

Manuel Sánchez: The effects of monetary divergence

Remarks by Mr Manuel Sánchez, Deputy Governor of the Bank of Mexico, at the symposium *Jornadas Económicas*, organized by the Banco de Guatemala, Guatemala City, 7 June 2016.

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Accompanying graphs can be found at the end of the speech.

I would like to thank the Bank of Guatemala for the invitation to participate in this symposium, now in its 25th year, which has become an invaluable forum for discussing substantive economic issues in Latin America. On this occasion, I will devote my comments to the divergence of monetary policy stances in advanced nations and the potential impact this may have on emerging economies.

As usual, my remarks are entirely my own and do not necessarily reflect the views of the Bank of Mexico or its Governing Board.

Monetary policy divergence

Central banks guide their actions according to the developments and outlook of their own economies. Most of them hold as a primary objective a low inflation rate, commonly two or three percent in annual terms, but they also take into account economic growth, either as an explicit objective or as an essential piece of information for pursuing price stability.

At any moment, economies could find themselves in different cyclical stages and confronted with particular challenges. Thus, it should not be surprising that monetary policies among nations do not coincide.

Not only can monetary stances vary internationally, being tighter or looser than their neutral references could be, but also, these differences can widen over time. One example of discrepancy occurred in the 1990s between the United States, which began to tighten policy in a context of economic growth, and Germany, which started to do the opposite in the face of higher unemployment stemming from political unification.

Notwithstanding such particular cases, there does seem to exist a certain tendency in the medium term toward the international synchronization of economic cycles, especially among high-income countries. Additionally, in recent decades inflation rates have been persistently declining in advanced as well as non-advanced economies. Consequently, a propensity towards convergence among monetary policies has become evident, particularly among developed nations. See Graph 1

In a world in which economic and financial integration has become tighter, it is difficult to conceive of domestic monetary policies as completely isolated, including those of large economies. By way of illustration, the U.S Federal Reserve has repeatedly stated that it will continue to consider global economic and financial developments in its decision-making process.

The aforementioned output and monetary synchronizations are far from perfect. Since 2013, which brought us the taper tantrum, the matter of international monetary divergence has captured the attention of market players in the face of the Fed's monetary normalization and the foreseen continuation or amplification of loose policies by other key central banks.

However, monetary policy divergence should be put into perspective. While the use of unconventional monetary tools makes historical comparisons difficult, the widespread nature of unusually expansive monetary postures leads us to conclude that current and expected monetary divergence is considerably less pronounced than in the past. The reasons are at least threefold.

First, the starting point for divergence is unprecedented monetary looseness among advanced economies. Accommodation to date encompasses the following: policy interest rates near zero and in some cases negative; further stimulus from considerable enlargement of central bank balance sheets through large-scale asset purchases; and forward guidance to orient market expectations.

Second, anticipated U.S. monetary policy normalization, as foreshadowed by the Fed, includes gradual hikes in the fed funds rate, which would continue to be below the level consistent with full employment, even after this condition is achieved. Third, the Fed plans to maintain the size of its balance sheet until interest rate normalization is well advanced.

However, despite the foreseen measured pace, monetary policy divergence has sparked concerns over possible impacts on other nations, particularly emerging economies. Worry has increased perhaps because central banks find themselves in uncharted waters.

Indeed, monetary differences across countries have arisen many times in the past. But less experience with unconventional monetary policy instruments and the intensity of their use make the present situation unique.

In any case, the dangers are hard to assess, including the complexity of timely withdrawal of monetary stimulus without violating central bank mandates, and the risk of unleashing a chain reaction of financial instability. The latter is particularly important in the face of growing monetary looseness in many countries and continued consideration of additional accommodation options, such as negative or even more negative policy interest rates, longer-term interest rate targeting, and monetization of public-sector deficits.¹

Possible impacts

To examine the potential effects of monetary divergence in a context of generalized loose policy in advanced countries, two hypothetical scenarios bear analysis and contrast. The first is based on an economy which reduces monetary stimulus in a preemptive way for “good reasons.” For example, in a context of anchored inflation expectations, the central bank could seek to avert aggregate demand pressures coming from an economic upswing.

