

## **Manuel Sánchez: The impact of monetary policies of advanced countries on emerging markets**

Remarks by Mr Manuel Sánchez, Deputy Governor of the Bank of Mexico, at the 55th annual meeting of the National Association of Business Economics, San Francisco, 9 September 2013.

\* \* \*

I am honored to participate in the annual meeting of the National Association of Business Economics. Thank you for inviting me to speak on the implications of monetary policies of advanced countries for emerging markets. As you know, this topic is at the heart of policy making in most central banks today.

The monetary expansion undertaken in developed countries in recent years has no parallel in history, and its repercussions, already significant, are still to unfold in full. Moreover, recent indications by the U.S. Federal Reserve that it might soon start unwinding its unconventional policies have raised a host of questions regarding the characteristics of this and the following stages of its overall exit strategy.

As a consequence, the financial boom emerging markets enjoyed during previous years stemming from lax monetary stances in industrialized countries has begun to be displaced by tighter financial conditions and increased uncertainty. From the beginning, not all emerging economies were affected equally, and this will likely continue to be the case in the future. But for the sake of simplicity, I will try to comment and conjecture on general trends in these countries, without neglecting international differences.

Specifically, I will organize my remarks as follows. First, I will examine the effects of expansionary monetary policies of the main advanced economies on emerging-market countries; second, I will discuss the implications of the recent change in market sentiment; and third, I will identify some policy challenges faced by emerging economies in dealing with this rapidly changing international environment.

### **Previous financial boom**

From the outset of the big financial crisis, the central banks of major industrialized countries have implemented a variety of unconventional policies, first, to restore confidence in financial markets and, later, to boost economic growth. The leader in these efforts has been the U.S. Federal Reserve, which widened its liquidity facilities significantly and, by the end of 2008, reduced its policy interest rate to near zero.

Afterwards, the Fed began purchasing financial assets from the market, notably Treasury bonds and mortgage-backed securities, in successive programs referred to as quantitative easing (QE). Also, it has provided forward guidance expressing its intention to maintain the Fed funds rate near zero for an extended period of time, conditioned on certain parameters related to unemployment and inflation expectations. These policies seek, among other objectives, to influence market expectations and thereby reduce long-term real interest rates. Other advanced economies have followed suit, employing similar features of monetary accommodation.

QE is widely seen to support private spending and employment, while stable inflation expectations are maintained. The domestic transmission channels may encompass first, a rise in perceived consumer wealth through increases in asset prices; second, the rebalancing of investor portfolios toward assets that are imperfect substitutes of those purchased by the Fed, typically with higher risk-adjusted returns, thereby making funds cheaper across many productive areas; and third, signaling that policy interest rates will remain low for an extended period of time, contributing further to the flattening of the yield curve.

So far, the expansionary monetary policies in the United States and other advanced countries have been effective at normalizing the functioning of financial markets and, to a certain extent, still open to debate, firming the pace of the ongoing economic recovery.<sup>1</sup>

While these benefits were important, there have been some costs and risks associated with the unusually lax monetary policies of advanced countries, among which the following stand out. First, negative real interest rates punish savings and reward investment, thereby implying a transfer of resources from the former activity to the latter. To counter this effect, savings institutions such as mutual and pension funds may seek higher returns in risky assets with price implications that may not be fully understood.

Second, extraordinarily benign financial conditions may have created an environment of over-leveraging and excess lending, potentially endangering the stability of the financial system. Third, the size and composition of the asset purchases may have distorted resource allocation, postponing balance sheet adjustments and crowding out other financial-market players. Fourth, the independence of monetary policy from fiscal policy may have been damaged. Finally, central banks are navigating in uncharted waters and, hence, risks of higher inflation may emerge if eventual monetary unwinding is inadequate.<sup>2</sup>

To different degrees, these costs and risks have impacted emerging economies. In particular, ample global liquidity and the search for yield translated into a financial boom for a variety of asset classes, including local government bonds, currencies, private-sector borrowing, stocks, and real estate.

Perhaps the most widespread and prolonged effect in emerging economies was the continuous down-shift in yield curves, in tandem with that of the United States, often more significant, pushing domestic interest rates for different maturities to all-time lows. There is evidence that the effect on other asset prices, on average, has also been considerable.<sup>3</sup>

An important vehicle for the financial boom in emerging-market economies was a surge in capital inflows by nonresidents, observed since 2010. Although annual flows were not unprecedented, this time their persistence, and more importantly, their composition, characterized by a higher proportion of portfolio funds, were distinctive features.

