INTRODUCTORY REMARKS

• The objective of this panel is threefold: i) to assess if countries other than the main advanced economies (US, EU, UK, Japan, Canada) have engaged in UMP\(^1\) and in given case, what have been the strategies and tools they have used; ii) to identify the main implications of UMP on other economies; and iii) what have been the policy reactions of countries that have been affected (positively and/or negatively) by UMP.

• I will give the point of view of EMEs, limiting the analysis to the recent crisis period (2007 up to today). This clarification is important, given that in the 70s, 80s and early 90s many EMEs engaged in VERY unconventional policies, that led to disastrous outcomes.

• Given the above, my remarks will be organized as follows: i) Is there a case for UMP to have been applied by EMEs in the recent crisis period?; ii) What have been the implications of UMP on EMEs?; and iii) What have been EMEs policy response (including both conventional and unconventional measures)?

\(^1\) All along this presentation, UMP refers to unconventional monetary policies adopted by the main advances economies during the crisis period (2007 – 2013)
I. THE APPLICABILITY OF UMP IN EMEs

• Before the eruption of the crisis, monetary policy in most advanced economies (and in many EMEs as well) was quite conventional:
  - Focus on anchoring inflation expectations to control the future path of inflation;
  - Short term interest rate adjustment as main policy instrument;
  - Policy rate was used also to smooth the business cycle, counting on market arbitrage to affect the yield curve, and by these means affect consumption and investment decisions;
  - Financial stability concerns, mostly absent, did not play a central role in monetary policy determination.

• As the crisis unfolded, it became clear that it was far more serious than originally thought. It soon became obvious that the “conventional approach” was insufficient to tackle the new and daunting challenges (major threat of a financial sector meltdown, sharp falls in economic activity, patent risks of deflation, immediate global contagion):
I. THE APPLICABILITY OF UMP IN EMEs

- The possibility of policy interest rate reductions ran its course, hitting quickly the zero lower bound (ZLB);
- Quantitative easing was required to affect the yield curve, to reduce long term real interest rates;
- Forward guidance was introduced to offer markets certainty on the permanence of accommodative monetary policy stance; and
- Unprecedented threats to financial stability motivated the provision of extraordinary liquidity, often against the outright purchase of securities, including some issued by the private sector. Central banks became “market makers of last resort”.

• By and large, EMEs have not been forced by events to modify in a significant way its monetary policy stance and policy instruments:
  - Conventional approach remained operational and effective;
  - No constraint by the ZLB;
  - EMEs, for a change, were not in the crisis’ epicenter;
  - Impact on growth, trade and financial stability has been considerable, but side effects manageable mostly with traditional instruments.
I. THE APPLICABILITY OF UMP IN EMEs

**Figure 1. Economic Growth and Inflation**

Annual % change, average 2009-2012

CONCLUSION: UMP were not needed in the case of EMEs

- The relatively more favorable performance of EMEs also prevented in most cases countries to be enticed to adopt **unconventional fiscal policies**. At the same time, EMEs have fully embraced the call to enhance financial stability by early adoption of internationally agreed financial sector reforms (Basel III).
I. THE APPLICABILITY OF UMP IN EMEs

- Bottom line for EMEs:
  - For the time being, they still enjoy reduced degrees of freedom to use unconventional policies, both fiscal and monetary.
  - Main line of defense: to persevere in strengthening macrofundamentals, together with the promotion of economic growth through structural reforms, precisely so as to build credibility to acquire degrees of freedom for the future.
  - Lastly it is worth pointing out that UMP, even for advanced economies, do not represent a final and sustainable solution to the crisis. UMP only provides a temporary window of opportunity to adopt credible fiscal consolidation programs, the recapitalization of financial institutions, and the implementation of structural reforms, among others.
II. IMPACT OF UMP ON EMEs

- Very difficult to disentangle the impact of UMP on EMEs from the impact of the dynamics of the crisis. Interconnections have made “decoupling” impossible.

**Figure 2A. World Trade and Industrial Production**
Annual % change; s.a.

**Figure 2B. Emerging Economies’ Exports and World Industrial Production**
Annual % change of 3-month moving average

Source: CPB Netherlands, Haver Analytics and INEGI.
II. IMPACT OF UMP ON EMEs

• Conventional Wisdom: UMP have been very effective in helping the stabilization of financial markets and somewhat effective in stimulating economic growth, but with diminishing returns.

• PERSONAL OPINION: The main contribution of UMP is that they have been effective "circuit-breakers":
  - They have broken, at least temporarily, the very pernicious feedback loop in several countries between weak economic activity, unsustainable fiscal positions and fragile financial institutions; otherwise, catastrophic tail risks could have materialized.
  - They limited the extent of self-reinforcing amplification of asset price cycles and borrowing constraints.

