



ECONOMIC POLICIES IN THE AGE OF GLOBALISATION

EPOG STUDENTS AND ALUMNI ASSOCIATION

**The impact
of the Fed's
“normalization” of
monetary policy
on Emerging
Market
Economies**

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Tighter global credit conditions limit the external funding of Emerging Market Economies and the most fragile countries are already facing sudden stops of capital flows. The external nature of the constraints must be recognized in order to equilibrate the external accounts and tackle the drain on foreign resources effectively.

**NORMALIZATION OF THE U.S.
MONETARY POLICY**

After the great financial crisis (GFC), the Fed – followed by other important central banks – adopted unconventional monetary policies in an attempt to rescue the financial system and stimulate the central economies. The bulk of this monetary policy mix was a very low base interest rate tied to the purchases of financial assets, broadly known as quantitative easing (QE). The reduction of the effective Fed funds rate to the zero-lower bound and the expansion of the Fed's assets can be seen in **Figures 1** and **2**, respectively.

In September 2014 the Fed announced the “Policy Normalization Principle and Plans” ¹, outlining the movement to gradually “normalize” its monetary policy. The first important movement was the gradual increase of the Fed funds target rate that was set to a 1.75-2%

• **FIGURE 1**



Source: Federal reserve board.

• **FIGURE 2**



Source: Federal reserve board.

range in June 2018 and is expected to keep increasing until it reaches a level between 2.9 and 3.5% in 2019. Moreover, a consistent reduction of the securities held by the Fed started in October 2017, with a monthly absorption of 10 billion U.S. dollars from the markets, with scheduled increases in these amounts at every quarter until it reaches 50 billion dollars per month. The Fed is expected to keep absorbing liquidity from the system until it is “holding no more securities than necessary to implement monetary policy efficiently and effectively”.

IMPACT ON EMERGING MARKET ECONOMIES

One important side-effect of the expansionary monetary policies adopted in the central economies was the sudden floods of capital flowing towards the Emerging Market Economies (EMEs). These markets offered attractive yields and high prospects of

growth in the immediate aftermath of the GFC and attracted direct investments as well as portfolio financial investments. The latter was reinforced by “carry trade” operations, aimed to profit from combined movements of currency appreciations and the existence of positive interest rate differential. However, this strategy is highly sensitive to adverse exchange-rate movements, being subject to rapid reversals if global conditions change.

To understand the vulnerabilities of EMEs to reversals of capital flows and their policy alternatives, it is important to recognize that the international monetary and financial system is asymmetrical and hierarchical. The most important global investors are resident in the U.S. or in other central economies. Their liabilities are mainly denominated in dollars, and their exposure must take into consideration the risk to transform their assets in dollars quickly and without capital losses in case of necessity. Therefore, assets denominated in EMEs currencies are structurally speculative and have to pay a premium for the absence of liquidity in dollars.

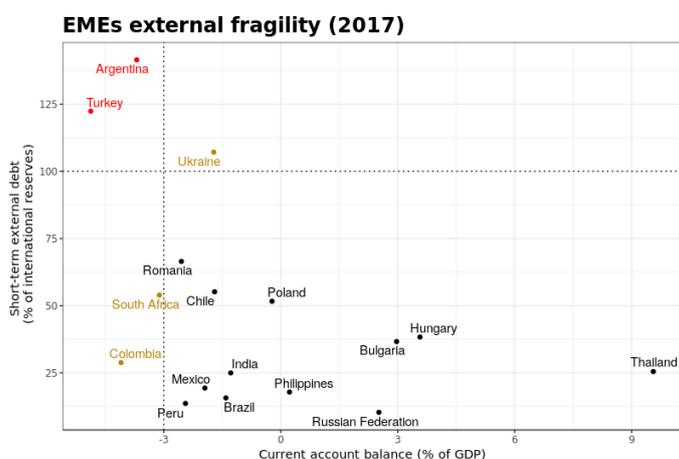
There is a currency hierarchy in global markets, with the dollar on the top and EMEs and other less developed economies on the bottom². Moreover, the scale of markets is not the same. EMEs financial markets are significantly smaller than the financial markets in central economies. As a consequence, reallocations of global investors’ portfolios can be very disruptive to EMEs even if the shares of assets invested in these markets are not very significant in these portfolios³. For these investors, the decisions of the Fed will always affect the relative returns of their assets and liabilities. Therefore, the Fed will attract capital from the rest of the world whenever it increases its base interest rate, affecting adversely the EMEs. Thus, as long as the dollar remains hegemonic, the monetary policy stance of the Fed will spill-over to the rest of the world, leading “the global financial cycle”⁴.

