# Economic Watch

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## Uneven financial tensions in a volatile environment

Since the start of the global crisis, the way the "tensions"<sup>1</sup> have developed in the financial markets in different regions have been similar, independent of their origin. This comovement is perfectly reasonable, not only in times of crisis, given: i) the instantaneous transmission of information; ii) the freedom of movement of capital flows; and iii) that there is no measurement of the price of the financial asset concerned – certainly more closely linked to the idiosyncratic conditions of each economy – but rather of the risk and the uncertainty – volatility – concerning the valuations. Nonetheless, since the second quarter of last year we started to observe differences between the financial tensions in emerging and developed markets, and this decoupling is the subject of this box.

We use as a proxy for the non-observed variable "tensions" the indices constructed by BBVA Research. The Financial Tensions Index (FTI) combines in a single indicator the dynamic of a number of variables in the financial markets that approximate risk and uncertainty<sup>2.</sup> For the purposes of this study we compare the FTI of developed economies (the US and Europe) with the FTI of emerging economies (the aggregate FTI of LatAm, emerging Asia and emerging Europe).

One of the distinctive features of the present crisis is that it originates in some of the most developed economies, while the EMs are in general better equipped than in the past in terms of defining and managing their macroeconomic policies as a result of their own crises in previous decades. However, the tensions in the emerging markets have "one by one" reflected the instability derived from developed markets, and this is manifested in the way the financial tensions in emerging markets imitated those in the developed markets. Thus the collapse of Lehman Brothers had a high level of contagion to all the EMs, although more markedly to Latin America. On the other hand, the European debt crisis and the turbulence generated by the Arab Spring also had an impact on emerging markets, although as was to be expected, they had the most effect on European EMs.

However, since May 2013 there has been a decoupling of the financial tensions in these regions. While the tensions in the developed markets have continued the downward trend observed since mid-2012, in the emerging markets this favourable trend reversed, giving rise to an increase in tensions in the second quarter of 2013. At present, the tensions in EMs are at similar levels to June 2013.

<sup>1:</sup> The financial tensions cannot be observed directly, but rather than looking at asset prices, attempt to capture the risks in terms of the spreads over riskfree assets - and uncertainty - through measuring volatility. 2: In the construction of each index we include information on credit risk: on the one hand sovereign, banking and corporate (the two latter do not apply in

<sup>2:</sup> In the construction of each index we include information on credit risk: on the one hand sovereign, banking and corporate (the two latter do not apply in the case of EMs due to the lack of information) and on the other capital markets volatility, interest rates and exchange rates. In addition, in the case of developed markets we add measurements of tensions and liquidity.

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Source: BBVA Research

This divergence is fundamentally explained by the different impact on the two areas of the change in expectations last May regarding global liquidity. The monetary expansion programmes introduced by the developed countries to support their economies (fundamentally in the US and the UK and more recently in Japan) generated a record volume of liquidity at a global level. Some of this liquidity made its way to the EMs in a fairly indiscriminate search for yield, without consideration for the differences in the outlooks for the economies or in the valuation of the assets, and thus moderating the measurements of risk and volatility.

In May 2013, given indications that activity was improving, the Federal Reserve (Fed) announced the possibility of starting<sup>4</sup> to withdraw the monetary stimulus programme earlier than expected. The Fed's announcement generated global uncertainty, but the worst impact was on the EMs as a consequence of the great underlying diversity of the financial assets that had received the flood of liquidity derived from the previous expansion. In this context, given the expectations of reduced global liquidity, according to our indicators the wave of capital outflows from the EMs gave rise to a substantial increase in financial tensions. Once this fact had been absorbed by the markets, there was a gradual decline in tensions, although at present they are above their levels prior to the Fed's announcement.

## Volatility is a key element in this new global scenario

On a longer-term perspective, note that altogether we are in an environment of moderate financial tensions that tend to converge to pre-crisis levels. However, this is happening simultaneously with a period of high volatility in the financial markets that is not fully reflected either by our FTIs or by the VIX, the commonly used indicator for global volatility. In the case of the FTI, being an indicator that includes risk and volatility components, the gradual decline in the former as we gain distance from the crisis and move towards recovery eclipses what has happened in terms of volatility. In the case of the VIX, its reach is limited in this context, as the indicator measures the implicit volatility of the S&P 500 index. What would a global volatility index tell us?

<sup>3</sup> The methods used in the construction of the FTIs enable the comparison of the development of tensions, but given that the indicators are standardised no conclusions can be drawn regarding their levels.

<sup>4:</sup> The market had been assuming September 2013.

Our global volatility index (GVI) attempts to synthesise in a single variable the volatility dynamic of the financial markets in a more global way than with the indicators available to date. In this sense the indicator is more global, as it covers different economies<sup>5</sup> and also different markets: fixed-income, equities and FX.

Since the start of the crisis, the dynamic of the GVI has been similar to those of the various FTIs, and as is to be expected, to the VIX as well. However, since the beginning of 2013 there has been a significant increase in global volatility that is only partly reflected in financial tensions and in the VIX<sup>6</sup>. This increase in the GVI, which started in the early months of 2013, has been associated with the uncertainty regarding the actions of the principal central banks, and their impact on markets: i) the launch of a massive quantitative easing by the central bank of Japan; and ii) subsequently, and most importantly, the above-mentioned change in the Fed's communication regarding the possibility of starting to reduce its third round of stimulus earlier than expected. Thus the uncertainty regarding the possibility of a reduction in global liquidity, as well of the effects on financial tensions already noted above, generated an increase in global volatility in a scenario of moderate financial tensions.



Source: BBVA Research

Over the course of 2014, a year when the central banks of the principal developed countries will continue to be the protagonists, it will be particularly interesting to monitor this global volatility indicator, as periods of high volatility could indicate potential channels of financial fragility.

<sup>6</sup> The correlation between the GVI and the VIX between 2004 and 2009 is 90%, while between 2010 and January 2014 it is 70%. The correlation falls to 30% when we look at just 2013 and January 2014.

<sup>&</sup>lt;sup>5</sup> The countries included are: Japan, China, the US, Germany, Spain, Italy, Mexico, Brazil, Turkey and Poland.



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