Javier Guzmán Calafell: The normalization of monetary policy in the United States – challenges for emerging market economies

Remarks by Mr Javier Guzmán Calafell, Deputy Governor of the Bank of Mexico, during the panel on "Central banks' policies: the new normal in monetary policy, the USD and implications for emerging market", at the 21st Reserve Management Serminar, organized by UBS AG, Ermatingen, Switzerland, 16 June 2015.

* * *

The views expressed in this document are strictly personal and do not necessarily coincide with those of Banco de México's Board.

I am very honored to have the opportunity to participate in this Conference. I thank the organizers for the invitation to share with this distinguished group my views on some of the challenges that emerging market economies (EMEs) will be facing as monetary policy in the United States is normalized.

EMEs displayed a remarkable performance in the years that preceded the global financial crisis. During 2000–2007, real GDP growth for the group as a whole was more than double that observed in the advanced economies, while also showing a significant acceleration with respect to the 1990s.[1] Furthermore, emerging economies recovered quickly from the adverse impact of the crisis, with growth peaking in 2010 at a pace, again, more than twice as much as that in the advanced economies.

Ever since, however, the pace of economic activity in EMEs has been continually declining, with growth in 2015 expected to mark the fifth consecutive year of deceleration. This has been the result of a number of factors, chief among them lower rates of actual and potential growth in the advanced world; the continued slowdown in China, as the economy transitions towards a more sustainable growth path and the sources of demand rebalance; the end of the commodity price boom, and particularly the sharp fall in oil prices, that has adversely affected the terms of trade of many of these economies; and the emergence of internal and external vulnerabilities, as well as supply side constraints, in a number of countries of the group.

With the expectation of an increase in interest rates in the United States as monetary policy in this country normalizes, external conditions for emerging economies are unlikely to make a turn for the better in the foreseeable future. In fact, we are already witnessing a tightening of global financial conditions, and net private capital inflows for the group as a whole are expected to fall in 2015 to the lowest level since 2009.[2] While this is the result of a combination of factors, including the situation in Greece and problems of a geopolitical nature, the prospect of an upward trend of interest rates in the United States seems to be playing a major role. In this context, the date of the first increase in the federal funds rate has become one of the main issues of concern for both market participants and emerging market economies' authorities.

The process of monetary policy normalization in the United States is surrounded by a significant amount of uncertainty. The Federal Reserve has made clear that adjustments to the federal funds rate will depend on the evolution of the economy, and particularly on further improvement on the labor market and reasonable prospects that inflation will move back to its 2 percent objective over the medium term. However, as a result of a combination of

---

1 The annual average rate for EMEs in the period was 6.5 percent, compared with 2.7 percent in the advanced economies, and 3.7 percent in emerging economies during 1990–1999.

2 Institute of International Finance (2015): "Capital Flows to Emerging Markets", May 28.

factors, assessment of both the underlying strength of the labor market and of inflationary pressures is particularly difficult under current circumstances. Furthermore, the impact of normalization on emerging market economies is also uncertain, as is the possible timing of such impact, especially since markets are likely to anticipate such a move. Federal Reserve officials have insisted that rather than the date of the first increase, the focus should be on the subsequent pace of interest rate adjustments, which is expected to be gradual. Nevertheless, thus far this has been of little help to calm market and emerging countries' anxieties.

The above concerns are understandable when put against the recent experience.

First, as advanced economies engaged in a process of monetary policy easing and international interest rates dropped to historical minima in the aftermath of the global financial crisis, a surge in foreign capital inflows to EMEs was observed. Three features of these flows are particularly relevant:[3] a) they represented a major redirection of capital flows towards EMEs, which implied that the latter received close to half of global flows between 2010 and 2013, quite far from what fundamentals in those economies could explain; b) contrary to the experience of the preceding period, portfolio flows gained an increasingly important share; and c) in an environment of strong appetite for risk, EMEs issuance of below investment-grade debt jumped swiftly. Furthermore, as a side effect, such inflows gave rise to a significant appreciation of real exchange rates and a rapid expansion of credit, including through the shadow banking system, in many EMEs, thus increasing their vulnerability.

Second, the "taper tantrum" episode of 2013 provides further evidence on the significance that spillovers from shifts in monetary policy in the advanced economies, even when they are only perceived and do not actually occur, can have on emerging markets. Expectations of an unwinding of the unconventional monetary policy implemented in the United States led to a strong market reaction during that period. Consequently, financial volatility rose sharply and capital flows to EMEs fell, leading to pressures on the exchange rates and asset prices in these economies, increased external risk premia, and in general a severe tightening of financial conditions. Some authors have stressed the significance of financial market turmoil during May-August 2013, despite the relatively small decrease in capital flows to EMEs (about 1% of GDP).[4]

It is of course natural to ask to what extent the above experiences are applicable to the current situation. In other words, is the normalization of monetary policy in the US likely to have a major impact on EMEs? Here we have divergent views.

