Monetary Policy in US/Advanced countries: Impact on Emerging Markets

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Issues Considered

- Relevance of advanced economies monetary policy for emerging countries
- Current stance of Monetary Policy in Advanced Economies, and how is it likely to evolve?
- How is the "Lift-off" Likely to impact Emerging Markets?
- Role for

(i) Policy coordination

(ii) Policy response of Emerging markets

- Other global developments of relevance to Emerging Economies

Presentation Draws on some of my recent Research

- Eichengreen and Gupta (impact of tapering talk on Emerging markets)
- Kaushik, Eichengreen, and Gupta (India's policy response to the Tapering Talk)
- Ongoing work on sudden stops of capital flows (drivers, impact, and policy response)
- And of course the wider literature on these issues…

1. Why is the Monetary Policy in Advanced Economies of significance to EMs

"Surges and Stops", increases macroeconomic volatility, and policy conundrums

Surges: Excess liquidity in AEs/global financial markets finds its way into EMs in surge of yields

- Fuels asset price bubbles; appreciation of real exchange rate
- Asset price bubbles fuel consumption; which along with the loss of competiveness result in higher current account deficit
- Households and corporates become more leveraged
- Due to the appreciation of currency, less incentive to hedge
- Lending standards are lowered; and the quality of lending is compromised

Sudden Stops: The surges are inevitably reversed, succeeded by sudden and sharp capital outflows

- Asset prices correct, can cause financial disruption
- Financial disintermediation
- Sharp correction in current account deficit; Investment particularly suffers
- Exchange rate depreciation and negative balance sheet effects
- Financial volatility further dents investment sentiment

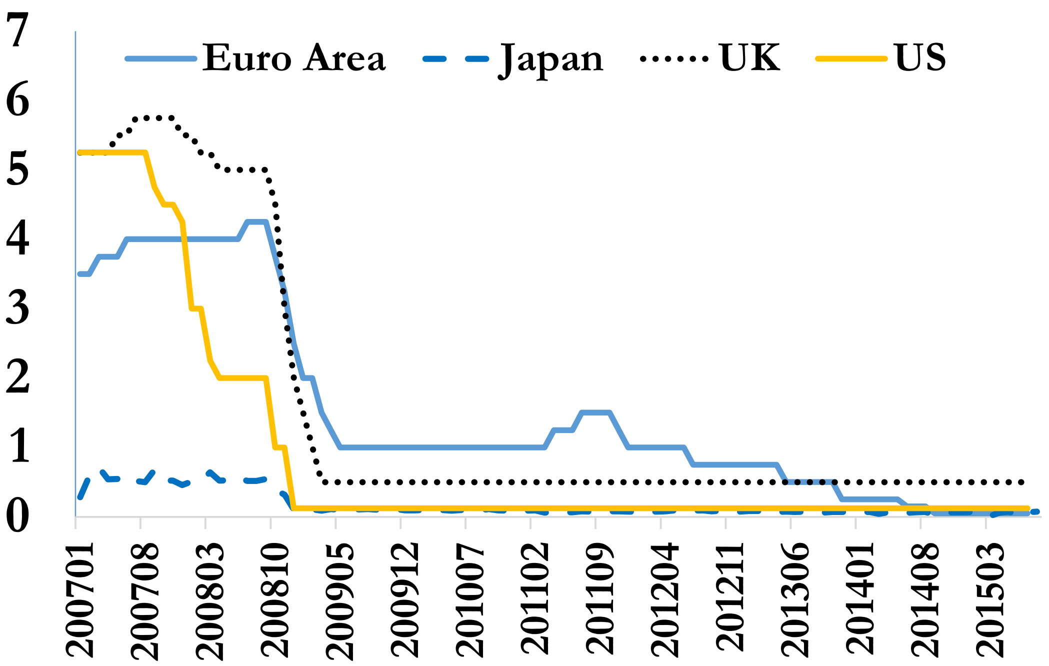
No wonder then that the EMs complain during each phase of the cycle.

