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Monetary Policy in Advanced Economies: Some Challenges for Emerging Economies

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Monetary Policy in Advanced Economies: Some Challenges for Emerging Economies*

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Resumen

Este documento explora las consecuencias y opciones de política de las economías emergentes ante las medidas monetarias expansivas adoptadas por los países avanzados en años recientes. Considerando el rol que juega el dólar estadounidense como principal moneda de transacción y reserva en los mercados globales, la atención se centra en la trayectoria de la política monetaria en Estados Unidos y su propagación hacia los mercados emergentes. Se pone especial énfasis en el marco de políticas en vigor en Chile y cómo ayuda dicho marco cuando toca enfrentar situaciones como las de los últimos años y las que probablemente ocurran en el futuro.

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Summary

This document explores the consequences and policy options for emerging market economies facing the expansionary monetary policies followed by advanced economies in recent years. Given the US dollar's role as the primary transaction and reserve currency in global markets, the main focus is on the path of monetary policy in the US and its spill-over into emerging markets. Special attention is given to the policy framework that Chile has in place and how this framework helps to face situations like the ones we have seen during the last years and those that are likely to occur in the future.

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I. Introduction

In the aftermath of the 2008 global financial crisis, the US Federal Reserve (Fed), the European Central Bank (ECB) and other central banks around the world pursued super-expansionary monetary policies to boost aggregate demand and prevent the collapse of financial markets. They slashed nominal interest rates to historical lows and, as the zero lower bound became binding, they responded with unconventional monetary policies, including large-scale asset purchases for a wider range of securities or “quantitative easing” (QE), as well as long-term refinancing operations, and forward guidance, by which central banks adopted the strong commitment to keep rates exceptionally low for a prolonged period of time. Since 2013, investors have become increasingly focused on the exit strategy from easy monetary policy in advanced economies. The Fed and the Bank of England (BoE) are gradually moving closer to beginning a normalization stage for monetary policy. The Fed will probably end its asset purchase program by October, and both the Fed and the BOE will start raising their monetary policy rates at some point in the next few quarters. In the meantime, the ECB and the Bank of Japan (BoJ) will probably remain under pressure to maintain their current stance or even expand further their balance sheets.

This document explores the consequences and policy options for emerging market economies facing the expansionary monetary policies followed by advanced economies in recent years. Given the US dollar’s role as the primary transaction and reserve currency in global markets, the main focus is on the path of monetary policy in the US and its spill-over into emerging markets. Special attention is given to the policy framework that Chile has in place and how this framework helps to face situations like the ones we have seen during the last years and those that are likely to occur in the future.

II. Monetary Policy in Advanced Economies and Emerging Economies

Immediately after the collapse of Lehman Brothers, central banks around the world implemented aggressively expansionary monetary policies. In the case of the United States, three phases of quantitative easing—QE1, QE2 and QE3—with different effects on developing economies can be distinguished. The first phase (QE1) was adopted right after the Lehman Brothers crisis, and it was overall positive for the world economy since it reduced the

risk of a complete financial meltdown at the height of the debacle. A report from the IMF stated that “few countries complain about the Fed’s QE1 action in 2008-09 or about the ECB’s LTRO operations in 2011-12 because these occurred at times of near collapse...” (IMF 2012). During this phase, bond yields and risk premiums in global markets declined, while capital flows to emerging markets started to normalize. These “push factors” were accompanied by “pull factors” like rapid growth and better prospects in emerging countries. The assessment about the other two phases of unconventional expansion, QE2 and QE3, remains controversial. They took place when there were signals of economic heating in some emerging economies. After the third quarter of 2009 and until mid-2011, economic growth in emerging markets was high and their currencies appreciated significantly. In this context, additional expansion creating higher levels of capital flows, fueling aggregate demand, domestic inflation and currency appreciation was certainly less welcomed than during QE1.

In general, and the recent experience has been no exception, prolonged periods of lax global liquidity conditions result in large capital inflows to emerging economies. The literature on the determinants of capital flows is quite extensive. Recent work by Forbes and Warnok (2013) finds that changes in global risk, uncertainty and global growth are important variables determining large shifts in capital flows by foreign and domestic investors, while changes in US interest rates and liquidity appear to play a less important role. However, US reductions in interest rates tend to lower measures of risk and uncertainty and these are also related to global growth expectations (Rey, 2013). Large capital inflows may fuel macrofinancial vulnerabilities to a point where they become dangerous. These vulnerabilities reflect global and country-specific conditions, including currency and maturity mismatches, over-leverage, under-developed financial markets or fiscal weaknesses. Periods of high liquidity are often related to increases in asset prices that may end up in an asset bubble or excessive build-up in debt leverage with dangerous potential effects once they burst or during periods of liquidity withdrawal. Economic history teaches us that periods of increasing interest rates by the Fed are associated with higher emerging markets’ volatility, capital outflows, real exchange rate depreciations, equity declines, and increased borrowing costs.