On the one hand, there are those who believe that the outlook for emerging market economies is not as gloomy as it seems:

- The upcoming tightening cycle will most likely take place within the context of a firmly established recovery in the United States, which is a scenario that has seen emerging market economies thrive in the past. As a reference, some estimates point out that, over the year following the beginning of the last three tightening cycles in the United States, industrial production in emerging markets grew between 7.5% and 10%, while export volumes did so by some 10% to 15%.[5] All in all, the argument

[3] See Sahay, R. et al. (2014): "Emerging Market Volatility: Lessons from the taper tantrum", IMF Staff Discussion Note No. 14/09, September.

[4] See Dahlhaus, T. and G. Vasishtha (2014): "The Impact of U.S. Monetary Policy Normalization on Capital Flows to Emerging-Market Economies", Bank of Canada Working Paper 2014–53, December.

[5] See Musalem, Alberto G. (2015): "US macroeconomic and regulatory developments and emerging market economies", speech at the International Financial Conference Annual Meeting, Cartagena, Colombia, 9 March.

goes, higher interest rates in the United States associated to a stronger economy in that country are a net positive for emerging market economies.

- The ongoing efforts from the part of the Federal Reserve and other central banks in the advanced economies in terms of their communication with the public and the transparency of their decisions, are expected to play a key role on how markets react and emerging economies are affected as monetary policy in those economies goes back to normal. As evidence in support of this argument, it is noted that anticipated interest rate increases by the Federal Reserve have been followed by minor pullbacks in capital inflows to emerging markets, while the impact of unanticipated moves has been much larger.[6]
- After years —and perhaps decades in some cases— of continued policy efforts in some key areas, emerging economies in general are today more resilient than they were in the past to external shocks.

On the other hand, there are also compelling arguments calling for extra caution going forward, as international financial markets adjust to monetary policy normalization in the United States:

- Unconventional monetary policies affect financial markets in a way that differs from the more conventional interest rate policy, and the extent of such difference is largely unknown. For instance, the large-scale asset purchase programs deployed by the Federal Reserve and other central banks in advanced economies have affected global interest rates along the yield curve through a significant compressing effect on bond risk and term premia, something that does not necessarily follow from changes in short-term interest rates.[7] Thus, there is a risk that such premia, and particularly the term premium, quickly decompress, giving rise to an abrupt adjustment of long-term interest rates as the Federal Reserve begins to tighten.
- The marked divergence in the expected path for the federal funds rate between that implied by market instruments (such as federal funds futures or overnight indexed swaps) and that obtained from FOMC projections and forecasters surveys, increases the possibility of surprises and sharp adjustments in financial markets.
- The share of the nonbanking sector in the intermediation of international credit has risen substantially after the crisis, with the growing role of the asset management industry being particularly noteworthy. It has been noted that this kind of investors may be more prone to herd behavior, and therefore EMEs may be facing an increased risk of contagion during episodes of financial turbulence.[8]

It is of course impossible to determine ex ante which of these views is correct. As far as I'm concerned, the conclusion is obvious. In the face of an uncertain scenario with very high potential costs, it is far better for policymakers to err on the side of caution. Therefore, a close look at the factors that in the past have contributed to alleviate the difficulties resulting from similar episodes is clearly warranted.

---

[6] See International Monetary Fund (2011): "International Capital Flows: Reliable or Fickle?", Chapter 4 of World Economic Outlook, April.

[7] See Dudley, William C. (2015): "The global implications of diverging monetary policy settings in advanced economies", speech at the Sixth High Level Conference on the International Monetary System: Monetary Policy Challenges in a Changing World, Zurich, Switzerland, 12 May.

[8] See for instance IMF, Global Financial Stability Report, October 2014.

Several elements stand out in this respect.[9] First, at the onset of an external shock of this nature, markets respond rather indiscriminately towards emerging market economies as a group, with differentiation following after a relatively short time span. Secondly, differentiation is made on the basis of the strength of economic fundamentals. In particular, economies with stronger external and fiscal accounts, lower inflation, more international reserves, and sound and deep financial sectors, to name a few, normally experience more subdued market reactions. This also underlines the importance of building policy buffers during favorable times. Third, markets reward timely and credible policy action, as economies that respond to emerging challenges in a flexible way and with appropriate instruments generally fare better. Fourth, even though using the foreign exchange rate as a shock absorber has proved effective in helping emerging economies to better endure a tightening of global financial conditions, intervention in this market may be useful to cope with temporary bouts of volatility in a situation of adequate international reserves and an exchange rate which is not overvalued; however, the effectiveness of intervention tends to disappear when the degree of market uncertainty reaches very high levels. Finally, growth potential is another major element of differentiation during episodes of turbulence; more specifically, the better the prospects for growth the less severe the likely consequences of financial turmoil.

