Norman T L Chan: Domestic and international dimensions of unconventional monetary policy

Opening remarks by Mr Norman T L Chan, Chief Executive of the Hong Kong Monetary Authority, at the Conference on "Domestic and International Dimensions of Unconventional Monetary Policy", organised by the Hong Kong Monetary Authority and the Federal Reserve Bank of New York, New York City, 20 March 2014.

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Mr McAndrews, Professor Sims, Professor Woodford, ladies and gentlemen,

1. A very warm welcome to all of you for attending today's Conference jointly organised by the Federal Reserve Bank of New York and the Hong Kong Monetary Authority. This Joint Conference is very timely, as it is neither too early nor too late to examine the effects of the Unconventional Monetary Policy (UMP) of the Fed, including its spill-over effects on the emerging market economies (EMEs). As we all know, the Fed has already started tapering and, if everything goes according to plan, would end the asset purchase programme by the end of this year. The Fed has made it very clear in its external communications that tapering is not tightening and that there would likely to be a gap between the end of QE and the actual tightening of policy interest rates. However, the market considers that we are now in the phase of "exit" from the UMP, which also marks the beginning of the normalisation of US interest rates. When Chairman Bernanke first talked about a possible timeline for tapering in May last year, there were strong market reactions globally and all EMEs experienced significant sell-off. The market then calmed down somewhat for several months before we saw another round of EME sell-off in January this year. The question that is most talked about now in the financial and central banking community is the pace of the Fed's exit and its impact on EMEs going forward. Were these two rounds of EME sell-off merely isolated market over-actions or are they warning signals on the turbulence that awaits the EMEs when US interest rates normalise?

2. To assess what may lie ahead, it is useful to look back and try to understand what happened in the past five years during which the global monetary and financial environment was dominated by the UMP of the US and other advanced economies. In 2009, the market expectation was basically that QE would last for a year or so, i.e. "low for a short while". The expectation then changed to "low for long", and then "low for very long" and later to "low forever". Of course "low forever" was never the intention or prediction of the Fed, but many market participants just positioned themselves as if QE would last for a long, long time. This sentiment encouraged the dollar carry trades or so-called one-way bets. So it was not surprising that Chairman Bernanke's remarks on tapering in May/June last year had washed out a great deal of such one-way bets. But how do we explain the episode of the sell-off this January when the market already knew in December that tapering would proceed?

3. Conceptually, it is not very difficult to understand the spillover effects of the UMP on EMEs in the five years after 2009. There was the first phase of spill-over, which entails a period of heavy capital inflows, through the banking and bond market channels, to the EMEs. This was a "happy" phase of the spill-over of UMP because the EMEs basically enjoyed apparently pleasant outcomes in investment, consumption, job creation and economic growth. At the same time, EME currencies appreciated and their foreign reserves increased. However, this period also saw the build up of vulnerabilities in the EMEs. The inflow of capital, including the carry trade in search of yields, created easy monetary conditions, which encouraged rapid credit expansion amongst the households and corporates. While domestic consumption and investment became buoyant, most EMEs experienced a significant deterioration of their current account positions. Needless to say, inflationary pressure and overheating in the asset markets also built up in most EMEs. This was why some EMEs, Hong Kong included, have introduced macroprudential measures to tackle the spill-over

effects of the UMP of advanced economies. While it is too early to tell whether these macroprudential measures were effective, the EMEs seem to be entering the second phase, which I would call the "unhappy" period, of the spill-over. This period would entail rather unpleasant outcomes such as outflow of capital, depreciation of EME currencies, contraction of domestic and foreign credit, rise in interest rates (some of which were engineered by the central banks to dampen inflation and outflows). As a result, the growth in EMEs is slowing down and there is now a clear shift of market sentiment on the prospects of the EMEs in favour of the US and, to a lesser extent, Europe and Japan.

4. The question I hope this Conference would discuss in the next two days is in what way and to what extent EMEs would be affected by the exit of QE and normalisation of US interest rates in the next 12 to 24 months. This is a difficult question because it is far from easy to ascertain the magnitude of the dollar carry trade that found its way to EMEs in the first place and what impact such carry trade would have on EMEs when it unwinds. Another related question is what kind of responses or measures that the EMEs need to take to mitigate the risk of shocks or turbulence during this period. These are very important questions not only for the EMEs but also for the US and other advanced economies. This is not because the advanced economies need to be kind to the EMEs but because there is a feedback loop that could possibly transmit negative shocks from the EMEs to the advanced economies. 2014 is very different from the time of the Asian Financial Crisis in 1997 when Emerging Asia only accounted for 18% of global trade and 17% the World's GDP. Today, Emerging Asia makes up of 25% of global trade and 28% of the world's GDP. Moreover, the world has become so much more interconnected through the trade, FDI and financial market channels. It is all too easy to give too much credence to the "decoupling" theory than it deserves, as many people did when they over-rated the prospects of the EMEs when the advanced economies were having very difficult times after the eruption of the Global Financial Crisis. So the advanced economies also need to understand and watch out for the developments of the EMEs and their spillover effects.

5. Finally, I wish the Conference every success and all the participants a very pleasant stay in Hong Kong. Thank you.