Starting in mid-2013, the US Federal Reserve and the Bank of England have been gradually moving closer to beginning a normalization stage for monetary policy. The Fed will probably end its asset purchase program by October 2014, and both the Fed and the BoE will probably

start increasing their monetary policy rates at some point in the next few quarters. In the meantime, the ECB and the Bank of Japan (BoJ) will probably remain under pressure to maintain its current monetary stance or even to expand further their balance sheets.¹

Back in May 2013, the markets looked highly vulnerable to any hint of an exit from accommodative monetary policies. Chairman Bernanke's testimony to Congress raising the possibility of tapering Fed's securities purchases from US\$85 billion a month to a lower amount had a negative effect on financial and economic conditions in emerging markets and triggered the opposite type of pressures to the ones discussed above in the case of capital inflows to emerging markets: capital outflows and real depreciations. Indeed, the effects of the announcement on emerging markets were far more relevant than the ones when the tapering actually began at the end of last year.

As during the phase of capital inflows, not all countries were hit in the same way when markets started fearing the possibility of an abrupt liquidity withdrawal. A number of recent studies have found that emerging markets with better macroeconomic fundamentals and greater institutional strength experienced milder impact when talk turned to tapering. Higher current account deficit, higher inflation and lower international reserves were associated with a larger increase in domestic bond yields following tapering talk.

Eichengreen and Gupta (2013) note that emerging markets that allowed the largest appreciation of their real exchange rates and the largest increase in their current account deficits in the prior period of quantitative easing saw the sharpest currency depreciation, reserve losses, and stock-market declines in the more recent period. They also found that measures of policy fundamentals and economic performance do not indicate that better fundamentals provided better insulation.² However, this conclusion about the role of countries' fundamentals is not out of controversy. Some argue (e.g. Forbes (2014)) that since greater depreciations after the "Tapering Talk" occurred in countries with higher current account deficits, economic fundamentals are important in determining which countries would be more affected by a monetary normalization.

¹ The ECB announced new measures in June and September 2014.

² These measures refer to the budget deficit, the public debt, the level of reserves, and the rate of GDP growth.

Also according to Eichengreen and Gupta (2013), another important determinant of that differential impact was the size of a country's financial market. Countries with larger markets experienced more pressure on the exchange rate, reserves, and stock. Liquid financial markets may be a mixed blessing: they are able to attract capital inflows, but when things take a turn to the worse they are often the initial sell-offs of investors trying to make portfolio adjustments.

Clearly, during that period there were also changes in important factors like economic growth prospects in the developed and developing world and agents' perceived uncertainty. For instance, at the end of last year, growth forecasts for the major developed economies and China were better, and uncertainty about the global economy was lower than respective values at the announcement date. These more positive forecasts could have outweighed the negative effect of a small tightening of US monetary policy over emerging markets. This is just an example of the known identification issues present in studies of the determinants of capital flows.

In the case of Chile, greater exposure to trade with China, a greater share of commodity exports and a larger downward revision of the growth outlook have amplified the impact on the exchange rate of tapering talk. However, this adjustment is part of the solution to a period of lower terms of trade and domestic demand impulse coming from capital expenditure in the mining sector. Another relevant aspect of Chile's experience is a significant base of domestic institutional investors which has been helpful in coping with periods of global financial volatility. Pension funds have invested more than 40% of their portfolios in global markets, the equivalent to 30% of GDP. Capital inflows and outflows associated to pension funds and other domestic institutional investors have tended to counteract opposite movements by international investors during periods of global turmoil. As international volatility and risk aversion increases, these investors tend to return to the domestic market, allowing for a smoother adjustment of fixed-income and money markets. Indeed, during the 2013 turmoil period, short-term and long-term domestic interest rates fell in Chile, contrasting with the experience in most emerging market economies.

After more than one year since the start of the tapering talk, global financial conditions still look relatively easy. Central banks in advanced economies have been successful in delivering the message of a smooth exit from the current monetary stance, perhaps too successfully. If

the exit from accommodative monetary policy proceeds gradually, as is currently anticipated, it should not significantly worsen the financial conditions for emerging markets, or at least its impact should be manageable.

