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Beyond zero rates and unconventional monetary policy

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The topic of this panel is "Monetary policy, at the zero lower bound and beyond". I shall take as my theme the *beyond* – in the sense of how zero interest rates and unconventional bond-buying in the major currency countries have affected the rest of the world.

The discussion of the spillovers raises interesting questions today. Over the past two decades, emerging market economies (EMEs) have no doubt undertaken significant and positive transformations in their economic fundamentals and policy frameworks. And yet, EME vulnerabilities have recently returned to the fore, shaking the outlook for global growth. The question is whether we are seeing isolated tremors due to idiosyncratic factors or the release of previously accumulated pressure.

Today, in four points, I'll summarise some reflections on this question and the policy implications. I'll build on the spillover themes in my talk in Santiago almost two years ago.[1]

– First, I will recap the argument that I made then on the nature of spillovers.

– Second, I will suggest that, rather than facing just a series of idiosyncratic shocks to EMEs, we are watching the continuation of the same movie in which the accumulated effects of spillovers and spillbacks take on a prominent role.

– Third, I will argue that, for policymakers in the major currency countries, anticipating the spillovers and factoring them into policy, in a spirit of "enlightened self-interest", would be better than simply reacting to the subsequent spillbacks in currency and bond markets.

– Fourth, I will submit that today's international monetary and financial system (IMFS) does not have sufficiently strong mechanisms to constrain spillovers and spillbacks. This perspective on the IMFS is the subject of one of the chapters in this year's BIS Annual Report.

1 "Ebbing global liquidity and monetary policy interactions", speech given at the Central Bank of Chile Fifth Summit Meeting of Central Banks on Inflation Targeting, "Global liquidity, capital flows and policy coordination", Santiago, Chile, 15 November 2013; see also "International monetary policy interactions: challenges and prospects", speech to the CEMLA-SEACEN conference on "The role of central banks in macroeconomic and financial stability: the challenges in an uncertain and volatile world", Punta del Este, Uruguay, 16 November 2012.

Spillover channels

Easy monetary conditions in key currency countries have propagated themselves to the rest of the world – to EMEs and small advanced economies alike. Floating exchange rates have turned out to be not enough to insulate domestic policies from global conditions.

We at the BIS usually highlight five channels through which monetary policy spills over from the key currency jurisdictions to the rest of the world.[2]

1. The policy reaction channel. Central banks set policy rates lower than experience would have suggested. This has often been done to resist currency appreciation and capital inflows.
2. In integrated markets, common factors (VIX and bond term premia) move bond, equity and currency prices. Monetary policy pressure on bond yields in the key currency economies feeds through into other bond markets through portfolio balance effects. This pressure is especially pronounced if monetary policy is implemented directly in bond markets through large-scale asset purchases.
3. Pressure on exchange rates from lower rates in key currencies.
4. Borrowing in foreign currency. Federal Reserve and ECB policy immediately affects financial conditions in the rest of the world, given the prevalence of dollar- and euro-denominated debt worldwide. Specifically, non-bank borrowers outside the United States have accumulated dollar debt, totalling $9.6 trillion at the end of Q1 2015, over a third of it in EMEs. While policymakers in many EMEs have used various measures to slow the growth of dollar credit, EME borrowers have been welcomed into the international bond market, whether they are long-standing participants such as large oil or mining firms (the intensive margin) or firms or sovereigns that have never previously issued international bonds (the extensive margin).
5. Capital flows provide additional finance for domestic equity and credit booms.

Isolated tremors?

So how should we interpret the recent pressures on emerging market economies?

One way is to think of this episode as just a coincidence of idiosyncratic factors. After all, the commodity cycle has turned; China is undergoing a challenging rebalancing of its growth, contributing to the turn of the commodity cycle; and idiosyncratic political and security risk events have commanded more attention from investors.