The second involves the case in which monetary tightening takes place for “bad reasons,” such as misaligned inflation expectations, high inflation pressures and, possibly, an output contraction. In both scenarios, transmission channels to other economies are twofold: one financial and the other real.

The two scenarios would tend to generate opposing effects. In the favorable case, the financial impact would include an adjustment in international portfolios benefiting assets denominated in the currency of the country beginning the divergence. Some reversion of capital flows from economies perceived as having weak fundamentals could also be expected. The real effect would operate through greater external demand from the leading country, favoring especially its key trade partners.

The adverse scenario would have contrary effects. In particular, the adjustment of portfolios would not favor the country leading the divergence, and real support to the rest of the world economy would be difficult. In both scenarios, the effects could be amplified or weakened by other non-monetary factors.

Current monetary divergence should be placed within the first scenario, with the United States as the epicenter. Anticipated monetary decoupling, at least since 2014, has resulted in a stronger U.S. dollar versus other major currencies. Presumably, the dollar has

¹ See for example, Bernanke, B.S. (2016). “What tools does the Fed have left?” The Brookings Institution, Ben Bernanke’s Blog, March and April.

strengthened in the face of wider interest rate spreads and better economic performance from the United States with respect to other developed nations.

Indeed, expectations of normalization in this country have resulted in higher short- and medium-term market interest rates, giving rise to a flatter yield curve. This, in turn, has led to wider spreads between U.S. Treasuries and European bonds, such as those of German bunds at various maturities. **See Graph 2**

Moreover, in the last two years, financial volatility, as measured by the VIX for instance, has become more acute at times. Transitory spikes have also been associated with non-monetary factors, such as declining commodities prices and jitters over the health of the Chinese economy. **See Graph 3**

To date, the financial impact on emerging markets has been relatively moderate. It has included a slowdown in net portfolio capital inflows and temporary outflows of foreign funds. **See Graph 4**

At the same time, external interest rates, as reflected in JP Morgan's EMBI global index, have seen upward pressures, beginning with the taper tantrum, although access to foreign financing under still reasonable conditions has continued. Furthermore, domestic interest rates, which have traditionally followed the path of U.S. rates, have recently gone their own way, with an upward tendency and widening spreads. **See Graph 5**

By far, exchange rates have been the most affected financial variable, with generalized depreciations of emerging-market currencies against the U.S. dollar on a trade-weighted basis. Flexible exchange rates have served as a valuable buffer against deteriorating sentiment toward emerging markets. **See Graph 6**

The positive real effect from U.S. economic recovery has not yet emerged. This is because the United States has been affected by a downsizing of its energy sector in the face of lower international oil prices, among other issues, restraining industrial production and external trade.

The absence of a positive real effect has been particularly noteworthy in the case of my own country, Mexico, an economy highly linked with that of the United States. In spite of significant peso depreciation, low U.S. external demand has dominated as a drag behind declining growth for Mexico's total manufacturing exports, a high percentage of which goes to its northern neighbor.

For several years, global monetary accommodation has had a spillover effect on monetary policies in emerging economies, with postures generally looser than what would be dictated by Taylor rules. The beginning of the withdrawal of U.S. monetary stimulus has led to higher policy interest rates in some countries, partly closing this gap.

Moreover, during recent years, some economies have used capital controls, with generally lower-than-expected results, and direct exchange market interventions, in order to preclude larger currency depreciations. Motivations for the latter vary across countries, including protection of inflation expectations and fear of floating.²

Challenges and outlook

Advanced and emerging economies face considerable challenges. For developed nations, the following possible difficulties can be identified. First, incipient monetary divergence could butt up against domestic or external limits. For example, the Fed could decide that dollar appreciation or deterioration of international conditions could detain U.S. economic recovery.

