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Monetary policy response in emerging market economies: why was it different this time?

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Monetary policy response in emerging market economies: why was it different this time?

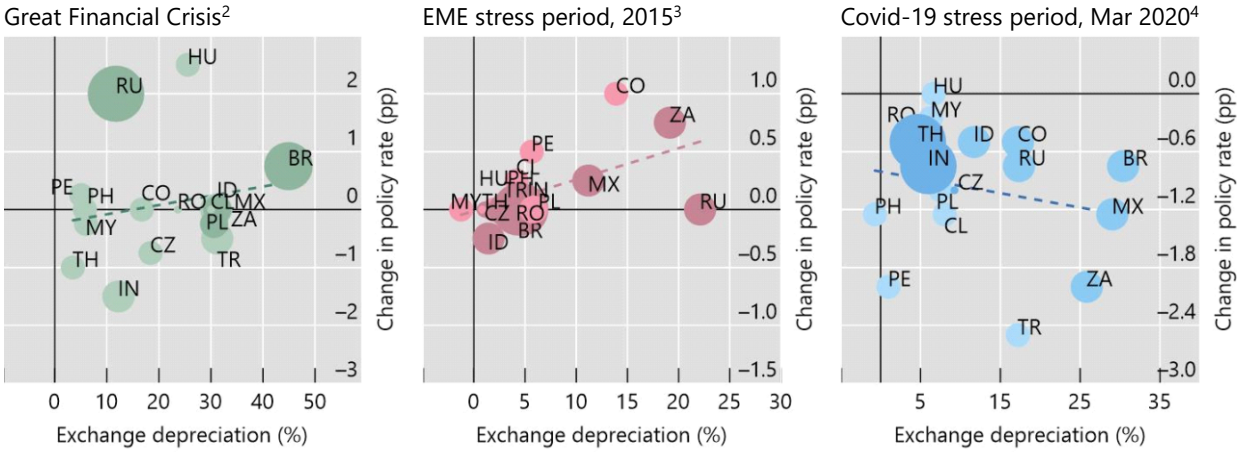
Key takeaways

- *During the Covid-19-induced financial stress in March 2020, central banks in emerging market economies (EMEs) departed from their monetary policy playbook by cutting rates even in the face of sharp currency depreciations and massive capital outflows.*
- *Two factors were at play. First, the cyclical position of EMEs gave more room for easing of monetary policy, while structural changes improved the anchoring of inflation expectations and kept a lid on exchange rate pass-through. Second, the swift monetary policy easing by the Federal Reserve and other advanced economy central banks calmed global financial conditions. These policies capped the appreciation pressures on the US dollar, an EME risk factor, and gave EMEs greater room to cut interest rates.*
- *Monetary easing and asset purchases helped cushion the impact of portfolio outflows on local currency sovereign bond markets. Synchronised monetary and fiscal policies supported one another.*

The playbook of emerging market economy (EME) central banks facing a financial crisis calls for them to tighten monetary policy sharply in order to stem massive capital outflows and a sharp currency depreciation. Monetary policy is then procyclical. It is tighter precisely when capital outflows and currency depreciation dent domestic economic activity. EMEs departed from this playbook in the Covid-19 stress period of March and April 2020. They were able to cut policy rates and ease monetary policy aggressively, thereby supporting domestic activity. Moreover, some also adopted asset purchase programmes (Arslan, Drehmann and Hofmann (2020)). Why was it different this time?

This Bulletin examines the context and drivers of interest rate policy decisions by EME central banks. We compare the interest rate response in three crisis episodes: the Great Financial Crisis (GFC) of 2007–09; the stress period of 2015; and the Covid-19 stress period of March–April 2020 (Graph 1). First, in early 2020 most EMEs were at a relatively low point of the business cycle, with aggregate demand below potential, while structural changes that better anchored inflation expectations and reduced exchange rate pass-through ensured that central banks could cut interest rates without raising inflation risks. Second, broad and bold actions by advanced economy (AE) central banks curbed the appreciation of the US dollar and calmed the turmoil in global financial markets, allowing rates to be cut aggressively in EMEs in spite of large capital outflows and sharp currency depreciations. These two factors made a coordinated policy response between fiscal and monetary authorities in most EMEs possible – even with limited fiscal space. So far, monetary policy and fiscal policy easing have complemented each other in supporting the flow of credit and aggregate demand.