• This achievements contained the spread of the negative consequences of the crisis, enhancing financial stability and world’s economic growth. IN THIS SENSE, UMP HAVE BEEN FAVORABLE FOR EMEs.
II. IMPACT OF UMP ON EMEs

• BUT THERE HAVE BEEN ALSO UNDESIRABLE SIDE EFFECTS THAT HAVE MADE THE IMPLEMENTATION AND DESIGN OF EMEs MONETARY POLICY VERY CHALLENGING.
  - The main issue has been the impact of UMP on capital flows.

• UMP has:
  - Stimulated capital inflows to EMEs, in some cases generating mispricing in local asset markets (including forex), increasing financial stability risks;
  - Reversals have happened, and they could become larger in the future as UMP exit strategies progress.
  - Heightened volatility of flows have been very pernicious, and to some extent UMP has induced at least some of the increased volatility.
II. IMPACT OF UMP ON EMEs

Figure 3. Emerging Economies: Weekly Capital Flows
Billions of dollars

Debt

Equity

Source: Emerging Portfolio Fund Research.
II. IMPACT OF UMP ON EMEs

- It would be unfair to blame UMP for all this volatility. The crisis itself is the main culprit.
- A sustainable flow of capital from advanced to emerging market economies would be expected in the face of differentials in the following concepts:
  - Economic growth rates and perspectives;
  - Fiscal sustainability;
  - Financial sector resilience; and
  - Monetary policy stance.

Figure 4. Country Allocation of Bond Fund Flows, 2009-2013
Accumulated flows in billions of USD

Latin America

Source: Emerging Market Portfolio Fund Research
II. IMPACT OF UMP ON EMEs

BUT UMP HAVE NOT BEEN WITHOUT CONSEQUENCES

• On the other hand, as the crisis evolved, we have faced sequential episodes of risk on/risk off, in some instances elevating substantially the probability of catastrophic events and of widespread contagion, which in turn triggered capital outflows. In most of these episodes, UMP helped in stabilizing the situation.

• On the other hand, under a crisis environment, authorities face an extremely complex scenario. Typical macroeconomic relationships and models break down, making the situation akin to navigating in a storm without sufficient instruments. At the same time, it is unavoidable for authorities to articulate a prompt and hopefully effective policy response, a scenario that often leads to mistakes and/or insufficient responses. Based on this, it is difficult to rule out the possibility of UMP in some instances to have contributed to augment the volatility in capital flows.
II. IMPACT OF UMP ON EMEs

- Capital flow volatility tends to elevate exchange rate volatility. In small open economies the exchange rate is a very important component of the monetary policy transmission mechanism; therefore, having more volatility in such relative price makes the design and implementation of monetary policy challenging. At the same time, exchange rate volatility is part of the adjustment process out of a crisis scenario, so to allow exchange rate adjustments most of the time is desirable.

Figure 5. Daily Implicit Volatility on One Month at the Money Options

Source: Bloomberg.
II. IMPACT ON OF UMP ON EMEs

• The key problem for EMEs is that excessive capital inflows could lead to non-equilibrium real exchange rate appreciations, hampering competitiveness, reducing exports and economic growth, and creating financial stability risks.

• Despite foreign exchange rates volatility, the very low interest environment in advance economies due to UMP, together with frictions in financial markets created by the crisis environment have generated situations in which perceived uncovered interest rate arbitrage opportunities persist for relatively long periods of time. This has opened up opportunities to market participants to implement massive carry trade strategies, inducing large, short term speculative capital inflows, which deepened the mispricing in local markets and increasing the risk of substantial reversals, as we have seen recently.
II. IMPACT OF UMP ON EMEs

Figure 6. Returns of a 3-Month Carry Trade Investment Strategy: 2010-2013\(^1/\) %

1 / The returns of the carry trade strategy are the percentage change in the exchange rate between periods \(t\) and \(t-h\) (\(h = 3\) months) plus the 3 month return of the JP Morgan Government Bond Index-Emerging Markets (GBI-EM) for each country minus the 3 month T-Bill quarterly rate. These returns are annualized.

Source: Estimated by Banco de México with data from JP Morgan.
II. IMPACT OF UMP ON EMEs

- A complicating factor has been the simultaneity through most of the period of volatile capital flows and an underlying upward trend in world commodity prices.

Figure 7. Commodity Prices
Index 03-Jan-2006 = 100

Source: Standard & Poor’s.
II. IMPACT OF UMP ON EMEs

- Given that food and energy comprises a relatively larger proportion of EMEs consumption basket, higher and more volatile commodity prices have affected in some countries measured inflation and expectations thereof. Often this type of situation has made it difficult to allow interest rates reductions in response to capital inflows, to facilitate the adjustment to such flows (i.e. by maintaining and overly tight monetary policy stance). Relatively higher local interest rates might help anchor inflation expectations in the face of commodity price shocks, but it might have the (unintended) consequences of a higher than desired real exchange rate appreciation, or a very expensive increase in international reserves (through sterilized forex intervention), and what probably is worse, perpetuating the incentives for capital inflows, elevating the risk of distortive capital reversals in the future. This is a different manifestation of the well known “impossible trinity 3/”. This represents a huge problem for some EMEs.