Undoubtedly, putting in practice the above lessons will determine to a great extent the success of emerging market economies in coping with the possible turbulence that lies ahead. However, I would like to emphasize that advanced economies are not exempt from responsibility in this respect.

Federal Reserve officials have repeatedly noted that promoting growth and stability in the United States is the most important contribution the Federal Reserve can make to the global economy, and that this is precisely the focus of monetary policy in this country.[10] They have also stressed the need for effective communication to limit the risk of surprises and the possibility of abrupt market responses.

I have no quarrel with these arguments, and I believe there is widespread recognition of the major efforts undertaken by the Fed to increase transparency and communication in recent years. However, I see room for further action from advanced economies in at least three areas.

First, unconventional monetary policies, though fundamental to overcome the global financial crisis and underpin the recovery of demand in recent years, provide only a temporary stimulus to economic activity. Ensuring adequate and sustained rates of growth implies the adoption of measures focused on enhancing efficiency and productivity that go well beyond the reach of monetary policy. Indeed, there is a lot that advanced economies still need to do to meet these needs.

Second, actions taken by major central banks have important consequences for other economies which deserve careful consideration. Yet, an adequate understanding of such spillovers is still lacking. Although literature on the subject is scant and definitive conclusions are difficult to arrive at, to have an idea of the challenges we are facing, it may be useful to note that recent research carried out at the BIS concludes that US quantitative easing has

---

9 See, among others, Sahay, R. et al. (2014): “Emerging Market Volatility: Lessons from the taper tantrum”, IMF Staff Discussion Note No. 14/09, September; World Bank (2015): “Hoping for the Best, Preparing for the Worst: Risks around U.S. Rate Liftoff and Policy Options”, Special Feature 1 in Global Economic Prospects, June; Eichengreen, Barry and Poonam Gupta (2014): “Tapering Talk: The Impact of Expectations of Reduced Federal Reserve Security Purchases on Emerging Markets”, Policy Research Working Paper No. 6754, The World Bank, January; and International Monetary Fund (2013): “Taper Talks: What to Expect when the United States Is Tightening”, Box 1.1 in World Economic Outlook, October.

10 See for instance Dudley, William, Op. Cit. and Fischer, Stanley (2015): “The Federal Reserve and the Global Economy”, remarks at the conference held in honor of Professor Haim Ben-Shahar, Tel Aviv, Israel, 26 May.

had a greater impact on emerging market economies than on the US economy itself.[11] Greater awareness among advanced economies of the consequences of their monetary policy actions would be a major step forward for a more productive dialogue with EMEs.

Third, the room for expanding international cooperation is wide. The strengthening of the global safety net is a key area in this respect. The creation of a permanent and broad network of bilateral central bank swap facilities; the conclusion of the still pending IMF reform and the deepening of efforts in this direction, to provide the institution with proper resources and more legitimacy in its decision making; and greater collaboration between multilateral organizations and regional financial arrangements, should clearly be part of these endeavors. While some of these tasks need the involvement of both emerging and advanced economies, the crucial role of the latter is evident.

I would like to conclude my intervention by stressing that, beyond the challenges resulting from the beginning of the cycle of interest rate increases in the United States, emerging market economies will face a less favorable external environment in coming years. On the one hand, potential growth in the main advanced economies and China has declined and the prospects are not very encouraging either. As a result, emerging economies as a group will probably be facing a weaker demand for their exports, and thus further pressures on their external and fiscal balances. Furthermore, and related to this, the projected evolution of commodity prices in the medium and long term implies a deterioration of the terms of trade for an important subset of these economies, vis-à-vis the levels that existed before the global financial crisis. Lastly, in the face of a gradual but very prolonged increase in interest rates in the United States, conditions of access to external financing will tighten. It is clear, then, that the deterioration of external conditions should not be seen as a short term phenomena, and that EMEs should strengthen their domestic sources of economic growth. This implies ensuring macroeconomic and financial stability, the timely tackling of any potential sources of vulnerability, both internal and external, and the implementation of any structural reforms required to encourage investment and productivity growth.

[11] See Chen Q. et al. (2015): “Financial crisis, US unconventional monetary policy and international spillovers”, BIS Working Paper No. 494, March.