Despite a sharp depreciation and portfolio outflows, rates were cut aggressively[1] Graph 1



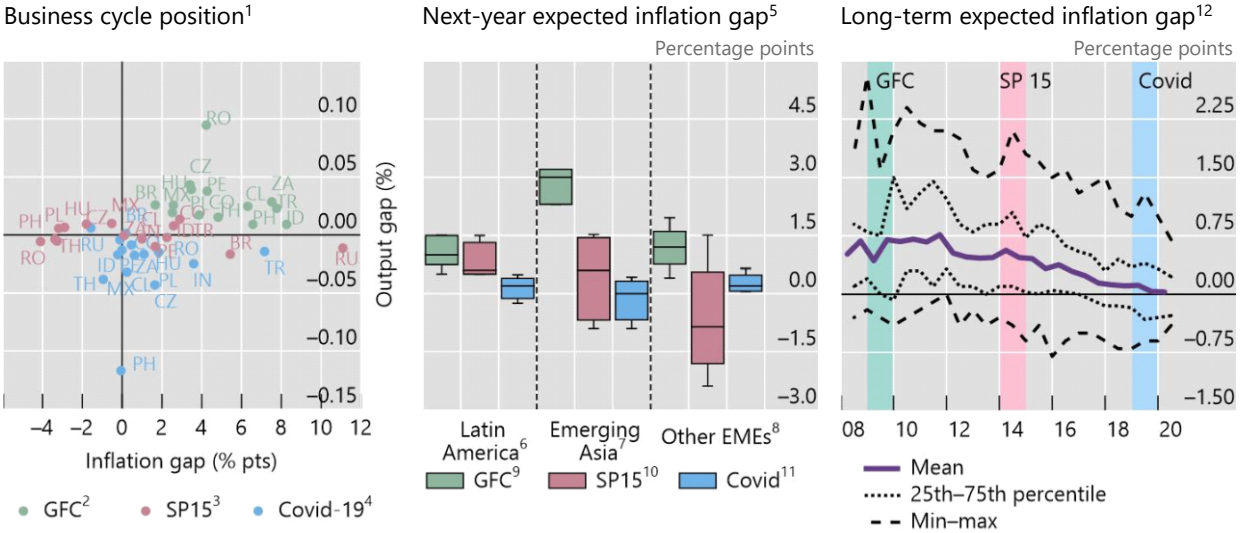
[1] The size of the bubble is proportional to portfolio outflows (USD bn) and is comparable across panels. Accumulated weekly sum of bond and equity fund flows. [2] From 7 Sep 2008 to 7 Dec 2008. [3] The end of the commodity price boom and a sharp appreciation of the US dollar tightened financial conditions in EMEs. From 1 Nov 2015 to 7 Feb 2016. [4] From 2 Feb 2020 to 10 May 2020.

Sources: Bloomberg; EPFR.

Cyclical and structural conditions in EMEs expanded monetary policy space

EMEs' cyclical position at the time of the Covid-19 shock opened up more room for easing monetary policy compared with other crises. In September 2008, most EMEs were in the expansionary phase of their cycle and inflation gaps were positive (Graph 2, left-hand panel). Importantly, central banks still had to rein in inflation expectations (centre panel). These cyclical conditions kept central banks from cutting rates immediately and, in some countries, pushed them to raise rates (Brazil, Hungary, Peru and Russia).

Economic slack and well anchored inflation expectations allowed policy easing Graph 2



[1] Output gaps calculated with a double-sided Hodrick-Prescott filter on quarterly real GDP. Inflation gap defined as inflation minus the midpoint of the inflation target band. [2] Aug 2008 for inflation and Q3 2009 for output. [3] Oct 2015 for inflation and Q3 2015 for output. [4] Jan 2020 for inflation and Q1 2020 for output. [5] Next-year inflation expectations. Plots show median, interquartile range and range. [6] BR, CL, CO, MX and PE. [7] ID, IN, MY, PH and TH. [8] CZ, HU, PL, RO and ZA. [9] Forecast for 2009 in Aug 2008. [10] Forecast for 2016 in Oct 2015; SP15 = 2015 stress period. [11] Forecast for 2021 in Jan 2020. [12] Six- to 10-year inflation expectations.

