Unconventional Monetary Policies, Spillovers and Policy Options for EMEs

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Financial systems in most emerging markets economies (EMEs) are bank-centered.

Given that EMEs had already suffered a sequence of crises in the 70’s, 80’s and 90’s, their financial systems were better regulated and supervised at the time of the Global Financial Crisis (GFC). Therefore, they were able to weather it relatively well.

During the last years, the resiliency of bank-centered models improved even further as a result of the application of international reforms agreed as a response to the GFC.
However, unconventional monetary policies (UMP) in advanced economies (AEs) generated a much higher participation in market-based financing in EMEs. At the same time, some of the regulatory reforms have induced a retreat from EMEs of some global banking institutions that used to play a key role as broker-dealers, market makers and providers of risk-taking capacity. This is part of the transition to a more resilient global financial system. Meanwhile, these has led to thinner markets and more volatility in EMEs.
The high degree of global interconnectedness has raised policy challenges for EMEs, particularly given the implementation of UMPs.

These policies – although by and large necessary – created search for yield incentives for AEs investors and generated massive capital inflows to some emerging markets for several years.

These capital flows, even though helpful at the beginning, have generated vulnerabilities that EMEs now have to deal with:

- Asset prices misalignments (extreme spread compressions);
- Macroeconomic distortions (RER overvaluations and Dutch disease effects);
- Vulnerabilities associated with the potential of massive capital flow reversals in the context of insufficient global safety nets.
Emerging Economies: Capital Flows (Equity and Debt)

Accumulated Flows
Billions of US Dollars

Weekly Flows
Billions of US Dollars

1/ The sample covers funds used for the buying-selling of stocks and bonds from emerging countries, recorded in advanced countries. Flows exclude portfolio performance and changes in the exchange rate.
Source: Emerging Portfolio Fund Research.

Foreign Holdings of Local Denominated Government Bonds; EMEs
Percentage of total amount outstanding

Source: Haver Analytics and Banco de México.
Nature of Adjustments to the Unwinding of UMP

• The potential impact of the unwinding of UMP in AEs is large, given that some features of current investors in EMEs assets may amplify price consequences of changes in the direction of capital flows.
  – Global asset managers (AM) have intermediated a large fraction of capital flows to EMEs.
  – Investments oftentimes were made predicated on continued markets’ liquidity.
    • Potential mismatch between fund investment and redemption terms.
    • Leverage within investment funds?
Nature of Adjustments to the Unwinding of UMP

– AM compensation tend to be based on relative performance; herd behavior can show up. Result: crowded trades and exacerbated volatility.

– The search for yield attracted resources from retail investors through vehicles like ETFs, which might be prone to generate the illusion of liquidity, i.e., bundling of illiquid assets does not result in a liquid asset.

– Most investment entities are part of the shadow banking system, and thus not fully regulated.

– All these factors might lead to procyclicality.
The scenario has been complicated further by the fact that new financial regulation has reduced incentives for broker-dealers (usually GSIBs) to hold inventories, reducing their market making activities and thus eliminating a buffer in financial markets.

Sources: Banco de México and Comisión Nacional Bancaria y de Valores (CNBV).

Sources: Central Bank of Mexico and Reuters.

1/ The average trade size is calculated by dividing the daily traded volume by the total number of trades (includes data only from Reuters’ electronic platform).
Policy Options in the Current Environment

- Given the way that international capital flows have been intermediated and the presence of relatively thinner financial markets in EMEs, the unwinding of monetary policies in advanced economies could trigger portfolio adjustments that might be quite destabilizing. The underlying situation for EMEs is even more delicate, given the sharp decrease in commodity prices, slow global economy and trade growth, and particular vulnerabilities in important EMEs – China, Brazil.

- Policy Options:

  At a National Level (EMEs)

  - EMEs should monitor closely their monetary policy stance relative to advanced economies, to minimize the potential of capital outflows.

  - An important side-effect of the UMPs was a compression of spreads. The unwinding of these policies will therefore decompress spreads. Through strengthened macroeconomic fundamentals and structural reforms, EMEs should try to compensate the decompression of term premia by reducing country risk premia.
Policy Options in the Current Environment

- Notwithstanding, portfolio adjustments could be overwhelming. A drastic and sizeable stock adjustment is very difficult to handle by traditional macropolicies. In extreme cases, it might come the time for EMEs to become “unconventional”.
  - Interventions in forex markets, if foreign exchange dynamics could lead to a “bad equilibria”.
  - Market maker of last resort: financial authorities should be prepared to intervene, in case necessary, in domestic bonds and securities markets to facilitate investors’ portfolio adjustments.
EMEs accumulated during the last years significant FX reserves and probably this was the most important macro-prudential measure they were able to take collectively. Some countries have complemented their “war chest” by the IMF’s FCL.
Policy Options in the Current Environment

At the International Level

– Tighter monitoring of AM by home authorities:
  • How much risk is shifted to final investors? How transparently this is done?
  • AM liquidity management. Stress tests.
  • Evaluate the possibility of applying prudential policies, like liquidity requirements.

– Liquidity Backstops.
  • Usually oriented for banks.
  • Very limited at the international level.
Conclusions

• International financial reforms improved the resilience on bank-centered models. However, global asset managers currently intermediate a large proportion of capital flows, confronting EMEs with new financial stability risks.

• These risks have become evident in the initiation of unwinding of UMP, raising the likelihood of sudden capital flow reversals and their potential destabilizing effects.

• The build-up of financial imbalances makes the strengthening of EMEs macroeconomic fundamentals of the essence. In an extreme scenario, this might not be sufficient to contain financial risks. EMEs authorities must be prepared to use international reserves and other types of backstops and may need to act as market makers of last resort in their local securities market. It might be their turn to be “unconventional”.

• Furthermore, international organizations should promote cross-border cooperation; in particular, it is of the essence that institutions like the IMF catalyze efforts to strengthen the global safety nets globally, as tail-risks have increased.