Global factors and monetary policy in emerging economies

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As always, it is a pleasure to participate in this session sponsored by the BIS. My participation in the technical meetings organized by the BIS started more than 12 years ago. These meetings, and the support and guidance of the BIS, have been extremely useful for me and also for the Colombian central bank.

The title of this session is "Global factors and monetary policy in emerging economies". My presentation will be divided into three parts: (1) the main global factors, (2) risk and risk management, (3) monetary and financial policies. I will also comment briefly on fiscal policy, which I consider to be one of the three pillars of macroeconomic policy along with monetary policy and financial policy.

I. Main global factors

Let me highlight two main global factors. First, we are now in a world that is *multipolar*. One or two decades ago the United States was extremely important for the development of emerging economies, for example, Latin America. Nowadays, however, more countries have an impact.

Emerging economies (mainly Asian) now account for 50% of world imports and for two thirds of the global growth we have seen in the last five to 10 years. Emerging economies are also the main engine behind commodity prices. This is partly because of the very rapid process of urbanization and industrialization in China and in India, which has created a demand for metals and energy. In addition, as China, India and other emerging economies develop and living standards rise, the demand for high-quality food and protein increases. All these factors raise commodity prices. Higher commodity prices increase the return on capital in the commodity-producing sector. In Colombia, we are seeing a lot of investment in oil, coal, gold and some other commodities, and the same thing is happening in other emerging economies.

In contrast, we have countries like the United States and some European countries. These, apart from some exceptions, present what I call "anemic growth in major advanced economies". This is typical post-financial crisis behavior. As a paper by Reinhart and Reinhart[2] shows, in the five to 10 years following financial crises, the median rate of GDP growth decreases on average by 1%, while unemployment increases by 5%. The exceptions this time include Australia and Canada, which are recovering relatively fast.

The second global factor is the need for fiscal consolidation in a setting of excess capacity, low inflation expectations and low confidence. Monetary authorities have responded with very low policy rates for longer periods (for example, zero or near zero in the cases of the

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1 Governor, Bank of the Republic, Colombia. Presentation at the BIS-sponsored session on "Global factors and monetary policies in emerging market economies" at the LACEA meetings in Medellín, Colombia, November 2010.

2 C Reinhart and V Reinhart, "After the fall", *Federal Reserve Bank of Kansas City Economic Policy Symposium, Macroeconomic Challenges: The Decade Ahead*, Jackson Hole, Wyoming, 26–28 August 2010. Also issued as *NBER Working Papers*, no 16334.

United States or Japan) and unconventional monetary policy in some major industrialized countries – so-called quantitative easing.

What are the implications? Some of the most relevant for Latin American countries are: (1) high commodity prices and high terms of trade, (2) strong investment, both local and foreign, in commodity sectors, and (3) strong capital inflows.

II. Risk management

The global factors mentioned before (high commodity prices, strong investment and capital inflows) have positive effects. In particular, the short- and medium-term prospects for commodity-producing emerging economies look favorable. However, existing conditions also imply some risks that need to be carefully managed.

The first point regarding risks is that commodity prices are very volatile and highly uncertain. Short-term demand and supply curves for commodities are very inelastic. As a result, any movement in the supply or demand creates major swings in prices. The second is that the long-term supply and demand elasticities are greater than the short-term elasticities because consumers economize and find substitute products.

These two features create risks. Businesses, households and policymakers tend to overreact to the short-term increases in commodity prices. Also, strong capital inflows may feed financial imbalances (excessive credit growth and asset prices) as well as unbalanced growth between the non-commodity tradable and non-tradable sectors.

Moreover, if in response to a large currency appreciation, local interest rates are held down for an extended period of time, there is (the possibility of) excessive risk taking as well as the risk of asset price bubbles and financial imbalances. We have learned this from previous crises and also from the international crisis that started in 2007 and that exploded in the fourth quarter of 2008.

Let me remind you of three basic principles we have learned from past crises.

First, flexibility is crucial. This means exchange rate flexibility and no exchange rate targets. Monetary and fiscal policy flexibility is also useful in responding to expected and unexpected events.

Second, avoid pro-cyclical policies. During boom periods, tax revenues increase and governments are severely tempted to spend. Central banks may have incentives to support unsustainable expenditure growth. This not only exacerbates the spending and financial imbalances during periods of favorable external conditions, but also hampers the ability of the authorities to implement countercyclical monetary and fiscal policy once external conditions have deteriorated.

Third, incorporate financial conditions and financial intermediation into the analysis.

III. Monetary and financial policies

Let me turn now to monetary and financial policies.

There are some points of agreement on this subject: (1) Price stability is not enough. Financial stability matters too, as we learned in previous crises (the last financial crisis in the US was partly because of that). (2) The interest rate alone is not enough to achieve both price and financial stability. More than one instrument may be required.

This means that we need a wide range of policy instruments, one of which, as I said before, is fiscal policy. Fiscal policy must, first, do no harm. Do not put fuel on the fire. It must also help through countercyclical policies. For example, when experiencing a positive terms of trade shock and capital inflows, fiscal authorities must increase savings in order to avoid an overheating of the economy as well as prevent financial imbalances and excessive credit and asset price growth.