² For the estimation of Taylor rules, see BIS (2015). "85th Annual Report, 1 April 2014–31 March 2015," June, p. 92.

In this case, one cannot rule out interruption in normalization or even a return to greater stimulus in the United States.

Second, continued orderly unwinding of lax monetary policy, including eventually smaller central bank balance sheets, could prove to be complicated. Third, the prevalence of the dollar as a safe-haven currency could weaken the credit channel through which loose monetary policy works in other economies.

Fourth, given diminishing returns from accommodation, further attempts at easing could damage the credibility of monetary policy. And finally, the tendency toward cyclical convergence could lead to the re-synchronization of monetary policies at some point.

In this context, the panorama for emerging economies could deteriorate significantly. Divergence is already reflected in portfolio adjustments and asset prices. However, as new information on monetary stances in advanced countries becomes available, new changes may ensue. In this regard, only surprises would carry weight.

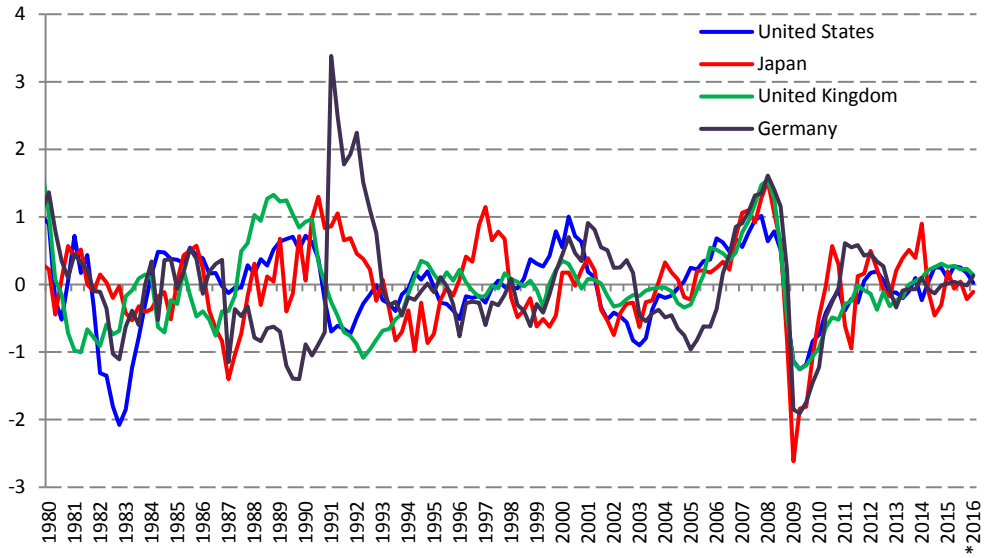
Possible effects could include more portfolio re-composition, decompression of interest rate term premiums, as well as further currency depreciations. The most adverse effects will likely be concentrated in those countries viewed as suffering from financial imbalances and fragile economic fundamentals. Thus, policymakers should focus on correcting deficiencies and solidifying strengths, including sound fiscal stances, opportune monetary policy actions, and the implementation of structural changes to foster long-term productivity growth.

Concluding remarks

Incipient monetary divergence has sparked concerns for market players as the current begins to shift slowly away from unprecedented monetary expansion. Advanced economies face an arduous task in managing the withdrawal of extraordinary stimulus, however gradual it may be. In particular, historically unequaled use of unconventional monetary tools makes it hard to know just how this scenario will eventually unfold.