If these global factors affect all the EMEs horizontally, it is the specific conditions of each country that determine their fragility to changes in the global economy. First, the more financially open is a country, the more exposed it is to changes in the U.S. monetary policy due to the higher presence of foreign investors in their economies. If the country is running persistent current account deficits, its fragility is substantially higher since it needs a steady flow of foreign capital to sustain its level of imported consumption and other current commitments. It is important to remind that the use of foreign savings (i.e. current account deficits) can stimulate the economy for a while but its persistence typically ends with a balance of payments crisis, abrupt real exchange

rate depreciation/devaluation and contractions of the economy⁵. Moreover, currency crises can trigger inflationary escalation, requiring more restrictive policies to tame it. Finally, governments and companies indebted in foreign currency face an important patrimonial risk if their currency loses value.

The “taper tantrum” turmoil in EMEs that started in 2013, following the mere possibility of a slowdown in asset purchases that year, anticipated the risks attached to the reversion of the monetary policy in the U.S. Despite the Fed forward-guidance in the “normalization” of its policies, some EMEs economies are facing significant risks due to their fragile external position. In **Figure 3** we compare the weighted average of the current account balance (CAB) of several EMEs from 2012 to 2017 with their short-term external indebtedness at the end of 2017. Argentina and Turkey were in the riskiest zone, facing persistent current account deficits that reached more than 3% of their GDP with a short-term external indebtedness that outweighed their level on international reserves.

• **FIGURE 3**

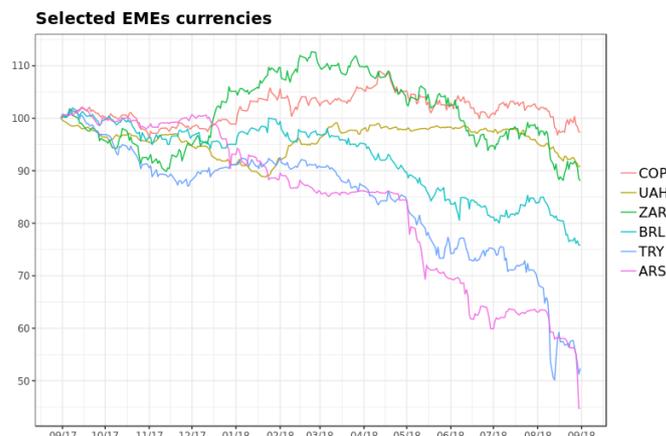


Notes: The selection of countries was based on the IMF list of EMEs with available data. The current account balance represents a weighted average of the years between 2012 and 2017, where the most recent observations are weighted twice as high as the immediately below ones

Source: BIS-IMF-OECD-WB Joint External Debt Hub; IMF; World Bank.

At the time of writing, these two economies are facing an exchange-rate crisis, with their currencies having lost around 50% of their value in relation to the dollar in one year, as can be seen in **Figure 4**.

• **FIGURE 4**



Note: 31 August 2017 = 100. The currency values correspond to the value of 1 selected EMEs currency in dollars.

