Monetary expansion: Is the sky the limit?
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Since 2007, central banks in advanced countries have undertaken unprecedented monetary loosening

- Policy interest rates cut to levels near zero, combined with forward guidance
- Special lending facilities offered to meet increased liquidity demand amid the financial crisis
- Successive QE programs aimed at supporting growth and heading off deflation¹

¹/ International reserve accumulation in the case of Switzerland
As a result, monetary authorities have inflated their balance sheets significantly.

Advanced economies: Central banks’ balance sheets

% of GDP

Source: Haver Analytics
Central banks have played an unusually dominant role in the financial markets

- Large-scale QE purchases have focused on domestic securities
- Assets have been mainly long-term government bonds, but also private-sector securities (e.g., mortgage-backed securities in the U.S.)
- Central banks have entered the credit business, undertaking quasi-fiscal operations and running the risk of drying the markets out by absorbing too many securities
Monetary authorities are now buyers of first resort, holding record high proportions of government bonds

Advanced economies: Central banks’ holdings of government bonds
% of outstanding market size, March 2016

1/ Except for Japan, which shows data as of the end of 2015
Furthermore, some central banks have set policy rates at negative levels

Advanced Economies: Interest rate target

1/ For the Euro zone, the deposit facility rate; for Japan, the one-day rate without collateral; for Switzerland, the 3-month interbank rate; for Denmark, the interest rate on certificates of deposit; and for Sweden, the Riksbank repo rate
Source: Haver Analytics
Monetary accommodation has led to historically low short-term interest rates

Advanced economies: Two-year government bond interest rate distributions

Proportion of total

0.0 0.3 0.6 0.9 1.2
-2 -1 0 1 2 3 4 5 6 7 8

May 10, 2016
December 28, 2007

1/ Includes Australia, Austria, Belgium, Canada, France, Germany, Japan, the Netherlands, Singapore, Sweden, Switzerland, the United Kingdom and the United States
Source: Own calculations based on Bloomberg
Negative policy rates have resulted in a growing amount of government debt carrying a negative yield

Advanced economies: Government debt with negative interest rates
Trillions of dollars

1/ Includes Sweden, Denmark, Austria, Belgium, Czech Republic, Finland, Ireland, Italy, Netherlands and Spain
Source: Own calculations based on the market value of the JPMorgan GBI Broad Index
Central banks managed the crisis well as lenders of last resort, but later results are subject to debate

- No doubt central banks were effective at providing more liquidity during the crisis, playing their role well as lenders of last resort.
- However, despite some evidence that expansionary policies have supported economic activity, returns there seem to be decreasing.
- At the same time, the effectiveness of lax policies remains unclear where inflation, core inflation, and inflation expectations are concerned.
- Fears of deflation appear somewhat magnified\(^1\)

The height of risks taken could be great, including a buildup of financial imbalances

... as well as possible overvaluation of assets

Selected stock markets:
price-earnings ratios
Averages to date

Selected advanced countries:
Difference between housing and consumer
price indices, December 2005 = 100
Basis points

Source: Own calculations based on Bloomberg

Source: Own calculations based on Haver Analytics
Negative interest rates may, in turn, hurt the health of financial institutions, with unclear benefits for growth.

Euro zone: Impact of the negative deposit facility rate on banks

Net percentage of respondents; over the past six months

1/ The net percentages are defined as the difference between the sum of the percentages for “increased considerably” and “increased somewhat” and the sum of the percentages for “decreased somewhat” and “decreased considerably”. The results shown are calculated as a percentage of the number of banks which did not reply “not applicable”.

Source: ECB (2016). The euro area bank lending survey, April.
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Monetary expansion in advanced countries has resulted in more favorable financial conditions for EMEs

- Starting in 2010, EMEs enjoyed increased portfolio capital inflows, a resumption of rising commodity prices, and appreciating financial assets
- Beginning in 2014, trends reversed due to expectations of approaching U.S. monetary normalization and fears surrounding the health of the Chinese economy

Nonresident holdings of local-currency government securities reached record highs before the taper tantrum.

