Manuel Sánchez: Emerging economies in the face of financial bonanza

Remarks by Mr Manuel Sánchez, Deputy Governor of the Bank of Mexico, at CEMLA's (Center for Latin American Monetary Studies) IX Meeting of Monetary Policy Managers, co-sponsored by CEMLA and the Central Bank of Argentina, Buenos Aires, 23 May 2013.

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It is an honor for me to address the monetary policy managers from the central banks that are members and invitees of the Center for Latin American Monetary Studies. I would like to thank the Central Bank of Argentina and the CEMLA for the opportunity to participate in this conference, devoted to a discussion of the possible implications of the monetary policies of advanced nations for emerging markets.

Since the global financial crisis of 2007–2008, advanced economies have implemented a wide range of measures to counter the ensuing financial turbulence and its consequences for economic activity. Among these actions, expansionary monetary policy has been both innovative and key to the management of domestic problems, and at the same time, has created challenges for emerging economies, both in terms of likely repercussions and the need to respond.

In my remarks, I would like to address first, the possible effects of the monetary policies implemented by developed countries on emerging economies, manifested especially through a significant rise in capital inflows; second, some concerns and risks associated with these larger foreign resources; and third, the most important measures that the authorities of many developing nations can adopt to mitigate some of the vulnerabilities derived from capital flow surges.

Advanced economies and capital flows

The global financial crisis led most central banks to relax their monetary policies considerably, which included unconventional strategies in some advanced countries. In particular, in the United States, the Federal Reserve cut its policy interest rate to near zero by the end of 2008, while it expanded liquidity facilities substantially.

Unlike the Great Depression of 1929–1933, which was characterized by bank runs in favor of cash, in the recent crisis, the public sought financial instruments backed by the government in an attempt to rid themselves of other assets suddenly perceived to be high risk. This time, the Federal Reserve acted in a timely way as lender of last resort, effectively controlling the financial panic.

Once the markets became calmer, some central banks of developed nations continued relaxing monetary policy in the aim of fueling the recovery of their economies. Thus, in the United States, successive quantitative easing programs have been put into place, consisting of the acquisition of financial assets, mostly Treasury bonds and mortgage-backed securities, in exchange for bank reserves. The size of the Fed's balance sheet has reached 20 percent of GDP, a record high.

Although monetary policy has supported economic activity, as expected it has not been able to generate on its own a firm and sustained recovery. In the United States, the nonstandard monetary expansion applied during more than four years has not precluded the economic upturn from being the slowest in the post-war period, with the economy remaining below its secular trend.

The Fed has announced that it will maintain its lax monetary policy for an extended period of time, conditioning its future interest-rate decisions on given unemployment and inflation parameters. Despite positive effects, this extraordinary monetary accommodation can cause problems. Low interest rates can facilitate excessive risk-taking and the financing of

low-return investments, which can undermine efficiency and put financial stability at risk. In addition, when the time comes, the unwinding of monetary stimulus could be complicated, causing volatility in financial markets and putting control over inflation at risk.[1]

Given the globalization of markets, it is natural to expect that abundant liquidity in developed markets may extend to the rest of the world, as part of the process of the search for yield at the expense of higher risk. Investments can go to the purchase of emerging-economy assets, either stocks or bank and nonbank debt.

Indeed, since the middle of the last decade, considerable net private capital inflows from nonresidents have been seen in emerging markets, with a peak in 2007, a slowdown in the following two years, and new momentum beginning in 2010. Approximately half of these inflows have been foreign direct investment. However, what is unusual about the last three years has been the significant share of portfolio funds, especially those dedicated to debt instruments, something which seems to have accelerated during 2013.[2]

Even though the recent significant investment in emerging markets does not represent a phenomenon without precedent in modern history, its current strength has reopened the debate on the role that lax monetary policy in advanced nations may be playing in fueling the trend. Undoubtedly, the synchronized nature of capital inflows to many developing and recently industrialized nations points toward the conclusion that external global factors are crucial.

Although research is ongoing, statistical studies suggest that the monetary policy of advanced nations has been a trigger of capital flows to emerging markets. This observation is consistent with the hypothesis that expansionary monetary policy includes a transmission channel that tends to amplify risks adopted by investors.[3]

A second determinant of capital inflows is lower global risk aversion. However, since at least 2009, it is possible that higher global risk tolerance has depended, to a certain degree, on the monetary policy stances and perspectives in advanced nations. Thus, for example, the beginnings of the most noteworthy drops in the average spreads of internationally traded emerging-market bonds included in JP Morgan´s EMBI+ Index appear to coincide with the announcements of various stages of the quantitative monetary easing in the United States.