A second policy instrument is financial policy. This is the first line of defense for preserving financial stability. The appropriate approach to policy depends in part on the institutional framework. For example, in the Colombian case, the financial sector supervision is outside the central bank. Thus, it is important for the central bank and supervisory authorities to work together.

Financial policy should aim at preventing excessive credit growth, asset price bubbles, and large currency and maturity mismatches. A set of measures must be implemented in order to achieve this, namely: (1) macroprudential regulation and supervision contributing to the flexible exchange rate regime and, to some degree, contingent on the business cycle, (2) the supervision and regulation of individual financial institutions, which is the traditional role of supervisors, and (3) monitoring and campaigning for support for appropriate policies, e.g. being careful about excessive credit growth, asset price inflation, etc. This can be achieved through the financial stability reports of central banks and public statements warning about risks.

The third instrument is monetary and foreign exchange market policy. A number of actions are required in this regard.

First, monetary authorities need to incorporate financial stability considerations in order to smooth out business fluctuations over long horizons that exceed the one- or two-year horizons of typical inflation targeting regimes.

In particular, projections of inflation for one or two years ahead may look good, but there may also be signs of financial imbalances that need to be taken into account. These may include excessive credit or asset price growth, or unwarranted confidence by households and businesses. Excessive confidence is very common in the case of bankers, and a horizon longer than two or three years may show that their actions create financial stability risks.

Second, interest rate policy decisions need to take into account the effect they will have on the inflation forecast *and* their impact on credit and the asset markets. These could exacerbate output fluctuations in the future – even more than two or three years ahead. That does not mean that central banks should have credit or asset price targets. It means that they should take information about those variables into consideration. Monetary policy can thus also play a role in preventing credit booms.

Third, authorities need to be prepared to use tools that help to manage leverage. Additional central bank instruments are needed – not only interest rates – and all of them must be chosen carefully. This means that instruments should be selected only when their expected benefits outweigh their costs.

In Colombia, we used some of these tools during the expansion phase of the cycle in 2006 and 2007. We were raising the policy interest rate, but the market interest rate was not responding as fast as we wanted. We were also witnessing high credit growth. As a result, we put in place strong marginal reserve requirements and immediately started to see a reduction in consumer credit growth, which had been around 50% at that time. This action also reinforced the interest rate transmission mechanism.

Other instruments are foreign exchange regulation or capital controls to counter currency mismatches and excessive borrowing. In addition to the internal marginal reserve requirement, in 2007 we imposed an unremunerated reserve requirement on external debt. We also have strong limits on FX maturity and currency mismatches of financial intermediaries, having learned the importance of such measures from past experience.

Still another instrument is foreign exchange intervention, specifically to maintain adequate levels of international liquidity and to correct occasional speculative behavior in FX markets that could destabilize the economy. For this, we have accumulated international reserves and can also draw on other sources of international liquidity, such as the flexible credit line of the IMF.

There are some issues associated with foreign exchange intervention that are worth highlighting.

One is that it is difficult to know for sure whether speculative behavior is driving activity in FX markets. In particular, as I always say, beware of exchange rate targeting, either perceived or real, because you may be in trouble when people believe that you have a nominal exchange target or, even worse, a real exchange rate target. (Speculators may seek to profit by taking positions against any exchange rate target.)

Another is that if you undertake unsterilized FX intervention, you may create excessive credit expansion, bubbles and inflation. On the other hand, if intervention is sterilized, it may attract more capital, which could render the intervention ineffective and unsustainable.

The bottom line is that you have to know when to intervene and how to do so. Presumably, each country has learned in the past what the main ways to intervene are. This is more art than science.

IV. Closing remarks

Let me conclude with four points. First, a combination of policy rates and macroprudential regulation and supervision is needed for an effective policy response. Experience shows that, given the risk of financial imbalances such as asset price bubbles or excessive credit growth, you have to think in terms of a combination of the traditional monetary policy tool, which is the policy rate, and macroprudential regulation and supervision. The BIS has been a leader in the discussion on macroprudential regulation and supervision.

Second, central banks must be prepared to use monetary policy for crisis prevention. As I said before, the first line of defense is financial (macroprudential and supervision) policies. However, monetary policy can also help when forecasts of inflation are low but do not capture financial imbalances. Here, authorities need to be mindful of experience that shows that very low interest rates may create problems over the medium term – not one or two years ahead, but three, four or five years ahead. Moreover, if regulation and supervision are not enough to prevent the build-up of imbalances, the help of monetary policy will also be needed.

Third, there may be conflict between price and financial stability over short periods. For example, inflation may drop below the target, but at the same time, there may be strong growth in credit and in asset prices. In resolving the dilemma, authorities may conclude that inflation can be allowed to fall a little below target for a while in order to avoid future problems due to financial imbalances. This can be easily communicated to markets to anchor inflation expectations around the target.

Finally, we should recall that even if you do everything right, that does not mean that you are totally immune. Most emerging economies are small open economies, and we feel the impact of external shocks very strongly.