrum. Yet most central banks have built deep pockets in the past fifteen years, affording them room to drawdown reserves to manage the exit of capital flows. Unlike in the late 1990's when currency mismatches were more severe, and reserves less adequate, making many pegs indefensible, EM central banks generally have more room to sell reserves to at least manage FX weakness this time.

On most conventional metrics, EM reserve levels looked healthy as of late 2014. A reserve-to-M2 ratio of 0.2 is typically considered as the upper bound of the danger zone. In the run-up to the crises of the 1990s, many emerging markets were flush with liquidity that was not backed up by reserves (Figure 17). Yet by the end of the 2000s, notwithstanding, all major emerging economies had pushed their reserve-to-M2 ratios above the 0.2 threshold. Another rule-of-thumb in policy-making is for emerging countries to be able to cover at least three months worth of imports out of reserves. Again, many only barely met this rule in the 1990s, but all major EM countries have moved comfortably above the threshold since the early 2000s (Figure 18).