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The Impact of Monetary Policy Normalization in Major Advanced Economies on Systemic Middle-Income Countries: Macroprudential Policy Responses

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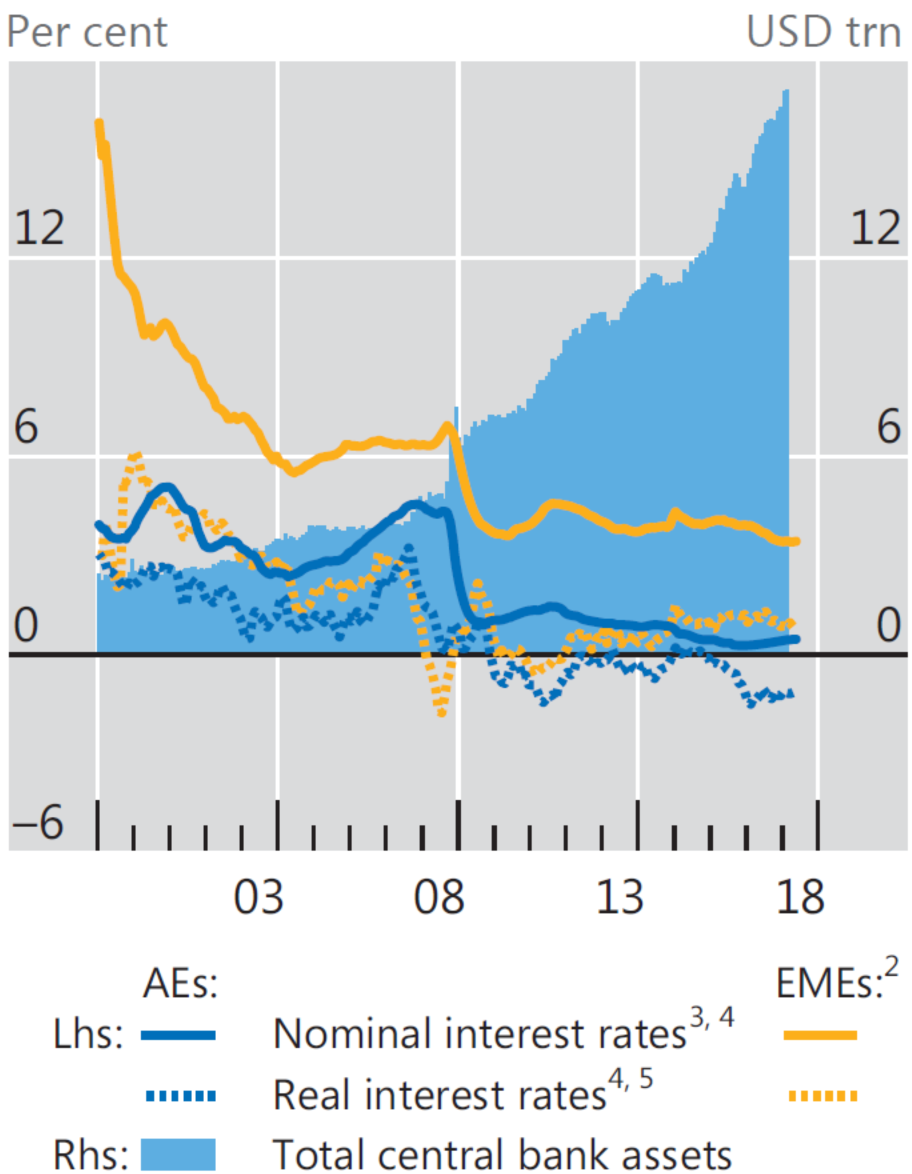
Background

- MAEs (Major Advanced Economies): heavy reliance on monetary policy to support the post-GFC recovery.
- Conventional and unconventional measures (low policy rates, asset purchases).
- Negative real interest rates, dramatic increase in central bank assets.