Sources: Bloomberg; Consensus Economics.

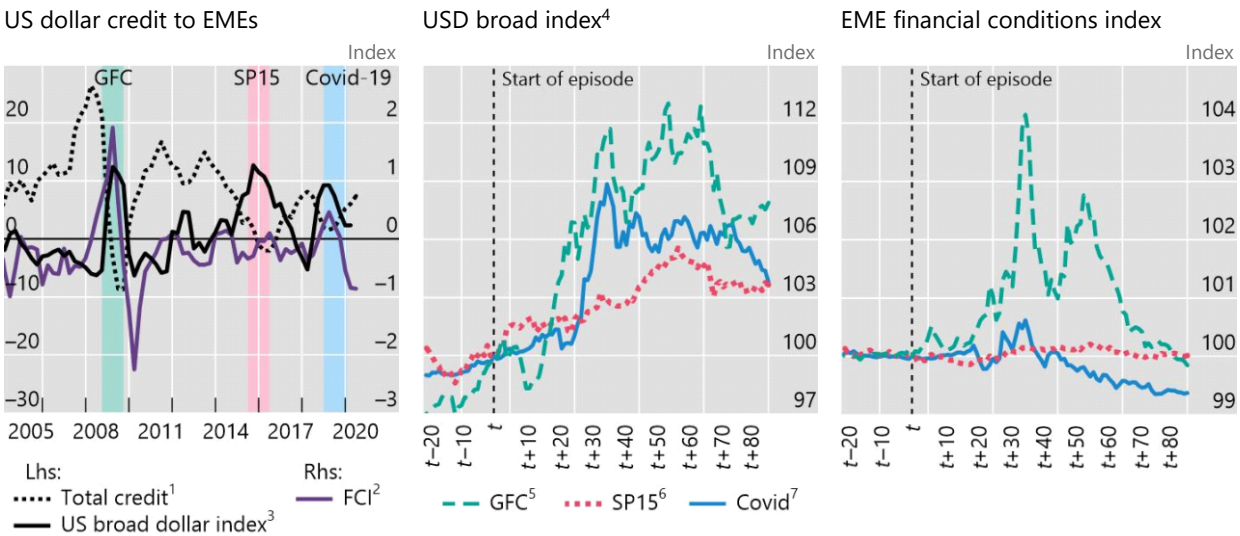
Similarly, in the stress period of 2015 economic slack was scarce and inflationary pressures stemming from currency depreciations threatened to de-anchor inflation expectations. Some central banks responded with a tighter policy stance (Chile, Colombia, Mexico, Peru and South Africa). By contrast, in early 2020 most EMEs had some slack and inflation rates either below or only slightly above target. Short-term expected inflation too was generally near inflation targets. The sharp drop in output and inflation that followed the Covid-19 shock compounded the depressed business cycle positions and opened up space for monetary policy easing.

Structural improvements in EMEs' inflation process are also likely to have supported central banks' countercyclical response. In the past two decades, EME central banks have gained more credibility and independence. Together with a shift towards fiscal consolidation, central banks' institutional progress reduced the sensitivity of inflation expectations to global and domestic inflation shocks and contributed to long-term inflation expectations converging closer to central bank targets (Yetman (2020) and Graph 2, right-hand panel). These changes lowered exchange rate pass-through, which further anchored inflation expectations (Ha et al (2019)). As a result, inflation dynamics became more stable and less persistent (Kamber et al (2020)). In turn, central banks were able to ease monetary conditions to buffer the fall in output without a significant risk of de-anchoring inflation expectations.

AE central bank responses quelled turmoil in global and EME financial markets

Financial turbulence and sharp currency depreciation tend to go hand in hand with higher inflation risks. Despite the different nature of the three crisis episodes considered, in all of them financial markets experienced severe stress. Significant reversals in capital flows and increased risk aversion raised the costs of external financing and tightened financial conditions across EMEs (Graph 3, left-hand panel). While the economic effect of financial turbulence on future average inflation could be negligible, tighter financial conditions and sharp currency depreciation increase tail risks (Banerjee et al (2020)). These risks seemed lower for most countries in the Covid-19 stress period of March 2020. The key difference this time around

Broad dollar index fell after the Covid-19 shock, easing financial conditions — Graph 3