2. Stance of Monetary Policy in advanced economies in recent years and how it may Evolve

Monetary Policy Conditions in Advanced Countries: Unprecedented loose--interest rates at zero bound, and unconventional monetary policy

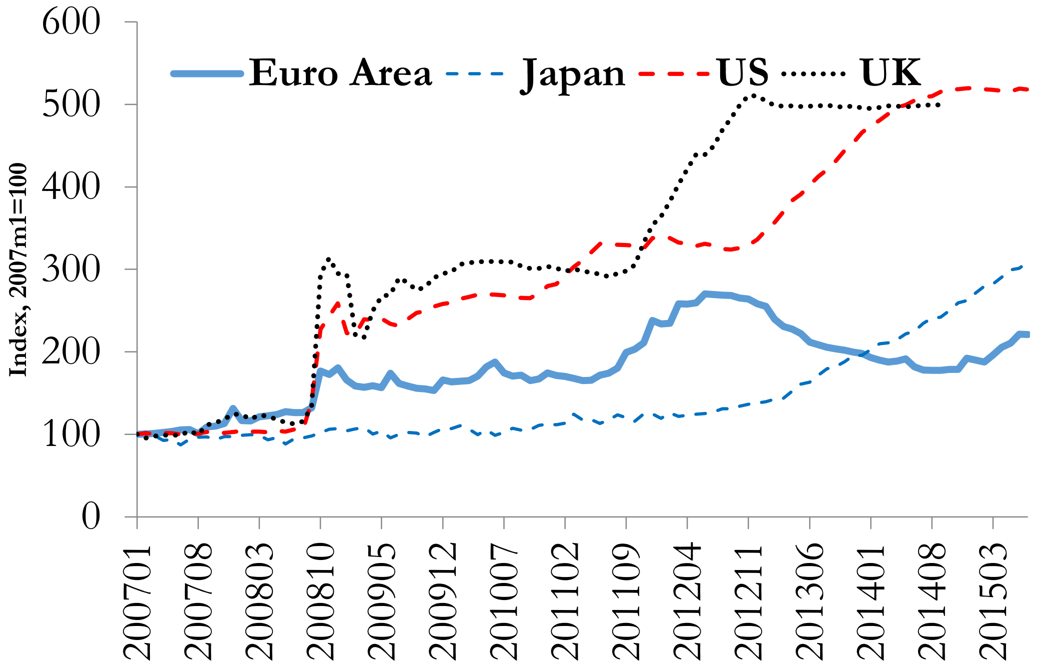
Policy rates have been brought close to the zero bound…

Policy Interest Rates



….while the central bank balance sheets have expanded due to UMP

Central Bank Assets



Monetary Policy Outlook in Advanced Economies

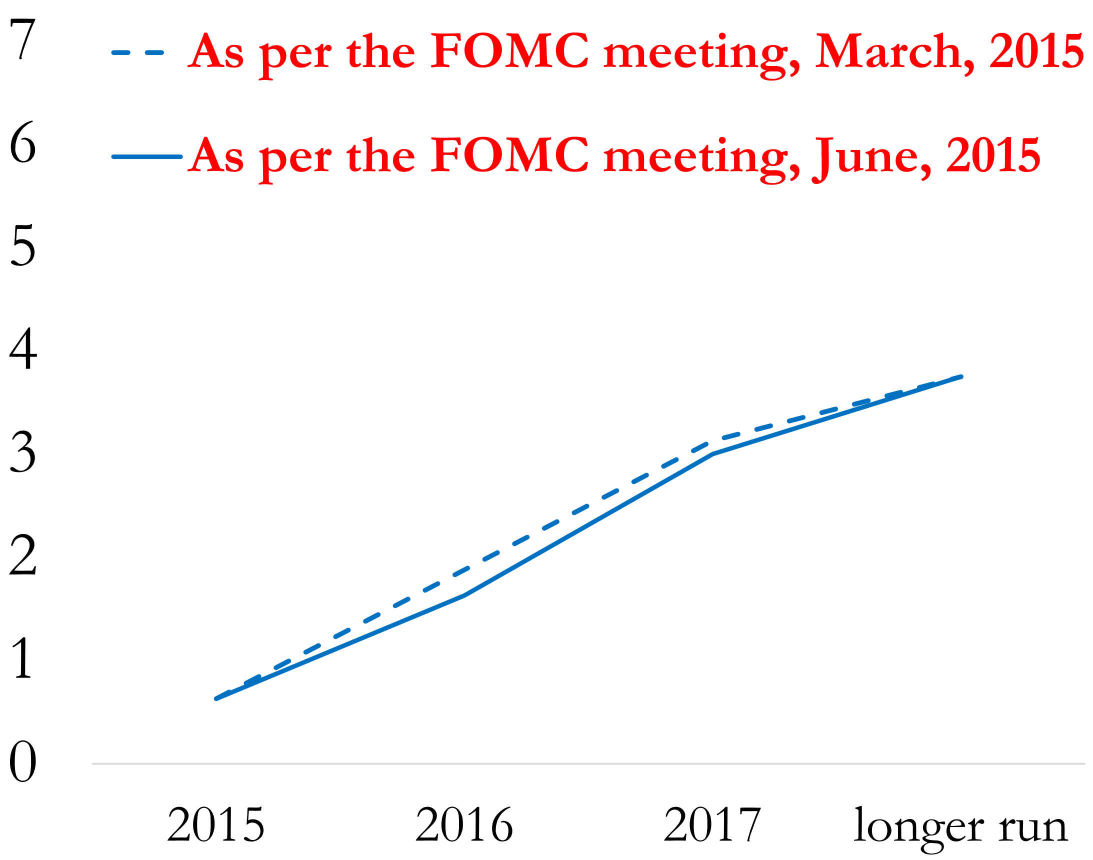
- UK: Likely to remain as is (until mid 2016-2017?)
- Euro Area: economic rebound modest, policy may remain accommodative
- Japan: similarly likely to remain accomodative