3/ This refers to the impossibility to control the exchange rate together with free capital inflows, while preserving monetary policy independence.
II.A. IMPACT OF UMP ON EMEs

- In addition, as a result of higher exchange rate and commodity prices volatility, we have seen an increase in inflation volatility in EMEs. This factor clearly generates social deadweight losses as it affects investment and consumption decisions. Moreover, it makes the management of monetary policy more challenging, as it becomes more difficult to anchor inflation expectations.

**Figure 8. Emerging Economies: Volatility of Monthly Inflation**

24-month moving standard deviation; s.a.

- Source: Estimated by Banco de México with data from Haver Analytics.
III. EMEs POLICY RESPONSE

- How to respond to large, potentially destabilizing capital inflows? I am afraid there is no overall good answer.

- Orthodoxy would prescribe an adjustment in the policy mix:
  - To tighten the fiscal policy stance; and
  - To implement a lax monetary policy.

- The fiscal restrain would induce a real exchange depreciation, which together with lower interest rates, would provide room for the resulting appreciation coming from capital inflows and reduce the incentives for such flows. But the problem is that this option is very difficult to implement politically. In a situation of exacerbated risk aversion, the credit channel in the economy could be impaired, so the rebalancing in the policy mix would generate costs in terms of economic growth and employment.
III. EMEs POLICY RESPONSE

• Looking for other options, here is where EMEs have in a way innovated, adopting some unconventional policies.

  - To limit capital inflows, some EMEs have imposed capital controls, and they have taxed either the inflows or their returns; other countries have demanded higher reserve requirements on commercial banks’ liabilities derived from borrowing abroad or deposits by foreigners.

  - To control the impact of flows on the exchange rate, some EMEs have relied on heavy intervention in the foreign exchange market, accumulating large international reserves.

  - To prevent asset price bubbles some countries have adopted some macroprudential policies, like adjusting loan to value for specific credits, establishing debt to income limits on potential borrowers, increasing risk weights on some banks’ assets and/or adopting time varying dynamic loan-loss provisioning.
At the same time, we need to understand better how these policies work, and establish best practices in their implementation. In a few cases, “beggar-thy-neighbor” policies were adopted under the umbrella of macroprudential policies; this is clearly unacceptable. Macroprudential policy actions should be tailored to address well-identified distortions, and preferable should be short-lived. It is also still an open question their efficacy.
IV. EMEs MORE RECENT CHALLENGE AND CONCLUDING REMARKS

• The most pressing challenge that EMEs are currently facing, and will face in the coming months, is the implementation of the exit of UMP by some major central banks. Since last May we have seen turbulence in financial markets around the world, once the “tapering talk” started, that is, once the possibility that the Federal Reserve will soon taper its asset purchases increased, given that the US economy is showing a stronger performance. As a result of this, we have seen EMEs impressive capital reversals (shown in figures 3 and 4), a substantial upward shift in yield curves (see figure 9) and sharp depreciation of EMEs currencies against the US dollar. Countries with relatively weaker economic fundamentals (with higher fiscal and current account deficits, for example) have been affected the most. This has come at a time where economic growth, and EMEs growth, has been slowing down.
IV. EMEs MORE RECENT CHALLENGE AND CONCLUDING REMARKS

Figure 9. Yield Curves of Selected Emerging Market Economies
January 2nd to August 15th, 2013

Source: Bloomberg
IV. EMEs MORE RECENT CHALLENGE AND CONCLUDING REMARKS

• There is the potential for additional spread decompression in EMEs’ debt. The IMF, in last Spring’s GFSR, presented a convincing analysis in which they estimated that from the EMEs bond yield compression seen from December 2008 to December 2012, close to 70 percent was explained by external factors, among them UMP. Thus unless domestic factors are improved, much of such compression will be given back once UMP exit starts in earnest.

• At the same time, the design an execution of UMP exit strategy is extremely difficult. Although enhanced forward guidance have been offered and communication by the Fed has been transparent, it seems that very risky positions are held by many market participants, which could induce herd behavior and a run in some asset classes. This should be prevented, since the financial stability effects could be substantial.
IV. EMEs MORE RECENT CHALLENGE AND CONCLUDING REMARKS

• What can be done to prevent situations to get out of control?

**Advanced Economies**
- Implementing a gradual and predictable UMP exit. Advanced economies’ central banks should mind the spillover effects of their actions. Otherwise the lingering crisis will be reactivated, but probably with new actors.
- Procure policy coordination. Monetary policies of advanced economies going in sharply different directions could become a source of instability for capital flows.

**EMEs**
- Strengthen economic fundamentals. In particular, it is important to maintain sovereign risk under control, reduce inflation premia and enhance the resilience of domestic financial institutions. In short, build up credibility.
- If appropriate, use credibility enhancers, like the IMF Flexible Credit Line.