[1] Annual growth of USD-denominated credit to non-banks in EMEs. [2] Annual growth of trade-weighted broad USD index. Higher values correspond to an appreciation of the dollar. [3] Annual growth of the Goldman Sachs Financial Conditions Index defined as a weighted average of riskless interest rates, the exchange rate, equity valuations and credit spreads, with weights that correspond to the direct impact of each variable on GDP. Higher values represent a tightening in financial conditions. Average of financial conditions index of BR, CL, CZ, HU, ID, IN, MX, MY, PH, PL, RU, TH, TR and ZA. [4] Time measured in days. Index = 100 in *t*. Shaded area corresponds to duration of the stress episode. Each episode lasts three months. [5] 7 Sep 2008. [6] 1 Nov 2015. [7] 2 Feb 2020.

Sources: Federal Reserve Bank of St Louis, FRED; Bloomberg; Consensus Economics; Datastream; Dealogic; Euroclear; Thomson Reuters; Xtrakter Ltd; national data; BIS locational banking statistics; BIS effective exchange rate statistics; BIS calculations.

was the trajectory of the US dollar, which eased financial conditions and made room to orient monetary policy towards domestic objectives.

The US dollar is a significant risk factor for EMEs. An appreciation affects EMEs' growth through financial channels linked to dollar debt and foreign ownership in local currency bond markets (Hofmann and Park (2020)). AE central banks' policy actions curbed US dollar appreciation and calmed the turmoil in global financial markets (Graph 3, centre panel). In the space of a few weeks, AE central banks deployed the facilities that took months to activate during the GFC (Cavallino and De Fiore (2020)). These actions, especially those implemented by the Federal Reserve, were bolder and broader compared with other crises and expanded central banks' role to that of market-maker of last resort. In addition, Federal Reserve swap lines and the FIMA Repo Facility addressed the severe stress in US dollar funding markets and gave EMEs access to US dollar liquidity. The effects of these policies on financial markets were immediate. The US long-term interest rate hit its minimum level in March and then recovered. At the same time, the US dollar broad index halted its sharp appreciation and slowly depreciated. Finally, as commercial banks were well capitalised, they continued to provide cross-border credit, which also contributed to a better external financing environment. As financial markets stabilised, EME central banks were able to cut rates aggressively in spite of capital outflows and exchange rate depreciation.

Financial conditions in EMEs started to ease one month after the start of the shock as central banks deployed an expanded toolkit to support financial markets and the flow of credit (Graph 3, right-hand panel, and online appendix). In addition to cutting rates, EME central banks implemented domestic lending operations and funding facilities to reduce illiquidity risks. They established direct lending to the private sector to ease financing conditions and intervened in FX markets to reduce currency volatility. Together with supervisory authorities, they eased prudential regulations to increase banks' capacity to lend. And in an unprecedented move for some central banks, they implemented asset purchase programmes of long-term government securities in the secondary market. These interventions provided liquidity and prevented fire sale spirals in those markets (Arslan, Drehmann and Hofmann (2020)). Finally, a few EMEs also drew on the IMF's Flexible Credit Line for macroeconomic stabilisation purposes. The simultaneous deployment of multiple instruments compounded the calming effects of AE central bank policies on domestic markets.