The same studies confirm that a third predictor of capital inflows are the individual characteristics of emerging economies, something that should be expected given the international differences in the intensity and composition of these flows. Idiosyncratic factors include the economic growth outlook, the openness of capital accounts, the foreign exchange regime, macroeconomic fundamentals, "country risk," and the financing needs of the emerging-market countries themselves.[4]

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[1] For a discussion of these risks, see the minutes of the Federal Open Market Committee (FOMC) of the Federal Reserve of March 19–20, 2013.

[2] See IIF (2013), "Capital flows to emerging market economies," IIF Research Note, January; and Banco de México (2013), *Inflation report: January–March 2013*, p. 27.

[3] A lower funding cost in foreign currency allows domestic banks to increase lending, which, together with other foreign investment, tends to cause the local currency to appreciate and dampens real volatility, making lending appear to be less risky and, in turn, promoting greater risk-taking. See Bruno, V. and H.S. Shin (2012), "Capital flows and the risk-taking channel of monetary policy," *BIS Working Papers*.

[4] Two empirical analyses of the factors that explain capital flows, including monetary policy, are Ghosh, A.R., *et al.* (2012), "Surges," *IMF Working Paper*, WP/12/22, January; and Fratzscher, M. (2011), "Capital flows, push versus pull factors and the global financial crisis," *ECB Working Paper Series*, No. 1364, July.

Concerns and risks from capital flows

In principle, capital inflows should be viewed as positive since they allow emerging economies to complement their sources of funding for economic activity, and they also make it possible for investors to obtain higher yields and diversify their risks. Notwithstanding these benefits, abrupt capital inflows, in particular capital inflows with short-term horizons, can trigger unintended effects. The key causes of concern are twofold.

The first has to do with the possible generation of financial imbalances for families, firms and governments, in the form of excessive and unsustainable borrowing. This phenomenon can be accompanied by bubbles in financial asset prices, in the sense of prolonged deviations in these prices above those values that may be consistent with fundamentals. For example, in the United States, the real estate bubble both stemmed from and fueled the credit bubble, a combination that led to the global financial crisis.

Assets with prices that can be highly sensitive to capital inflows are, in general, of two kinds. First, greater foreign funding tends to cause local currencies to appreciate, making the exchange rate a possible early indicator of pressures. Second, assets preferred by investors such as stocks, bonds and real estate may increase considerably in value.

To date, no clear evidence exists of possible widespread financial imbalances in emerging markets. Most countries with significant capital inflows have maintained their public and current account balances relative to GDP in surplus or only slightly in deficit, and they also have banking systems with adequate portfolio quality even in cases of rapid loan growth.[5] At the same time, the containment of domestic spending pressures on current accounts is explained, partly, by the accumulation of international reserves by central banks, as well as external financing by some firms, whose proceeds are invested abroad.

In contrast, data reveal that the prices of some assets have increased considerably. From 2007 to 2013, most currencies have appreciated in real multilateral terms. Some studies suggest that, in some cases, these rates could be above their fair values, when fundamental conditions are taken into consideration.[6]

Additionally, the stock market indices in most emerging economies have behaved similarly to those in the United States, some of them surpassing their levels prior to the crisis. However, as in the U.S. economy, rising stock prices could be justified by the generation of corporate profits in recent years. In contrast, no general trends of excessive rises in real estate prices have been observed.[7]

Government bonds have seen considerable appreciation, as the monetary expansion in advanced economies has contributed to downward shifts in and flattening of the yield curves in emerging economies.[8] To the extent that extraordinarily loose monetary policies in developed countries are not a normal situation, it is reasonable to infer that emerging-market bonds are currently above their long-term values.

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[5] See IMF (2013), *Global Financial Stability Report*, chapter 1, IMF; and Lanzeni, M.L. y C. Weistroffer (2013), "Emerging markets: Who is vulnerable to overheating?", *Deutsche Bank Research Briefing*, *Emerging Markets*, March 12.

[6] See, for example, Mustafayev, N. (2013), "Valuation of emerging markets currencies," *Credit Suisse Economics Research*, March 21.

[7] See Cubeddu, L., *et al.* (2012), "Latin America: Vulnerabilities Under Construction?", *IMF Working Paper*, WP/12/193, July.

[8] Edwards, S. (2010), "The international transmission of interest rate shocks: The Federal Reserve and emerging markets in Latin America and Asia," *Journal of International Money and Finance*, 29 contains an empirical examination of the transmission of changes in interest rates in the United States to those of emerging markets.