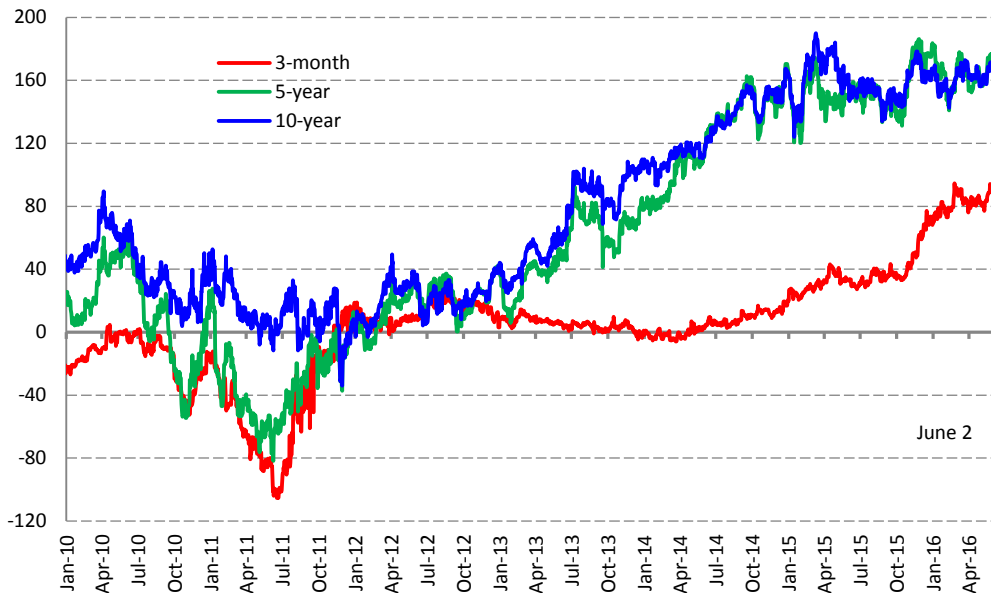
Until now, negative financial impacts on emerging markets from the beginning of this new phase have been relatively moderate. At the same time, however, the real positive expected effect of the U.S. economic recovery has not yet materialized. This is due in part to factors such as severely diminished oil prices. Given all the uncertainties in the present context, the outlook for emerging economies could easily deteriorate, and thus they should concentrate on fortifying their fundamentals as never before.

Graph 1
Advanced economies: Cyclical component of GDP¹
% deviation from the trend



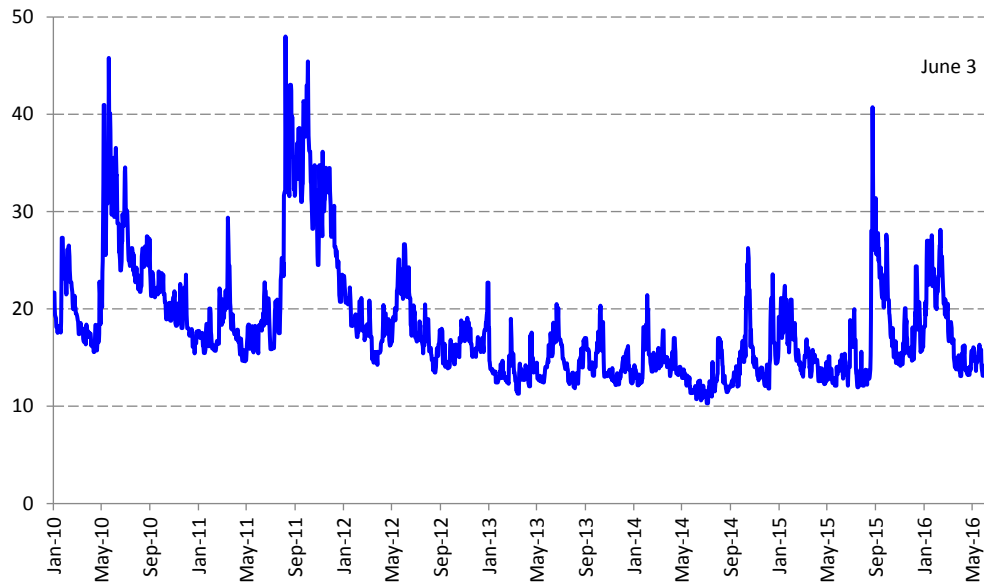
1/ Trend component extracted by Hodrick-Prescott filter.
*/ First quarter.
Source: Own calculations with data from Haver Analytics.