Overall economic recovery is still tenuous; inflation remains low; monetary conditions are likely to remain accommodative

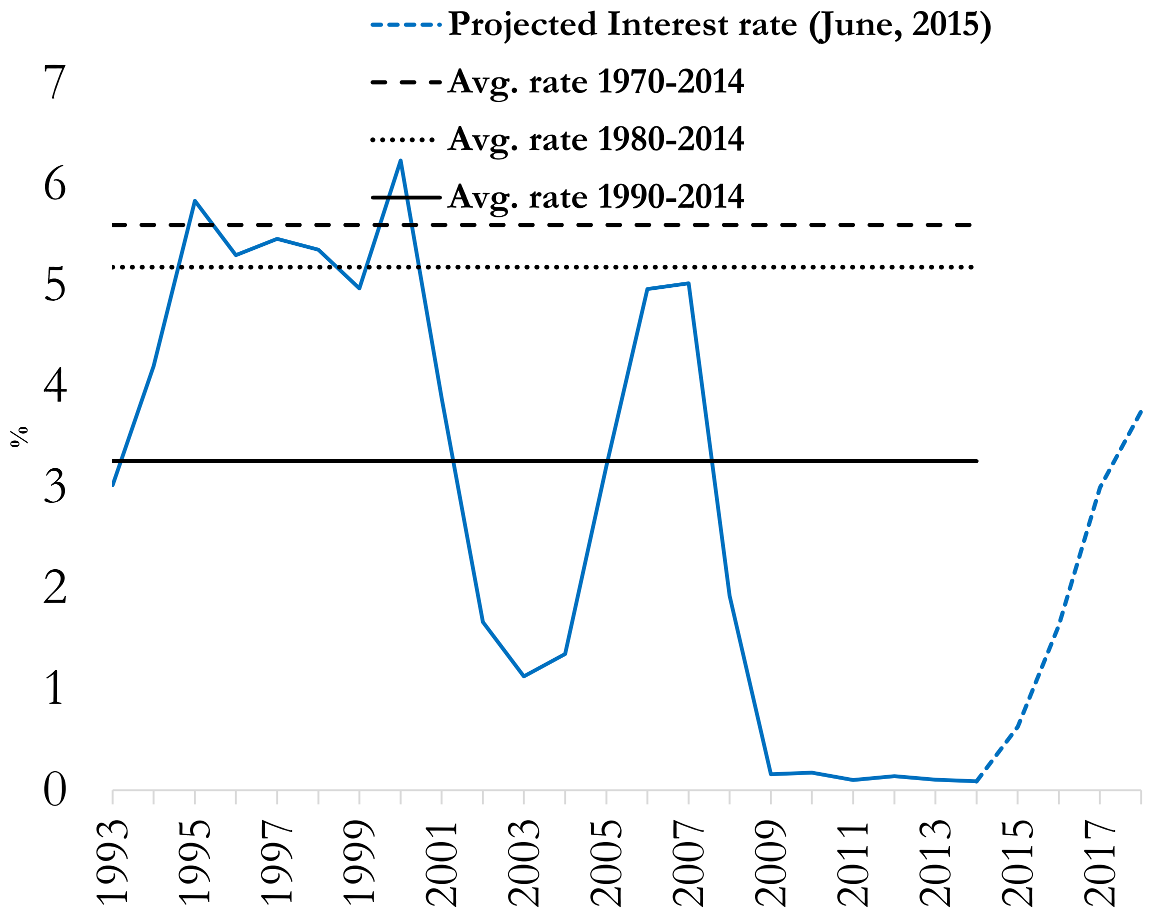
US is the most relevant advanced economy for emerging markets outside of Europe; its balance sheet is the largest and has expanded the most