A synchronised monetary and fiscal response

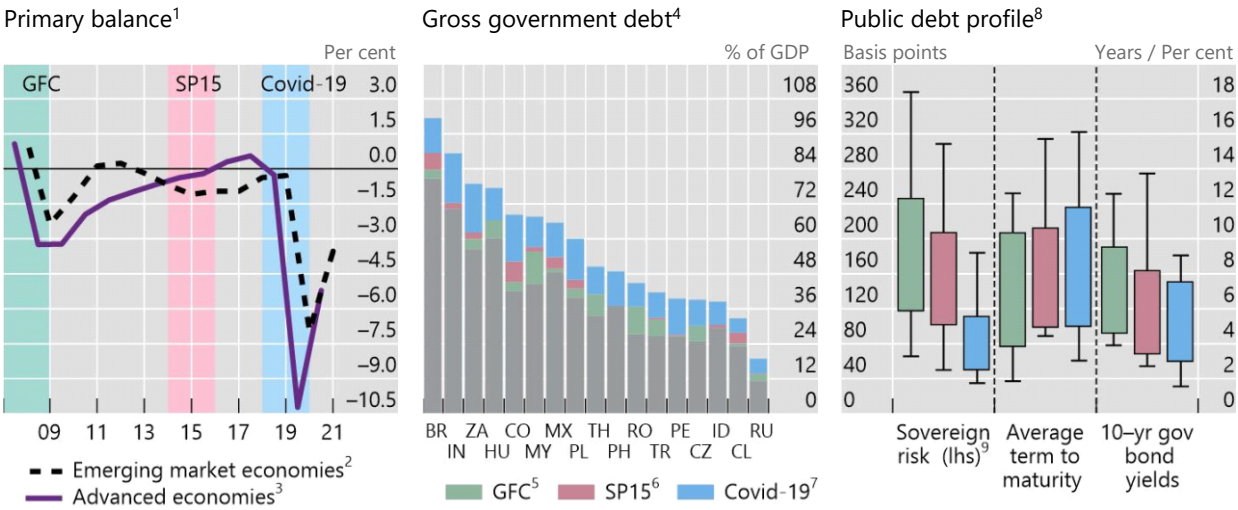
Fiscal policy was also on the front line of the economic policy response. In EMEs, the response was smaller than in AEs but large by historical standards (Graph 4, left-hand panel). The difference compared with AEs reflects in part the markets' willingness to finance relief measures (Alberola, Arslan, Cheng and Moessner (2020)). Even before the crisis, gross government debt had risen in EMEs, limiting fiscal space (Graph 4, centre panel). However, EMEs' improved public debt profile allowed governments to issue additional debt and expand spending (right-hand panel). Deeper local currency government debt markets allowed governments to increase the average maturity of their debt, thereby reducing rollover risks. In addition, the global low interest rate environment helped to compress long-term rates in most EMEs and to lower the cost of issuing additional debt. This reduced the risks of switching to a perverse equilibrium where high rates and rollover risks feed into one another.

The synchronised fiscal and monetary policy response was more aggressive than in other crises (Graph 5, left-hand panel), with the two interventions complementing one another. On the one hand, in most EMEs, governments' full or partial indemnities and loan guarantees to borrowers partially insulated central banks from credit risk and supported their operational independence. This allowed central banks to ease credit conditions and promote financial stability. On the other hand, central bank asset purchases and liquidity support helped to cushion the impact of portfolio outflows from the local currency sovereign bond market. Indeed, EME sovereign yields declined despite moderate portfolio inflows for dollar-denominated bonds and virtually zero inflows for local currency bonds (right-hand panel). Avoiding disruptions in the long-term part of the yield curve further supported fiscal expansion. Finally, an

unintended benefit of the monetary easing and asset purchase programmes was to soften the fiscal burden. That said, this was not the intervention's main intention.