Graph 2
The United States and Germany: Interest rate spreads¹
Basis points



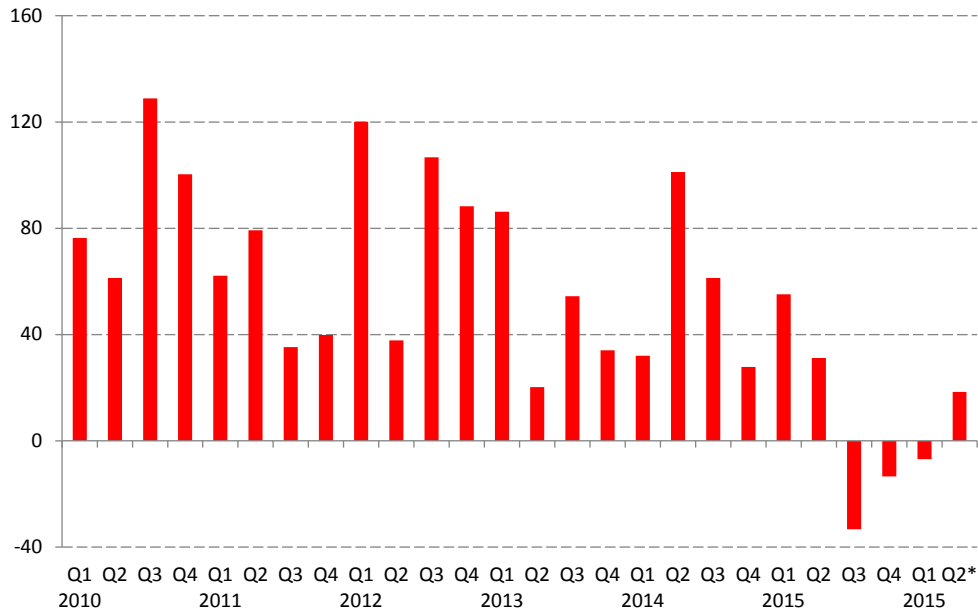
1/ U.S. Treasuries minus German Bunds.
Source: Bloomberg.

Graph 3
The United States: Volatility in the options market (VIX)¹
%



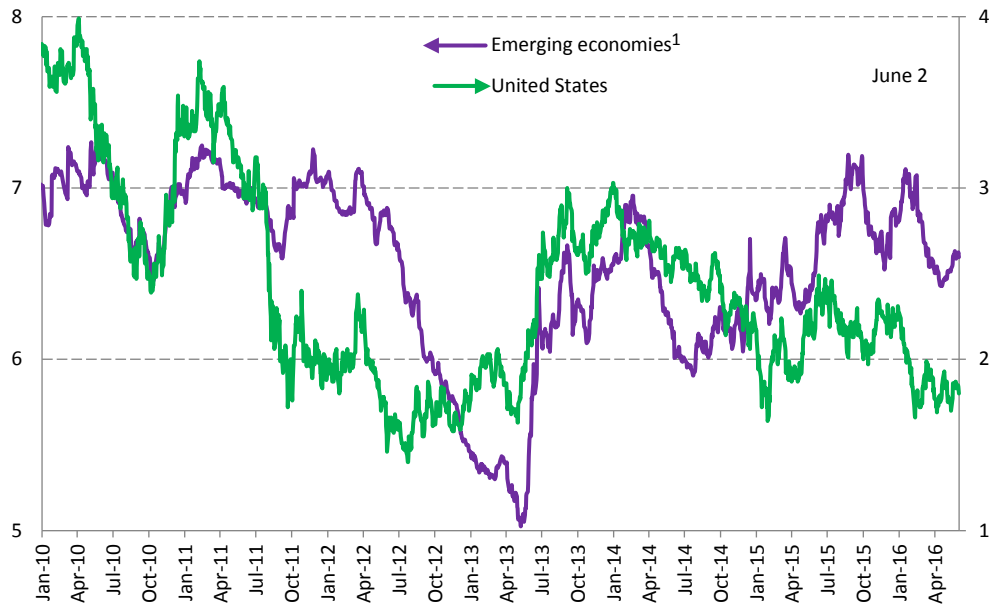
1 Volatility implied by S&P 500 index over the next 30 days, calculated by taking a weighted average of the implied volatility of eight call and put options. Source: Bloomberg.

