Peter Pang: Diverging monetary policies, global capital flows and financial stability

Opening remarks by Mr Peter Pang, Deputy Chief Executive of the Hong Kong Monetary Authority, at the conference on "Diverging Monetary Policies, Global Capital Flows and Financial Stability", jointly organised by the Federal Reserve Bank of New York/European Central Bank/Federal Reserve Bank of Dallas/Hong Kong Monetary Authority, hosted by the Hong Kong Monetary Authority, Hong Kong, 15 October 2015.

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1. It is my great pleasure to welcome all of you to this Conference jointly organised by the Board of Governors of the Federal Reserve System, the European Central Bank (ECB), the Federal Reserve Bank of Dallas and the Hong Kong Institute for Monetary Research.

2. Today's Conference is very timely. With the US Fed contemplating an imminent lift-off in policy rates, while the ECB and the Bank of Japan (BoJ) are still preoccupied with quantitative easing (QE), central banks around the world are carefully weighing the potential impact of the expected divergence in monetary policies on global capital flows and financial stability. Financial markets often move ahead of the real economy. We have seen global financial markets tumbled and emerging market economies (EMEs) experienced quite intense capital outflow pressures during this summer. Many would be interested to know whether such gyrations of capital flows and asset prices have already captured a good part of the adjustment process or are just a curtain raiser for even stronger threats to financial stability of the EMEs.

3. But, don't get me wrong. We welcome the normalisation of monetary policy in the US. A timely and orderly exit from zero interest rate policy by the Fed should facilitate adjustments of macroeconomic imbalances and help deflate asset bubbles in the EMEs which have been fuelled by excessive global liquidity since 2008. As the Fed's balance sheet is expected to stay elevated for some time while the ECB and the BoJ carry on with QE, global liquidity should remain abundant in the near term, which should help cushion the impact of a Fed rate hike to some extent.

4. That said, no one should safely assume that monetary policy normalisation in the US would be a smooth, painless process for the global economy. Even though the Fed has repeatedly signalled that its future rate hike path will be slow and gradual, its impact on global fund flows and financial stability is highly uncertain. This is particularly the case as many EMEs have built up varying extents of macroeconomic imbalances amid the exceptionally low interest rate environment in recent years.

5. To consider what may lie ahead for EMEs, it is perhaps useful to look back at past episodes of US monetary tightening. On the positive effects, Fed rate hikes were mostly associated with a pick-up in US growth momentum which could benefit EMEs' exports, although we have observed that the strength of this support has weakened considerably after the Global Financial Crisis. But, on the other hand, a tightening of US monetary policy and the resulting US dollar strength could expose the macroeconomic vulnerabilities of EMEs and potentially trigger financial instability. Experience of the Mexican peso crisis in 1994, the Asian financial crisis in 1997, the Brazilian currency crisis in 1999 and the Argentine economic crisis in the early 2000s clearly indicates EMEs that had accumulated significant macro-financial imbalances could be vulnerable during a strong US dollar cycle.

6. In fact, broadly speaking, most instances of financial turbulence in EMEs could be considered to be some form of balance of payments crisis, which were usually preceded by heavy capital inflows to EMEs that led to the build-up of macroeconomic imbalances, such as asset price inflation, strong credit growth and current account balance deterioration. These problems were particularly serious in the past when some EMEs violated the "impossible

trinity" by pursuing at the same time, a de facto dollar peg, free movement of capital and an independent monetary policy. These conditions tend to encourage an accumulation of significant short-term external debts in the EMEs. Eventually, a combination of US rate hikes and strengthening US dollar generated momentum for capital outflows from the EMEs, exposing their fault lines and macroeconomic vulnerabilities as domestic liquidity conditions tightened. Those with weak fundamentals and significant external imbalances could face speculative attacks, sharp currency depreciation, a surge in value of their US dollar denominated debts leading to a financial crisis.

7. Would history necessarily repeat itself? Some have rightly pointed out that the economic fundamentals of Asian EMEs are now much more robust than two decades ago, with improved current account balances and better coverage of short-term external debts by sizable foreign reserves. And currency and maturity mismatch in foreign liabilities are no longer a serious issue. Moreover, the more flexible exchange rate regimes adopted by many Asian economies should give regional currencies more flexibility to adjust according to market forces and may therefore serve as a shock absorber in the case of capital outflows. A number of Asian EMEs, Hong Kong included, have also stepped up their macro-prudential measures in recent years to tackle the spill-over effects of the unconventional monetary policies of the advanced economies.

8. There is, however, no room for complacency. We should also be aware that the external environment has become much more challenging for Asian EMEs compared with the 1990s. The global economy is now much weaker, meaning that EMEs may be less able to look to support from external demand to cushion the effect of tighter domestic liquidity conditions along with US monetary policy normalisation. Concerns over further economic moderation in Mainland China have also weakened market sentiment towards Asian EMEs and the strength of the region's "pull factor" to attract global capital flows.

9. More importantly, the region is now facing new risk factors that were unseen before. First, while the Asian region is once again awash with excess liquidity, this time the magnitude of capital inflows is unprecedentedly large, with an estimated cumulative short-term non-resident inflow of US$1.6 trillion between 2009 and 2014, according to the balance of payments statistics. Up to the second quarter of this year, only around US$160 billion, or 10% of the total inflows, have exited the region. This would suggest the size of potential capital outflows and the resulting unwinding of financial imbalances could be significant and disruptive. Second, the region's financial markets are now more globalised and interconnected than back in the 1990s. The impact from capital outflows could therefore be transmitted more quickly and widely across financial markets, as depicted by the sharp equity market sell-offs and currency depreciation across EMEs in August this year. Meanwhile, the increasing presence of foreign investors in Asia's debt markets and declining bond market liquidity in the region in recent years may also amplify the impact of capital outflows in case of distress.

10. With global monetary policy paths set to diverge, significant uncertainties and challenges lie ahead for advanced economies and EMEs alike. To what extent will they be susceptible to US monetary policy shocks? How should policymakers better prepare themselves to minimise possible disruptions to their economies and financial markets? I hope that this Conference will contribute useful insights and advice on these important issues.

11. Thank you.