Another interpretation is that, in addition to idiosyncratic factors, EMEs are grappling with something endogenous – a build-up of vulnerabilities in the form of a rapid rise in debt that resulted from, among other things, the difficult choices made in the face of the monetary and financial spillovers. In other words, it is the next reel of the same movie we have been watching so far: a movie that started with already accommodative global monetary and financial conditions before the Great Financial Crisis, and has continued with "no holds barred" easing since then. The spillovers from global conditions had the effect of constraining EMEs' policy choices, making more likely the build-up of vulnerabilities and the erosion of fundamentals. The upshot is that global economic growth could now be held back by the

[2] See BIS, *85th Annual Report*, Chapter V, June 2015, for a summary of these channels.

resulting spillbacks. This interpretation reinforces two notions: one is that policies to improve fundamentals, to mitigate vulnerabilities and to increase economic resilience are as vital today as they ever were; the other is that spillovers need to be anticipated and factored into policymaking.

Factoring spillovers into policies

Some of the headwinds to the world economy come from the strains in emerging market economies that reflect years of rapid credit growth. The spillbacks to the global economy are evident in the currency and bond markets.

In the currency markets, many EME currencies have fallen significantly this year. Market participants are also carefully watching the Chinese authorities' management of the dollar/renminbi rate.

In the bond market, the drawdown of official reserves by EME central banks in response to currency depreciation could amount to "quantitative tightening", as reserve managers sell bonds. Their sales of government bonds in the SDR currencies could rival, or even surpass, the scale of ongoing purchases by the ECB and the Bank of Japan. As EMEs' sales of bonds held in their reserves take place mostly in dollars and ongoing central bank purchases are in euros and yen, these effects compete in a global bond market.

How might the major currency economies react? Policy there may simply respond to the financial market manifestations of the accumulated vulnerabilities in EMEs, rather than anticipating the spillovers. If this is an accurate characterisation, then it is another case of policy asymmetry – in the sense that little attention is paid to the build-up of debt and vulnerabilities, but then the consequences are met with a forceful reaction, at the risk of overburdening monetary policy. I would argue, as I have on other occasions, that it would be better for all to factor the possible spillovers into policy ex ante, in a spirit of enlightened self-interest, than to react only ex post.[3]

Blind spot in the international monetary and financial system

We at the BIS have on various occasions spoken about how the current international monetary and financial system is unable to constrain the build-up of financial imbalances or to discourage spillovers and spillbacks. Global liquidity can amplify booms to the point of instability. This is what we have called a blind spot in the system.

There is a sort of tension in the current system. Economies and financial markets are increasingly interconnected globally. And yet central banks tend to interpret their policy mandates strictly in domestic terms. In other words, the game is global but the rules are mostly local.

How to reduce this tension? The response could be along the following three lines:

– First, if central banks could at least entertain a broader interpretation of their domestic monetary policy mandates so as to manage the financial cycle as well as the business cycle, most likely there would be fewer spillovers.

[3] "The international monetary and financial system: eliminating the blind spot", panel remarks at the IMF conference "Rethinking macro policy III: progress or confusion?", Washington DC, 16 April 2015.

– Enlightened self-interest would take us a step further. This means taking potential spillovers and spillbacks into account when setting policy, rather than waiting for financial imbalances to build up to the point of feeding abruptly back into the domestic economy.

– Most ambitious would be to revisit the rules of the game more broadly, as has been suggested.[4]

Two final points

To conclude, I would like to make two final points.

One is that, even though there is already some progress in recognising the implications of such spillovers and spillbacks, there is still much to be learned about their dynamics. Further research and analysis are needed to understand these phenomena better and ultimately to incorporate finance and spillovers into domestic policy frameworks properly. But I believe that, even at this stage, we know enough already to start translating the known elements into action.

And last but certainly not least, these observations about spillovers should not be read as an indication that there is nothing the rest of the world can do in the face of policy actions in the major currency economies. Quite the contrary, they underscore the importance of economic and financial resilience. Sound policies to improve fundamentals and reduce vulnerabilities are more important than ever.

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4 R Rajan, "Competitive monetary easing: is it yesterday once more?", remarks at the Brookings Institution, 10 April 2014.