An aggressive fiscal response despite limited policy space

Graph 4



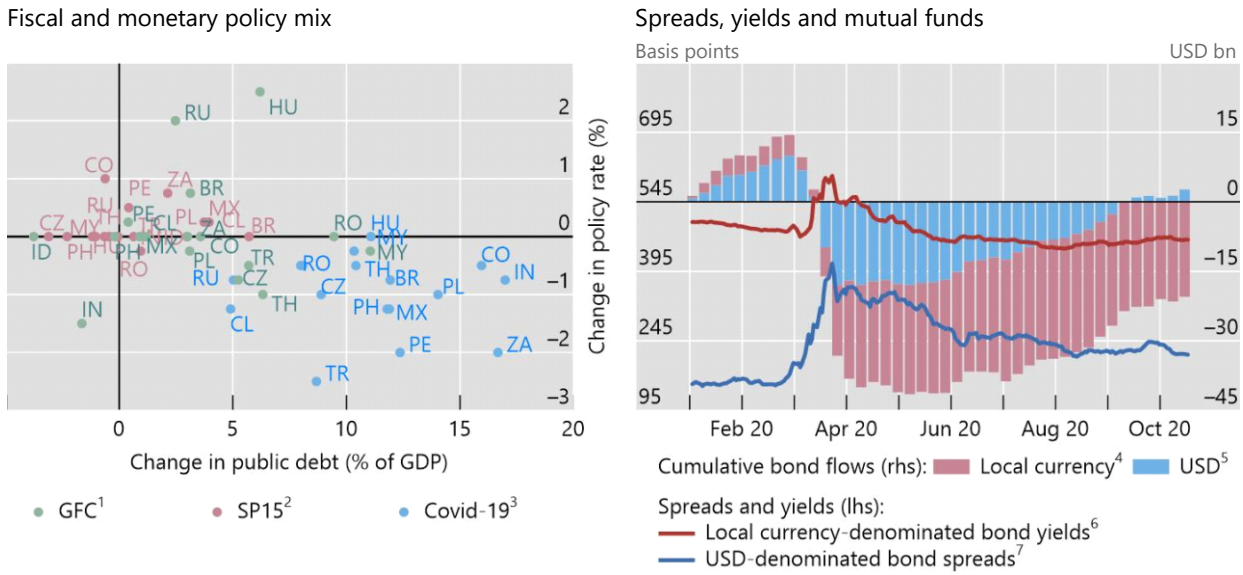
[1] Data for 2020 and 2021 IMF forecast. [2] BR, CL, CO, CZ, HU, ID, IN, MX, MY, PE, PH, PL, RO, RU, TH, TR and ZA. [3] AU, CA, CH, DE, FR, GB, JP, NL, NO, NZ, SE and US. [4] 2020 forecast. [5] 2008–09. [6] 2015–16. [7] 2019–20. [8] Box and whisker plots show interquartile range and range of yearly average across countries. Data for 2008, 2015 and 2019, respectively [9] Five-year credit default swap spreads.

Sources: IMF, *World Economic Outlook*; Bloomberg.

Up to now, EMEs appear to have overcome their fear of floating and of sudden capital outflows. They have allowed currency depreciations in spite of massive outflows in local currency government bond markets, which have not returned completely. But the looming second wave of Covid-19 and the dampening of the recession will stress fiscal and monetary positions even further. Erosion of confidence

Monetary and fiscal policy supported the economy and financial markets

Graph 5



[1] From 7 Sep to 7 Dec 2008. [2] From 1 Nov 2015 to 7 Feb 2016. [3] From 2 Feb to 10 May 2020. [4] Flows to local currency bond funds. [5] Flows to hard and blend currency bond funds. [6] Simple averages of JPMorgan Chase GBI Global sub-indices, traded yields. [7] Simple averages of JPMorgan Chase EMBI Global sub-indices, stripped spreads.

Sources: IMF, *World Economic Outlook*; Johns Hopkins University; Bloomberg; EPFR; IHS Markit; JPMorgan Chase; BIS calculations.

in the monetary system and generalised higher uncertainty could lead to a quick uptick in inflation. In turn, a vicious spiral between inflation and exchange rate depreciations could take off. In addition, a worsening outlook and increasing government debt could lead to higher sovereign yields, reducing policy space.

Conclusions

The Covid-19 shock has been singular in all respects. Its sheer magnitude was reflected in the unprecedented capital outflows during March and April. As it hit all economies alike, EMEs could cut rates aggressively to buffer the economic shock without concerns about interest rate differentials with their peers. However, that the interest rate response was countercyclical does not necessarily imply that EMEs are immune from the risk of sudden stops. First, the shock has so far been mostly deflationary, which may have lowered the likelihood of an inflationary depreciation spiral, a typical weakness of EMEs. Second, AEs' monetary accommodation curbed the dollar appreciation and led to extremely benign global financial conditions, which made EMEs' returns more attractive.

The crisis is ongoing, and the second stage – including dealing with the insolvency of many corporates in the hardest-hit sectors – is just starting (BIS (2020)). In this stage, the risk of shifting to an adverse loop between fiscal and monetary policy is higher. On the one hand, raising interest rates when inflationary pressures take hold will be harder as public debt continues to increase. Central banks will be even less inclined to raise rates if global financial conditions tighten again and the costs of external financing increase. On the other hand, the need to continue providing fiscal stimulus will threaten fiscal sustainability. These vulnerabilities could increase risk premia, erode investors' confidence and depreciate the currency, raising inflation risks and de-anchoring inflation expectations. Finally, there are the challenges of the reallocation of real resources in the economy and the difficulty of relying on fiscal and monetary stimulus. The abiding need for structural reforms is more alive than ever (Carstens (2020)).

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