

Spillovers from US monetary policy to EM financial systems. Musings

Olivier Blanchard

C. Fred Bergsten Senior Fellow, Peterson Institute

Tensions

- ▶ US monetary policy has been the source of EM worries and international tensions.
- ▶ Mantega: “Currency wars”
- ▶ Rajan: “Take into account spillovers. Need for coordination.”

Clearly something to the complaints

- ▶ Straightforward and standard channel of transmission: Either because of fixed exchange rates, or fear of floating, EMs feel they must adjust their domestic interest rate to avoid exchange rate appreciation.
- ▶ Then, effect of the domestic interest rate on financial system.
- ▶ But there seems to be more at work. In particular, Helène Rey's work: Evidence of effects on spreads, credit growth, even in countries which do not adjust policy rates and let the exchange rate adjust.

A powerful but highly misleading metaphor: Tsunamis

- ▶ Dilma Rousseff: Tsunamis (also: “walls of liquidity”): Image of capital inflows going straight into credit flows or elsewhere in EMs.
- ▶ Suppose no FX intervention, and no short term effect of exchange rate on current account.
- ▶ Then, change in gross inflows = change in gross outflows.
- ▶ Symptomatic of a more general and frequent mistake: Thinking about QE as “unleashing billions of liquidity.” QE is an exchange of assets.

Monetary policy and gross inflows. A first pass

- ▶ Take a decrease in US policy rate, so US assets relatively less attractive, EM assets relatively more so.
- ▶ US investors want more. But so do domestic investors. . .
- ▶ Outcome: To a first approximation, the EM rate appreciates until expected returns are equalized, and gross inflows nor gross outflows do not change.
- ▶ What we have are incipient, not actual, tsunamis.
- ▶ (If FX intervention, say, to prevent the appreciation, then no induced change in gross outflows, and increase in gross inflows equal to FX intervention.)

Monetary policy and gross inflows. Second pass.

- ▶ Consider a different shock, risk on/risk off (“market risk aversion”)
- ▶ Assume it affects foreign investors more than domestic investors
- ▶ Then “risk on” will lead to EM appreciation, and larger gross inflows (and outflows)
- ▶ Back to monetary policy. Effect will depend on sign of correlation with risk on/risk off
- ▶ If more expansionary policy positively correlated with risk on, then larger gross flows.

Implications seem to fit the data

- ▶ No consistent effect of US monetary policy on gross inflows to EMs (Effect on some subflows)
- ▶ Strong effect of VIX (related to risk on/risk on), but much less so of policy rate or QE proxies.
- ▶ More granular evidence (Fraztcher, using daily data). Evidence of strong but different signed effects of QE1 and QE2. Suggests different correlations of policy and market risk aversion.

But does the size of gross inflows really matter?

- ▶ (Building on Blanchard, Ghosh, Chamon, Ostry (2015))
- ▶ Suppose foreign investors want to hold more EM government bonds.
- ▶ The EM exchange rate goes up, leading domestic investors want to hold less of their own bonds, more US bonds.
- ▶ Higher exchange rate, but no further effect. Change of ownership, but little or no effect on the interest rate.
- ▶ So maybe the focus on the size of overall gross flows is a mistake. (looking at net flows is worse)

First way out. Exchange rate and balance sheets

- ▶ Since the Asian crisis, role of FX liabilities and assets is well understood (theoretically)
- ▶ Net FX positions of financial institutions (and firms, households to the extent that they affect balance sheets of financial institutions)
- ▶ Looser monetary policy + negative FX positions improve balance sheets.
- ▶ Big enough?

Second way out. Composition rather than size of gross flows

- ▶ Building on imperfect substitutability of domestic assets
- ▶ Gross inflows to banks. Offset in equilibrium by gross outflows from government bonds. Decrease in cost of funds for banks, for given policy rate
- ▶ Same if gross inflows to stock market. Decrease in the equity premium.
- ▶ How do lower US policy rates affect the composition of the flows? Could there be a difference between conventional and unconventional policy in this respect?

(Very tentative) conclusions

- ▶ Focus of much of the literature on the effects on the level of gross flows may not be right.
- ▶ Composition of flows more important.
- ▶ Exchange rates and balance sheet effects. How quantitatively important?
- ▶ If these are the main channels, suggests heterogeneity of effects across countries:
- ▶ As a function of the correlation between monetary policy and risk aversion; of the nature of monetary policy (conventional, unconventional) and its effects on the composition of inflows; on the structure of FX liabilities.