Emerging economies: NR holdings of local-currency government securities

% of total outstanding

1/ Unweighted average of ratios for Brazil, Colombia, Hungary, Indonesia, Israel, Malaysia, Peru, Poland, Russia, South Africa, South Korea, Thailand and Turkey. 2/ Total outstanding includes Bonos M, Cetes, Bondes D, Udibonos and BPA

Source: Own calculations based on finance ministries, central banks and other national authorities
Bouts of appreciation for EME currencies vs. the U.S. dollar have proved short lived

Emerging economies: Local currency value in U.S. dollar terms

January 2007 = 100

1/ GDP weighted average for the Chinese yuan, Russian ruble, Turkish lira, Korean won, South African rand, Brazilian real, Indian rupee, Polish zloty, Hungarian florin, Malaysian ringgit, Mexican peso, Thai baht, Chilean peso, Indonesian rupee, Philippine peso, Colombian peso, and Peruvian sol

*/ To May 11, 2016

Source: Own calculations based on Bloomberg and IMF
Many EMEs responded to advanced-country monetary expansion by loosening their own monetary stances

Emerging economies: The Taylor rule and policy rates

1/ Weighted average based on 2005 PPP weights. Comprises Argentina, Brazil, Chile, China, Chinese Taipei, Colombia, the Czech Republic, Hong Kong SAR, Hungary, India, Indonesia, Israel, Korea, Malaysia, Mexico, Peru, the Philippines, Poland, Singapore, South Africa and Thailand. Source: BIS (2015). “85th Annual Report, 1 April 2014–31 March 2015,” June
Additionally, FX reserve accumulation accelerated, attenuated only recently

Advanced and emerging economies: International reserves

Trillions of dollars

Source: IMF, IFS database
Spillover effects also encompassed higher corporate indebtedness in emerging economies.

Emerging economies: Corporate debt

% of GDP

1/ Includes local- and foreign-currency bonds and domestic and foreign bank loans for Argentina, Bahrain, Brazil, Bulgaria, Chile, China, Colombia, Croatia, Egypt, Hungary, India, Indonesia, Jordan, Kazakhstan, South Korea, Kuwait, Lebanon, Lithuania, Malaysia, Mauritius, Mexico, Morocco, Nigeria, Oman, Pakistan, Peru, the Philippines, Poland, Qatar, Romania, Russia, Saudi Arabia, Serbia, South Africa, Sri Lanka, Thailand, Turkey, Ukraine, the United Arab Emirates, and Venezuela.

In general, these countries face a tough situation characterized by decreasing growth and rising inflation.

Emerging economies: CPI and GDP¹

Annual % change

1/ Unweighted averages. For inflation countries are Brazil, Bulgaria, Chile, China, Colombia, the Czech Republic, Ecuador, Egypt, Hungary, India, Indonesia, Mexico, South Korea, Lebanon, Malaysia, Morocco, Nigeria, Peru, the Philippines, Poland, Romania, Russia, Saudi Arabia, South Africa, Thailand, Turkey, Ukraine and the United Arab Emirates; For GDP countries are the same, plus Argentina minus Lebanon and United Arab Emirates

Source: Own calculations based on IMF and Haver Analytics
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Monetary policy in advanced countries is at a crossroads

- Unsatisfactory results from monetary accommodation will likely lead to more gradual normalization and even further easing in some countries
- Divergence of monetary policy across countries will likely prevail
- One corollary is that the dominant role of monetary policy in advanced countries could result in further postponement of needed adjustments and structural reforms
- Low effectiveness of monetary policy could lead to disillusionment and loss of credibility
Future monetary stances in advanced countries could produce significant volatility

- Central bank balance sheets will not shrink in the near future and will even expand in some countries
- Negative policy interest rates may become more pervasive, and could even fall further
- Tools, such as long-term interest rate targeting and fiscal deficit monetary financing, may be contemplated¹
- All these measures may make eventual monetary unwinding more complex and riskier in terms of price and financial stability

¹/ See Bernanke, B.S. (2016). “What tools does the Fed have left?” The Brookings Institution, Ben Bernanke’s Blog, March and April
EMEs must prepare for possibly less benign times

- Any imbalances built up from monetary accommodation in advanced countries, or from domestic policies, must be managed carefully.

- Economic fundamentals should be strengthened, including:
  - Appropriate monetary policy
  - Sound fiscal stances
  - Well-implemented structural reforms
Reserve and fund managers will continue to face a challenging environment

- While risks and uncertainty are greater, very low returns on assets can be expected, even at longer maturities
- Less market liquidity and more volatile environments are also part of the outlook
- The duty of optimizing safety, liquidity and returns, obviously, will be ever harder
Final remarks

- Central banks in advanced economies are navigating uncharted waters. Thus, the results of their monetary stances and their eventual unwinding are unknown.
- Emerging markets must be prepared to face ever greater risks and volatility from potential spillover effects.
- Reserve and fund managers will have to use all their knowledge and talent to achieve the best risk and reward in such a constantly evolving context.
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