However, these observations cannot be considered to be complete or definitive. Available statistical information is limited and could impede a more adequate reading of some markets. In addition, the current scenario does not guarantee that, in the near future, evidence of problems will not surface. Furthermore, financial bubbles are hard to detect in advance, and when they are finally evident, it may be too late to do anything because market participants themselves may rapidly cause their elimination through bets against them.

A second cause for concern is that the factors that explain capital inflows, above all portfolio funds, can vary over time. International experience confirms, time and again, that increases in capital inflows have ended invariably in sudden stops and even reversals. This can occur even if internal financial imbalances are not generated, for reasons that have nothing to do with the recipient country, as can be the case with the anticipation of tighter monetary conditions and an increase in global risk aversion.

Independently of possible causes, capital flow reversals tend to depress asset prices and bring cuts in aggregate spending with adverse effects on economic activity. The impact is magnified by the simultaneity of these events in many economies and the frequently leveraged nature of the institutions that finance the flows. Domestically, debtors and savers with exposure to interest rate risk can suffer considerable damage.

Policies in emerging markets

The risks associated with increased capital inflows require the authorities to implement strategies that allow the prevention and management of possible problems in the economy and the financial system. The tools for policy makers fall into two groups.

The first consists of measures to discourage capital inflows, on the assumption that portfolio flows are the most volatile, the main incentive for them being the search for yield. One way to weaken the draw for external financing is to lower domestic policy interest rates, even to levels that might not be optimal from the point of view of price stability.

It is not possible to know the degree to which this consideration has influenced monetary policy in emerging economies, although some studies suggest that it could be significant.[9] Aside from the issue of frequency, this approach can put at risk the anchoring of inflation expectations and compromise control over future inflation. Additionally, the likelihood of financial instability can increase if many central banks react in the same way.

Another option in the same group is to enforce explicit capital controls, including restrictions on portfolio investment and short-term debt. Some emerging economies have used these measures with various degrees of intensity, but, in general, on a temporary basis since they have noteworthy limitations.

If they are effective, these controls can reduce the benefits of external resources that would not necessarily bring about future financial instability. But in general, their effectiveness itself tends to be weak, since it is hard to prevent evasion, and there seem to be no rules on the conditions under which the measures can be successfully applied. The resulting distortions reduce efficiency and can provoke protectionist measures in international trade.

The second group of tools seeks to mitigate possible adverse effects, rather than discourage capital inflows themselves. A frequently used measure has been intervention by central banks in foreign exchange markets through the accumulation of international reserves, which

[9] See Taylor, J. B. (2013), "International monetary coordination and the Great Deviation," presented in the "Session on International Policy Coordination, American Economic Association Annual Meetings," San Diego, California; and Caruana J. (2012), "International monetary policy interactions: challenges and prospects," speech given at the conference, "CEMLA-SEACEN, Punta del Este," Uruguay, November.

are a sign of domestic financial health, since they permit a country to face possible interruptions in the availability of foreign funding.

Nevertheless, international reserves can increase the attractiveness of a country to capital inflows and increase the expectation of future currency appreciation. The need to sterilize foreign currency purchases through open market operations to avoid pressures on inflation implies a carry-trade cost for the monetary authorities. Also, the accumulation of international reserves involves the risk of valuation losses due to the appreciation of the local currency.

A complementary approach to counter the possible undesirable effects of capital inflows is to strengthen the fiscal stance through the lowering of public spending, as well as deepening prudential regulation of the financial system. Standing out in the second range of tools are capital, liquidity, and provision requirements, as well as caps on leverage ratios, on exposure to foreign exchange risks, and on lending. Some of these measures have the advantage that they can be applied to diminish the possible surfacing of imbalances in specific sectors of the economy.

Conclusions

The extraordinarily lax monetary policy of advanced economies helps explain the high capital inflows seen recently in emerging economies. Although in principle they are beneficial, capital inflows, above all short-term, can end abruptly for reasons not necessarily related to the recipient country, causing financial instability and a drop in economic activity.

To date, available information does not suggest the existence of generalized imbalances arising from the abundant supply of foreign funds in emerging markets. However, the authorities should remain vigilant for the consequences of capital inflows and act swiftly to prevent imbalances from breaking out that can magnify the impact of a possible interruption in capital flows. Given the advantages and disadvantages of the tools available to face the risks associated with capital inflows, the strategy which seems preferable is the mitigation of possible adverse effects, especially through the strengthening of monetary and fiscal policies, and the deepening of prudential regulation of the financial system.