Might US raise its Rates soon? Is a "Lift-Off" in the Offing?

FOMC members assessment of policy rate (median)



Actual and Projected US Policy rate



Tapering—an early sign of Policy Reversal in the U.S.

On what might happen to Emerging markets when policy is reversed, perhaps the tapering event provides some lessons

Tapering Talk created sudden stop like syndromes (albeit of short duration)

But Tapering itself was less eventful when it actually happened

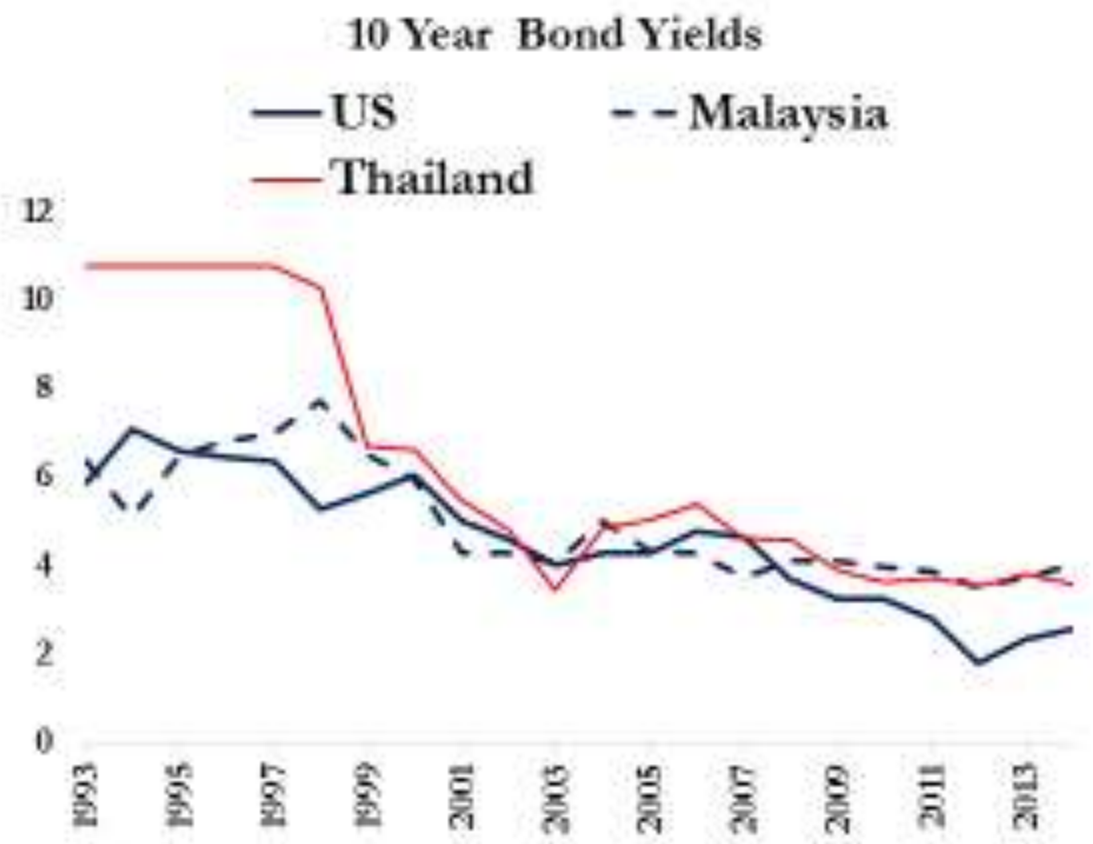
Among the five most badly hit countries by the Tapering Talk, "Fragile 5", are the largest Emerging Markets and the G 20 Countries