Although there is no agreement on the relative importance of the determinants of the capital flows, it is generally accepted that they include the prolonged monetary easing of advanced countries, a reduction of global risk aversion, which may not be independent from the previous factor, and the idiosyncratic characteristics of recipient countries, such as prospects for economic growth and financial stability, as well as the depth and flexibility of their financial markets.<sup>4</sup>

The available information suggests that, as a general rule, capital inflows did not result in widespread financial imbalances in emerging economies. For example, most of them maintained relatively stable ratios to GDP in their current accounts, public-sector debt, total external debt, and domestic credit to the private sector. Nevertheless, there seem to be

---

<sup>1</sup> For a review of the effectiveness of QE, see Martin, C. and C. Milas (2013), "Quantitative easing: a sceptical survey", *Oxford Review of Economic Policy*, 28(4).

<sup>2</sup> For an exposition of these and other risks and costs, see, for example, Carney, M. (2010), "Living with Low for Long", speech to the Economic Club of Canada, Toronto, Ontario, December; and Caruana, J. (2012), "International monetary policy interactions: challenges and prospects", speech given at the conference "CEMLA-SEACEN, Punta del Este", Uruguay, November.

<sup>3</sup> For an estimation of the international impacts of QE, see Chen, et al. (2012), "International spillovers of central bank balance sheet policies", *BIS Paper No. 66*, October.

<sup>4</sup> Two empirical analyses of the factors that explain capital flows 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.

vulnerabilities in some countries, such as significant FX exposure, as well as indications of overheating and excess credit, and additional information, especially as monetary tapering proceeds, may uncover further financial imbalances in these or other nations.<sup>5</sup>

### **The beginning of unwinding**

Since last May, there has been a negative change in investor sentiment towards emerging markets, expressed in sharp asset-price drops and heightened volatility. Notably, currencies have trended weaker, and domestic long-term interest rates have risen to levels not seen in more than a year. Also, portfolio capital inflows from nonresidents have slowed and even reversed, while the duration of foreign holdings of local-currency government bonds in some countries appears to have fallen.

The trigger of this shift in sentiment has been the market perception that the Federal Reserve will soon start reducing its asset purchases and conclude the program by the first half of the following year. Additionally, the estimated time before the first hike in the Fed funds rate has been shortened. The revisions in expectations were fueled by the Fed's forward guidance referenced to inflation and unemployment, official statements suggesting the proximity of tapering, and incoming data revealing improved economic conditions and prospects in the United States.

As a result, the U.S. yield curve has steepened, reflecting a higher term premium and thus probably the expectation of a greater supply of long-term bonds, as well as, to a lesser extent, anticipation of increases in the Fed funds rate. Other industrial nations have also seen similar effects.<sup>6</sup>

As was the case during the recent boom, the interest-rate reaction in many emerging markets has been more pronounced than in the United States, revealing additional risk premiums which may be related to credit and liquidity. Also, increased global risk aversion and deteriorated prospects for economic growth in emerging economies could be additional negative factors.

The possibility that the Fed may soon start reducing its asset purchases is a welcome development. The exceptionally loose monetary policy in the United States and other advanced countries cannot be indefinitely sustained, as the costs and risks involved may be rising and surpass the intended benefits. Additionally, the decision to taper will ultimately hinge on an improved U.S. economic outlook, which should benefit the rest of the world, including emerging markets. Finally, tapering may facilitate the adjustment required in certain economies afflicted by financial disequilibria which, at least in part, may have resulted from the abundance of foreign funds.

However, a complete exit from the extraordinary monetary accommodation in the United States could be complex indeed. There is no precedent from which to derive lessons. It will likely take several years. Implementation of the strategy should be neither premature nor delayed relative to the pace of economic recovery. Since future changes in the course of monetary policy or forward guidance cannot be ruled out, maintaining credibility could be challenging. To these difficulties, add the peculiarities of the eventual exit strategies of other advanced countries.

Therefore, the future external scenario for emerging markets will necessarily involve considerable uncertainty. Successive stages of monetary unwinding in the United States

---

<sup>5</sup> See IMF (2013), *Global Financial Stability Report*, chapter 1, IMF; and Tillmann, P. (2013), "Capital inflows and asset prices: Evidence from emerging Asia", *Journal of Banking and Finance*, 37.