Graph 4
Net portfolio capital flows to emerging economies¹
Billions of dollars



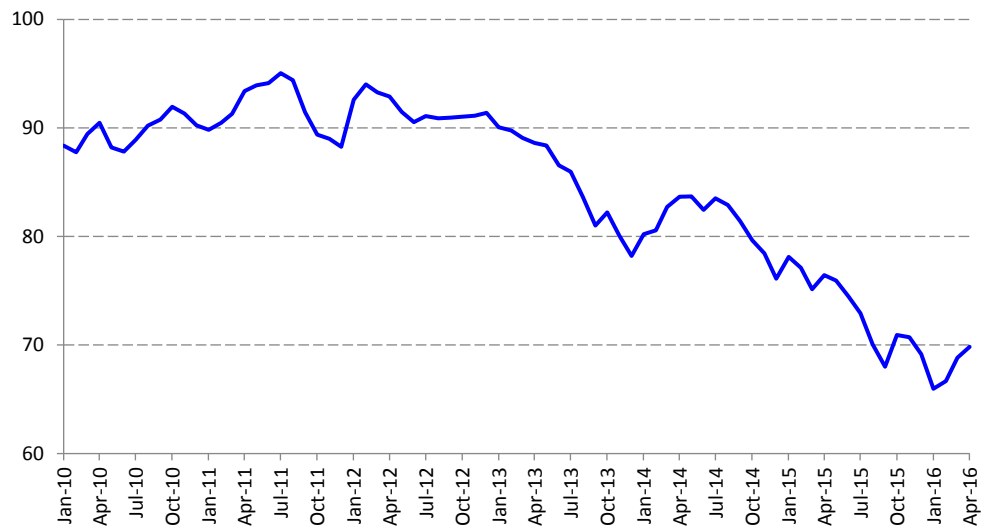
1/ Net purchases by non-residents of stocks and bonds in emerging economies. Emerging economies are Argentina, Brazil, Chile, China, Colombia, the Czech Republic, Egypt, Hungary, India, Indonesia, South Korea, Lebanon, Malaysia, Mexico, Nigeria, the Philippines, Poland, Russia, Saudi Arabia, South Africa, Thailand, Turkey, Ukraine, the United Arab Emirates, and Venezuela. */ Includes estimates for April and May. Source: IIF.

Graph 5
Emerging economies and the United States: 10-year interest rate
%



1/ Unweighted average of interest rates in Brazil, Bulgaria, Chile, China, Colombia, the Czech Republic, Hungary, India, Indonesia, South Korea, Malaysia, Mexico, Nigeria, Peru, the Philippines, Poland, Romania, Russia, South Africa, Thailand, Turkey, and Venezuela.
Source: Own calculations with data from Bloomberg.

Graph 6
Emerging economies: Local currencies versus the U.S. dollar¹
January 2007 = 100



1/ Trade-weighted average of values against the U.S. dollar of the following currencies: the Chinese yuan, Russian ruble, Turkish lira, Korean won, South African rand, Brazilian real, Indian rupee, Polish zloty, Hungarian forint, Malaysian ringgit, Thai baht, Chilean peso, Indonesian rupee, Philippine peso, Colombian peso, and Peruvian sol.
Source: Own calculations with data from Bloomberg.