Source: investing.com

The similarity of these two cases is striking, especially when we consider that their governments are adopting different economic policies. Macri’s government, elected at the end of 2015 in Argentina, opted for an orthodox management of the economy aiming to stabilize the currency and to return to global capital markets, financially opening the economy. On the other hand, Erdoğan’s government in Turkey tried to create strategic incentives for key sectors since 2013 in order to reduce the dependency on imported products. However, the currency is depreciating and inflation is rising in both countries, while current account deficits still persist. So far, the response of both countries to the crisis was different: the Argentinian government is following the guidance of the IMF and increasing interest rates together with fiscal austerity while the Turkish government refuses to increase interest rates and complains about a western plot to take down their economy. The common factor between these two countries is that neither was able to reduce the dependence on external resources and are now facing the typical constraints of sudden stops on capital flows.

The other countries in risky situations are South Africa and Colombia, with important current account deficits (although in the latter the flows are mainly composed by foreign direct investments, less unstable), and Ukraine, with a high exposure to short-term external indebtedness. The South African rand, for instance, lost more than 25% of its value in relation to the dollar between February and August 2018. The Brazilian economy is also facing a significant turmoil as it is still struggling

to recover from the crisis started in 2013 with the taper tantrum and the fall of commodity prices. The poor economic performance combined with financial openness and political instability exposes the country to external fluctuations. The Brazilian real lost 25% of its value from August 2017 to August 2018.

POLICY IMPLICATIONS

With unemployment falling, inflation rates getting closer to the Fed target, fiscal stimulus derived from Trump's tax cuts and possible price increases due to the recent tariffs imposed on imported goods, it is not likely that the Fed will stop the "normalization" of its monetary policy. In this scenario, it is important that EMEs authorities recognize the external nature of the constraints they can come upon. The most important thing to do is to re-equilibrate their external accounts, which will involve a real depreciation/devaluation of their currency. It must be clear that the transition to a more robust external position is not simple. The government must be ready to face political resistance in the short-run due to the effects of real depreciation on incomes and to facilitate exchange rate hedging for companies indebted in foreign currencies, preserving financial stability⁶. Restrictive policies might be necessary to accommodate the pressure on prices and the economy is likely to experience a growth slowdown in the process of adjustment. If the country is already facing an acute external funding restriction, with compromises in foreign currencies coming to due and ongoing resident-capital flights, a narrow focus on fiscal austerity and interest rates hikes without tackling the drain on foreign reserves is the type of medicine that kills the patient in the process. It does not attack the external problem directly and will only equilibrate the external accounts through a sharp reduction on economic activity, as happened in Brazil between 2014 and 2016.

In this situation, the adjustment plan must curb the capital outflows – with a mix of capital controls and incentives to stop capital flights – and search for alternative sources of external funding to alleviate the immediate pressures. However, these measures can only buy time and if the government fails to correct the current account imbalance, they will only aggravate the crisis in the future.

Furthermore, the adjustment plan should not be limited to immediate damage control, casuistically adopting measures to limit the drain on foreign resources. It must be tied to a long-run structural plan focused on developing strategic sectors and activities that are capable to generate foreign resources together with struc-

tural financial and macroprudential regulation aimed to reduce the influence of short-term speculative inflows on the local economy. The combination of these measures is important to create an economic environment capable to avoid external imbalances and accommodate increases in real wages with productivity gains.

¹The addendum to the Policy Normalization Principles and Plans can be found at <https://www.federalreserve.gov/newsevents/pressreleases/monetary20170614c.htm>

²The Chinese currency is a special case. It is not only growing in international relevance but it is central to agreements aimed to reduce the influence of the U.S. and its institutions on specific countries.

³De Paula, Luiz Fernando, Barbara Fritz, and Daniela M. Prates. "Keynes at the periphery: Currency hierarchy and challenges for economic policy in emerging economies." *Journal of Post Keynesian Economics* 40.2 (2017): 183-202.

⁴Rey, H el ene. *Dilemma not trilemma: the global financial cycle and monetary policy independence*. No. w21162. National Bureau of Economic Research, 2015.

⁵Cavallo, Eduardo, Barry Eichengreen, and Ugo Panizza. "Can countries rely on foreign saving for investment and economic development?." *Review of World Economics* 154.2 (2018): 277-306.

⁶The Brazilian experience with foreign exchange swaps was an interesting example of policies aimed to provide hedge without compromising the official reserves.



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