	Exchange Rate Depreciation	% change in Stock Prices	% Change in Reserves
Brazil	17.01	-5.28	-3.07
Indonesia	8.33	-14.21	-13.30
India	15.70	-3.32	-5.89
Turkey	9.21	-15.38	-4.56
South Africa	10.60	6.81	-5.05

3 How is the "Lift-off" Likely to impact Emerging Markets? (i) Capital reversal, and volatility

- Would depend on the extent of global rebalancing. Initially might not be large. anticipated; and initial increase in interest rate small
- As well as on country specific situations:
- Domestic vulnerabilities have increased (Turkey, Indonesia)
- Some countries simultaneously affected by low commodity prices, and the slowdown in China (Brazil, Russia, Indonesia, Malaysia)
- For a small set perhaps the fundamentals are somewhat stronger and are better equipped with reserves (India, Mexico? any other?).
- Even so some countries remain vulnerable on account of their size, extent of volatile capital

Impact of "Lift-off" --(ii) More appreciable might be the impact on the medium-long term cost of financing



Synchronizing Monetary Policy Globally—theoretical arguments

- Theoretically, if each country formulates its monetary policy on a rule based approach, then under flexible exchange rates and unhindered capital flows, a Nash equilibrium would be attained--limited gains from deviating e.g. through coordination.
- Question: whether the experience in the past five years were as per the rule based approach or deviated from it. While there are no definite views on that, some think that these were unprecedented times and it is difficult to judge whether there is a case for coordination.
- With no clear judgment from theoretical perspectives, practical issues become relevant

Synchronizing Monetary Policy—the practical aspects

- Coordination of policy among who—AE with each other; within G 20; with the wider set of countries; how about also the impact of the larger EMs on their peripheral countries?
- Given different business cycles, is synchronization feasible?
- At what frequency—most countries have about 6-8 weeks of policy cycle?
- Under what circumstances— only unusual circumstances or also under business as usual? And in which phase of the cycle—while expanding or also while normalizing?
- Any historical precedence?

- **What Else could the Advanced Economies do on their part to limit the Externality on Emerging markets?**
- Forward Guidance also for EMs?
- Swap Lines
- Some Internalization of both is already happening
- And is unlikely to go much further than this…
- **Role of the multilateral organizations or fora to limit the Externality on Emerging markets?**
- Coordination of Swap Lines
- Precautionary lines (by the IMF or another body)
- Facilitating Reserve Pooling

4. How can the emerging countries prepare to brace the impact of surges and stops--Policy Imperatives during each phase

- Calibrating the pace of inflows, the type of flows, duration and currency composition. Possibly using them counter cyclically.
- Macro prudentials—possibly underutilized so far; can be an effective tool to manage and modulate the boom and bust cycles.
- Reserve buffers—to lower the probability of sudden stop, to stem RER appreciation, to modulate excessive volatility, to modulate the impact of sudden stops
- Preparing for exchange rate volatility—hedging (including natural hedging), less balance sheet mismatches.
- Prepare for the higher cost of financing through wide structural reforms, including removing inefficiencies in their financial sectors.

5. Other global developments of importance to Emerging markets

- Global Growth and Trade Outlook
- Commodity Prices—even though the impact is heterogeneous
- China—impact through commodity prices, global growth, financial contagion through rebalancing

Sum up

- Excessive loose monetary policy in Advanced Economies and their inevitable winding has implications for EM…
- The onus of managing their surges and stops cycles lies defacto with emerging markets in my view.
- The tools available include managing the type and magnitude of capital flows, reserve buffers, macroprudentials, and preparing for greater exchange rate volatility.
- Even if potentially a first best (and not even clear whether it is), coordination; pooling of reserves; swap lines; or precautionary lines have not succeeded in the past, and unlikely to in future

Thank You