However, there is still considerable uncertainty about the actual speed and depth of the ongoing monetary policy normalization process in the US. There is uncertainty about the future path of both aggregate demand and aggregate supply in the US economy and more generally in advanced economies. It cannot be ruled out that interest rates will increase faster than currently envisaged by authorities, embedded in yield curves and investors expectations, creating some further turmoil in financial markets.

The benign risk scenario is one where aggregate demand in the US economy grows faster than expected, which moves forward the timing of monetary policy normalization. Although the growth performance of advanced economies during the first half of 2014 has been somewhat disappointing, a number of indicators—such as the recent pace of job creation, the optimism in manufacturing surveys, improving financial conditions and less fiscal drag—point in the direction of a faster recovery of aggregate demand in the coming quarters. This is certainly the case in the US and the UK, less so in the Eurozone and Japan.

If this benign risk scenario carries the day, the adjustment of monetary policy and asset market prices could happen earlier and faster than anticipated in current market expectations and prices, but it would be cushioned by better prospects for global growth and commodity prices, which could compensate the impact of higher global interest rates on emerging market economies.

The more pessimistic scenario is a reassessment of the amount of slack in the US economy and a less benign outlook for potential output. The evidence is contradictory. Based on recent GDP performance and the cumulative gap with traditional estimates of potential growth, it could be concluded that there is still considerable economic slack in the US economy. However, recent labor market data and the lackluster productivity performance indicate that slack in the US economy may be declining faster than expected.

The resolution of this puzzle will have relevant implications for the timing and intensity of monetary normalization in the US, as well as for emerging markets' prospects. If the pessimistic view on aggregate supply prevails, the adjustment of monetary policy and asset

market prices will also happen earlier and faster than the markets expect, but it will not have compensation in higher global growth and firming commodity prices, but the contrary. Based on the experience after past episodes of Fed Tapering announcements, we may expect that a situation like this would create significant turmoil in global financial markets, sharp reversal of capital inflows to emerging markets and adjustment in currencies, bond yields and stock markets.

For the time being, there are no signs of an acceleration of final goods and services inflation or nominal wages in the US, or any other advanced economy, that could validate this pessimistic view on the supply side, but it is a relevant concern that should remain in the cards as a risk scenario for emerging economies.

It cannot be ignored that there are risks in the other direction too. Despite a number of good economic indicators in some areas, the actual performance of GDP growth in advanced economies has continued to disappoint in recent quarters. Therefore, we cannot overlook the risk that the recovery in advanced economies may continue proceeding slowly, demanding a more extended period of monetary support.

From the point of view of emerging market economies, an “early and smooth” exit from an accommodative monetary policy would be safer than a “late and abrupt” exit. In fact, the worst-case scenario for emerging market economies would be one where the Fed and other central banks in advanced economies exit “too late” once aggregate supply constraints and inflationary pressures become evident, because the adjustment of interest rates and external risk premiums would be much sharper, leading to corrections in exchange rates and asset prices that might have negative impacts for domestic balance sheets, growth and financial stability. Conversely, a gradual path towards monetary normalization would create the necessary conditions for a smooth adjustment of relative prices which may be more helpful to enter a period of more balanced growth, with a greater contribution of external demand.

As economic conditions improve and rates begin their path towards normality, this will naturally shift the whole yield curve upwards. Is this process likely to be an ordered and gradual adjustment of bond prices? Although it could be the case, there are good reasons to think that under some circumstances that would not happen. Indeed, just as stocks are traded mostly by professional fund managers nowadays, fixed-income securities are also traded by

professional investors, for whom performance relative to their peers is a key determinant of compensation. This opens the door for strategic interactions, by which each fund manager tries to sell off securities before their peers in order to preempt the price decline. This “herd” behavior can introduce non-trivial volatility in medium- and long-term rates as the period of monetary easing comes to an end. Morris and Shin (2014) nicely illustrate this point in a recent article.

Another relevant uncertainty for commodity exporters is related to the outlook for their terms of trade. An unexpected weakening of the terms of trade, perhaps related to a further slowdown of China and other emerging market economies, would have negative consequences on the outlook of their external accounts, including a higher current account deficit and lower foreign direct investment inflows. A weaker external position would certainly exacerbate the financial risks associated with a sharper tightening of US monetary policy as discussed before. For the time being, growth prospects for China have stabilized around 7.5% and commodity prices, particularly metals, have recently firmed.

