Perspectives for the future rate and its importance for emerging economies' monetary policy XVII Annual Conference of the Central Bank of Chile, Santiago, 5 November 2024

Boris Hofmann, Bank for International Settlements (BIS)

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Q1: Which interest rates should be considered for monetary policy? Are there special considerations for EMEs?

- Global spillovers to EME domestic financial conditions
- Effectiveness of EME domestic monetary transmission

EME bond yields comove closely with AE yields

Nominal 5-year bond yields



Nominal 5year-5year forward bond yields



Global spillovers in domestic LC bond yields



1% appreciation of the US dollar

bp

6

3

C

3

30

Dollar exchange rate and macro-financial conditions in EMEs



• Original sin redux: financial channel of exchange rate even when borrowing in local currency due to dependence on foreign lenders (Carstens and Shin (2019), Hofmann, Shim, Shin (2020))

Monetary policy transmission in EMEs

- What do global financial spillovers imply for the efficacy of monetary policy in EMEs?
- Evidence on MP transmission in EMEs is limited because of identification challenges
 - High frequency identification is impaired by limited market liquidity
- Checo, Grigoli and Sandri (2024) overcome these challenges, constructing new monetary policy shocks for 18 EMEs using Bloomberg analysts' forecasts of policy rate decisions

Strong transmission to bond yields ...

- EME MP has strong effects on local-currency government bond yields
 - Full pass-through of MP shocks to 1 year bond yields
 - MP shocks also impact longer maturities but more modestly



Notes: the horizontal axis denotes the days since a contractionary one-percentage-point monetary policy shock.

Source: Checo, Grigoli, Sandri (2024)

...and to economic activity and inflation

• EME domestic MP tightening dampens economic activity and curbs inflation



Policy considerations

- Effective monetary transmission in EMEs operating through the short end of the yield curve
 - Containment of inflation surge through effective transmission of domestic monetary tightening
 - Spillovers of global tightening helped (together with reversal of adverse supply shocks)
- EMEs showed resilience in the face of rapid monetary tightening of MP in AEs (Hardy et al (2024))
 - Reflecting structural improvements in macro-financial stability frameworks as well as in financial structure (less reliance on FC debt and on foreign investors in LC debt markets)
 - Synchronicity of inflation surge and monetary tightening helped avoiding trade-offs

Q2: How does a change in the trends of interest rates affect the conduct of monetary policy? And what should we expect for future trends?

• The natural rate: whereabouts and outlok

• The interplay between the natural rate and the conduct of monetary policy

Market-based measures of r* have risen

5y-5y forward expected short-term real interest rate



Also other natural rate measures have increased, but model-uncertainty is high

Natural rate estimates for the US



Source: Benigno, Hofmann, Nuno, Sandri (2024)

Evolution of and outlook for possible structural drivers of r*



Primary fiscal deficits



Source: Benigno, Hofmann, Nuno, Sandri (2024)

Monetary policy and the natural rate

- Standard monetary theory posits that the natural rate is exogenous to monetary policy
 - Long-run neutrality of money
- But recent research highlights a surprisingly strong role of monetary policy in the secular decline in long-term interest rates
 - US monetary policy announcements explain large parts of the cumulative decline in US long-term yields since the 1990s (Hillenbrand (2023))
 - This finding also holds globally (Hofmann, Wu, Li (2024))

US 10-year nominal yield change and MP announcement effects (cumulative)



Source: Hofmann, Li, Wu (2024)

EUR and NZ 10-year nominal yield and change MP announcement effects (cumulative)

EUR 10-Year NZD 10-Year 2 2 % p.a. % p.a. -2 -2 -4 -6 -6 2000 2005 2010 2015 2020 2025 2000 2005 2010 2015 2020 2025

- Observed - FOMC - Dom. CB

Source: Hofmann, Li, Wu (2024)

How can monetary policy have such persistent effects on long-term rates?

- Central bank conveys information about true r* (Hillenbrand (2023)
- Alternative explanations
 - Prolonged monetary easing fuels debt accumulation pushing down r*
 - High debt weighs on demand (Mian et al (2021))
 - Financial crises have long-lasting effects on growth (Borio and Disyatat (2014))
 - Information feedback loop driving rates down and affecting spending decisions
 - Hall of mirrors effect (Rungcharoenkitkul and Winkler (2021))
- Global spillovers transmit effects from core economies globally

Policy considerations

- r* is a blurry guidepost for monetary policy
 - Measures surrounded by high uncertainty
 - Possibly influenced by monetary policy itself
- r* might be higher post-pandemic
 - Persistent fiscal deficits and greater fiscal spending needs (ageing, green transition, defense)
 - Tighter monetary policy