<sup>6</sup> For an explanation of the risk premia decompression effect on U. S. long-term interest rates, see Banco de México (2013), *Informe sobre la Inflación Abril – Junio 2013*, August.

could imply further downward, not necessarily smooth adjustments in asset prices. At the same time, capital flows from abroad may become much scarcer and even exhibit a sudden stop.

Nevertheless, portfolio adjustments may affect emerging economies differently according to their fundamentals. In general, it is reasonable to expect that countries with better macroeconomic foundations and growth outlooks may suffer less than those characterized by financial imbalances, stringent external funding needs, overheated economies or asset price bubbles.

## **Policy challenges**

What can policymakers in emerging markets do in order to deal with the challenges of tapering and the eventual exit from expansionary U.S. monetary policy? Given globalization, developments in and measures adopted by large industrial countries have always affected the performance and policy options of emerging economies.

The present situation is no exception. If the era of unusually cheap foreign funding is indeed over, economic policy in emerging economies must accept that reality, not be oriented towards trying to cancel it, any attempt at which would inevitably fail and likely result in financial instability.

A more reasonable policy objective for emerging economies may be to seek to prevent and manage possible problems derived from more restrictive conditions. As each country may be affected differently, the importance of specific alternatives will vary internationally.

During the boom, discussions on the role of economic policy were centered on how to deal with abundant capital inflows from abroad. Consistently, emerging-market policy actions focused on either discouraging capital inflows or attempting to mitigate possible adverse effects from those funds.

Measures within the first category included reducing policy interest rates to levels probably inconsistent with price stability and, most notably, enforcing a variety of capital controls. Examples within the second group involved accumulating international reserves, strengthening the fiscal stance, and improving the supervision and prudential regulation of the financial system.<sup>7</sup>

Each measure implied possible benefits and limitations, and many countries adopted actions from both approaches to varying degrees. However, in general, even when international differences are taken into account, the economies that showed more resilience to negative effects from the external bonanza seem to have been those that relied more heavily on the second approach, thus preserving their economic fundamentals.

For the tightening period, countries can now contemplate and some are already applying analogous policy alternatives, either by directly seeking to discourage capital outflows or preventing the surge of possible systemic problems. As in the boom years, well-known trade-offs can resurface. For example, a floating exchange rate regime can serve as a buffer to upward pressures on domestic interest rates, and an exchange-rate peg may result in sharper steepening of the yield curve.

As is usually the case, there is no unique recipe for successful economic policy for all countries. However, adequate regulation and continuous surveillance of the financial system and markets are essential defenses for turbulent times. Also, the pursuit of price stability and sound fiscal balances and, in extreme cases the provision of liquidity under appropriate

---

<sup>7</sup> For a discussion of these policy choices during the boom, see Sánchez, M. (2013), “Emerging economies in the face of financial bonanza”, speech delivered at CEMLA’s IX Meeting of Monetary Policy Managers, May, available at <https://www.bis.org/review/r130527g.pdf>.

conditions by central banks, complete the foundation for stability. Finally, structural reforms to enhance productivity growth and investment opportunities are an essential complement for attracting stable capital flows.<sup>8</sup>

### **Concluding remarks**

To conclude, the unconventional policies implemented by major industrialized countries' central banks during the last five years fueled abundant capital inflows and low funding costs in emerging markets. As a result, asset prices rose considerably, and although widespread financial imbalances have not been evident, some countries did experience overheating and price bubbles. Newly available information may uncover further financial imbalances in these or other nations.

The market perception that the Federal Reserve will soon start tapering asset purchases has resulted in significant reductions and heightened volatility for asset prices in emerging markets. Given the complexity of what could be the overall exit strategies of the United States and other advanced nations, emerging economies necessarily face a highly uncertain external scenario. Despite foreseeable adverse financial conditions, it is reasonable to expect that global portfolio adjustments may affect countries less severely if they enjoy stronger economic fundamentals.

Finally, emerging economies have different policy options at their disposal in the unwinding phase, especially to try to prevent and manage the surfacing of possible problems. The strengthening of the foundations of domestic financial stability and the implementation of structural reforms to enhance productivity growth and investment, have never been more important.

---

<sup>8</sup> For liquidity provision, the sound approach may be to follow Bagehot's advice: to only loan to solvent banks and against good collateral and at penalty interest rates. See Bagehot, W. (1873), *Lombard Street: A Description of the Money Market*, London. H.S. King.