III. Policy Responses for Emerging Market Economies. The case of Chile

Experience shows that central banks in advanced economies will ponder the risks according to their impact on their national economies. It would be “naïve” or wishful thinking to expect that they will internalize the impact of their decisions on emerging market economies, beyond limited “spillback” effects. Therefore, emerging markets should seek to minimize the impact of global financial turmoil into the domestic economy. Policymakers in developing countries need to make contingency plans and be prepared for the tightening of global financing conditions.

Better fundamentals and embedded safety valves in the macro and financial policy framework may reduce the impact of unexpected changes in global financial conditions. As argued in the previous section, not all emerging countries are hit in the same way by changes in capital flows.

Over time, Chile has developed a scheme of macroeconomic policies that permits it to deal with the regular volatilities of an open, commodity-exporting economy. This scheme leans on four main pillars: an autonomous central bank with an inflation targeting scheme, a floating exchange rate system, a fiscal policy based on a structural balance rule and a sound and strong banking system with an adequate regulatory and supervisory framework.

The first pillar relates to an autonomous central bank with the legal mandate to pursue price stability, and which has implemented an inflation targeting scheme. Since the year 2001, we are committed to an inflation target of 3 percent annually over a two-year horizon, with a tolerance range of 1 percentage point up or down. This target has been achieved most of the time. Average inflation between 2001 and 2013 was 3.1 percent annually. Medium- and long-term inflationary expectations are well anchored around this target. Building credibility through time has allowed the Central Bank of Chile to implement a countercyclical monetary policy more effectively, while keeping inflation expectations well anchored.

A floating exchange rate system is the second pillar. This allows the economy to rapidly and effectively accommodate external shocks such as large changes in the terms of trade by adjusting the real exchange rate and gives flexibility to monetary policy to help smooth the domestic business cycle. Foreign exchange interventions are occasional (the last one took place in 2011) in order to maintain a healthy stock of international reserves and correct large real exchange rate misalignments.

A number of studies have compared the macrofinancial performance of floating exchange-rate regimes against currency peg regimes, including “soft” and “hard” pegs. What are the main findings? In the upswing, credit booms in emerging markets often follow surges in capital inflows, and are accompanied by substantial real exchange appreciation (Mendoza and Terrones, 2010). The literature finds that episodes of credit booms, rapid credit growth or sharp changes in the credit-to-GDP ratio, are more frequent in rigid currency regimes than in floating regimes, particularly during capital inflows episodes. The difference can be traced to the pro-cyclical conduct of monetary and fiscal policies in rigid currency regimes during episodes of foreign capital bonanza. If there is a greater focus on exchange rate stability, particularly avoiding appreciation, monetary policy becomes constrained by the level of the exchange rate and capital inflows. Therefore, during episodes of capital inflows, exchange-rate targeters end up importing easy monetary and financial conditions from abroad, which imparts a greater elasticity of domestic credit and internal demand to capital inflows. Indeed, episodes of real exchange-rate overvaluation are more frequent in relatively rigid currency regimes than in floating regimes, and so are episodes of current account deficits (Ghosh, Ostry and Qureshi, 2013).

One reason often cited for the high elasticity of credit to capital inflows in rigid exchange rate regimes is the muting of the currency risk perception of local borrowers and foreign investors. The stability of the exchange rate, or implicit insurance, leads to over-borrowing in foreign currency during episodes of global capital inflows, increasing currency mismatches in local balance-sheets, and financial vulnerabilities. Empirical work shows that the extent of foreign exchange leverage and foreign exchange loans in the banking sector is significantly lower in floats than in less flexible regimes (Ghosh and others, 2014; Jeanneau and Micu, 2002). At the micro level, a number of studies for Latin American corporations find a reduction of currency mismatches after the switch from pegging to floating regimes.

Less currency mismatches allow for greater flexibility of the exchange rate and monetary policy during periods of market turmoil. A number of studies have compared the performance of alternative monetary regimes during the recent global financial crisis and its aftermath. Carvalho Filho (2011) finds that inflation-targeting countries, including advanced and emerging economies, outperformed their non-targeting peers in terms of output growth. This author finds that ITers were able to implement more aggressive countercyclical monetary policies and let the exchange rate absorb more of the adverse external shock without a deterioration of their risk assessment by markets. At the same time, they were more successful in keeping medium-term inflation expectations well anchored and less likely to face a deflation scare. Rose (2013), however, finds surprisingly small differences in the macroeconomic and financial performance of alternative monetary regimes.

However, IT-plus-floating exchange rate is no panacea. There is no perfect monetary or exchange rate system, as Stanley Fisher once said: “Whatever exchange rate system a country has, it will wish at some times that it had another one.” (Fischer, 1999).

Even good monetary policy and a floating exchange rate will not insulate a financially integrated country from the vagaries of the global financial cycle. Committed free floaters and inflation targeters among industrial economies, such as Australia and New Zealand, were unable to insulate their economies from the global financial cycle. But moving into the direction of less exchange rate flexibility certainly increases the risks of financial stability.

It must be recognized too that from time to time, the real exchange rate can deviate substantially from its fundamentals, so occasional foreign exchange intervention and other

adjustments to monetary policy or macroprudential measures may be required to address these issues. The relevant question, however, is not theoretical but operational. How much exchange rate flexibility, or even exchange rate misalignments, should authorities tolerate before starting to tweak monetary policy and running greater risks in other policy dimensions? This is a hard question, and the answers will vary from country to country depending on the specifics of each situation.

The problem with the exchange rate is that compared to other policy targets, like the inflation outlook or financial stability risks, it is far more visible and it can easily cast a shadow over other goals and take the driver's seat of monetary policy. Once the genie is taken out of the bottle, the policy process will focus on the exchange rate, and hope for the best in other areas.

The third pillar is fiscal policy based on a structural balance rule. This rule dictates clear fiscal commitments that ensure that public finances are both sustainable and predictable, which is essential to withstand periods of reduced fiscal income related to terms of trade deteriorations and/or below potential growth. Currently, the public sector is a net creditor. Indeed, the net public debt of the central government is negative, at around minus 6 percent of GDP.

Finally, the fourth pillar is a sound and strong banking system, with an adequate regulatory and supervisory framework. This combines with significant financial and trade integration, making it easier to search for new markets and opportunities for our businesses.

In recent years, there has been a revival of the interest in targeted capital controls, or capital flow measures, as an alternative strategy to regain monetary independence without giving away exchange-rate stability or curtailing access to long-term international capital. Since the mid-2000s, a number of emerging countries have reinstated capital controls to cope with capital inflows and exchange-rate appreciation.

Capital controls have been at the center of a long lasting debate. Some respected economists argue that it is better to let capital flows in and out of a country, while some other respected economists think that it is better to “put some sand in the wheels” and keep some control over flows. Which one is better would depend on many factors like the presence of distortions in a country. One possible policy reaction would be to use capital controls in the case that capital begins to flight out of developing countries in a monetary normalization phase. In the empirical literature, however, the evidence on effectiveness of capital control remains

inconclusive. Chile's experience with "encaje" is illustrative. Empirical studies have found that "encaje" did not have any significant impact on the real exchange rate, domestic interest rates or the level of capital inflows. The main effect was to shift the composition from "short-term" debt inflows to "long-term" debt inflows. Many other studies have found that "episodic" capital controls are a useful tool to reduce specific macroprudential risks but their impact on macroeconomic variables is not significant or, at least, very hard to pin-down. Therefore, capital flow measures can play a useful role to reduce the macroprudential risks which are often associated to foreign lending, but they cannot substitute for adjustment to macroeconomic policies nor sustain a misaligned exchange rate.

Macroprudential measures, including capital controls, have an important role to play in tackling systemic risks, especially during periods of abundant international liquidity, but they cannot take over the role of traditional monetary policy (and exchange rate flexibility). There is a complementary role for macroprudential policies to reduce the financial stability risks related to the global financial cycle. In the case of Chile, we have explored some measures in this area to reduce risks related to real estate and housing lending. There is a risk, however, of over-estimating the ability of these measures to solve the dilemmas between exchange rate policy and monetary policy.

IV. Concluding Remarks

The period of expansionary monetary policies implemented after the crisis will be naturally followed by a period of monetary normalization. This new period will likely be accompanied by increases in emerging markets' volatility and capital outflows from (or reductions of capital inflows to) emerging markets. The way that these developments will affect developing countries will depend, in the end, on the institutional and economic characteristics of each country and the policy actions taken by monetary and fiscal authorities. However, in all cases, it is important to see the whole picture and take into account that monetary normalization in the developed world comes with a better economic prospect in it which ultimately constitutes good news for its developing counterpart.

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