Interest rates and central bank balance sheets



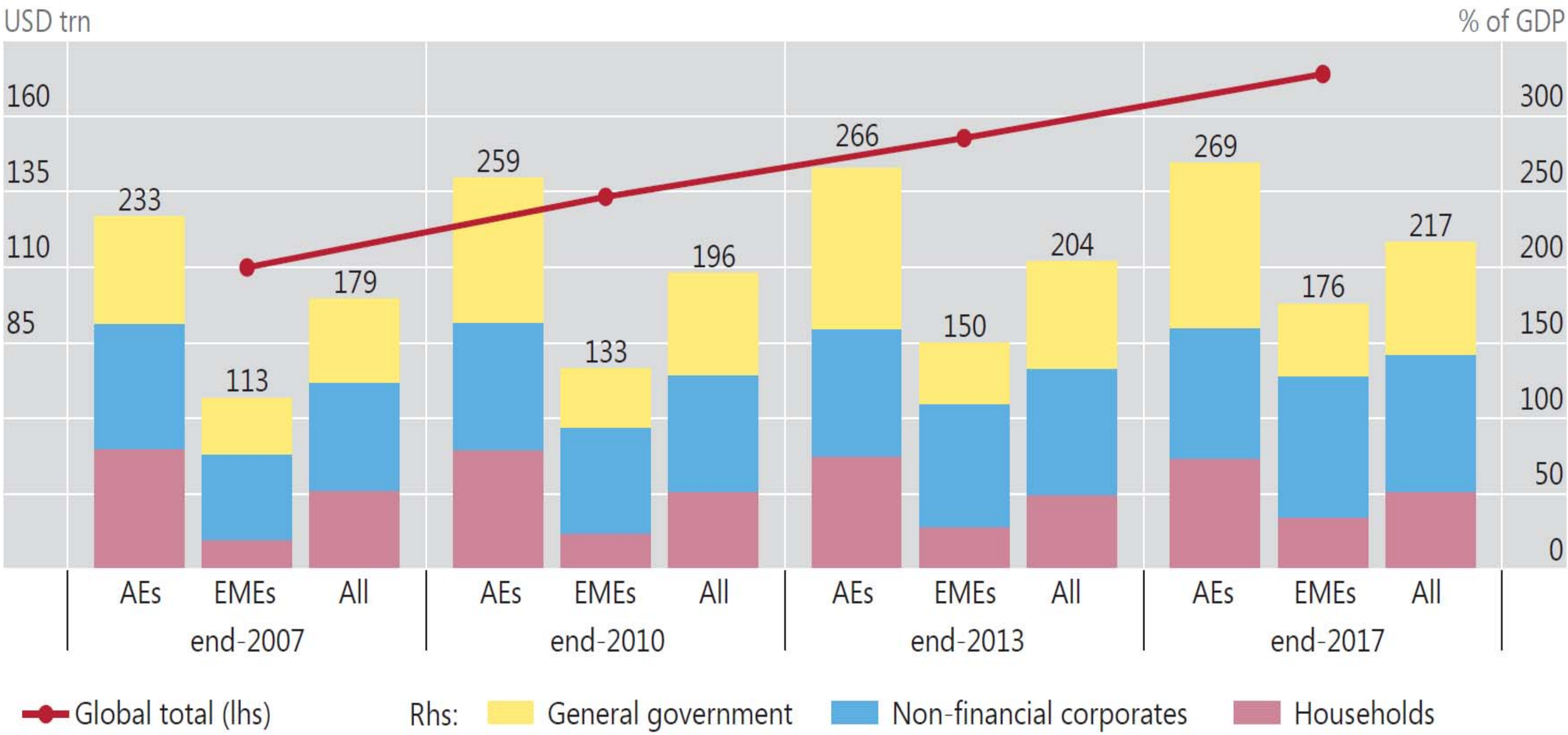
Source: BIS.

- Consequence: surge in global liquidity, which has fuelled a global increase in debt.

- Private and public, especially non-financial corporate sector.

Global debt continues to rise[1]

Graph E.2



[1] Weighted averages based on GDP and PPP exchange rates. The sample includes all reporting economies except Ireland, owing to large data fluctuations caused by the restructuring of large multinational corporations.

Sources: IMF, *World Economic Outlook*; BIS total credit statistics; BIS calculations.

Source: BIS.

- In parallel: globalization of banking has continued (World Bank (2018)); greater scope for regulatory arbitrage.

- Also, financial spillovers have become a two-way street (Agénor and Pereira da Silva (2018)).

- Spillbacks are stronger.

BANK FOR INTERNATIONAL SETTLEMENTS

Financial spillovers, spillbacks, and the scope for international macroprudential policy coordination

by Pierre-Richard Agénor and Luiz A Pereira da Silva

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- Normalization of monetary policy in MAEs: will involve higher interest rates, unwinding of central bank purchases.
- Creates challenges for themselves (high debt levels, impact of balance sheet normalisation on long-term interest rates, unregulated lending)…
- …but also heightened risks for rest of the world.

- Global financial conditions are tightening; appreciation of the US dollar since April 2018.
- As the process unfolds, potential for large capital outflows or sudden stops.
- Can exacerbate already difficult (in some cases) domestic conditions.

- Key issue: what impact normalization will have on Systemic Middle-Income Countries (SMICs) and how these countries should respond.

- SMICs: Brazil, China, India, Indonesia, Mexico, Russia, South Africa and Turkey.

- Agénor and Pereira da Silva (2018).

- EMEs is an obsolete concept, especially to understand international spillovers and spillbacks.

Three issues

- What are the risks for SMICs associated with monetary policy normalization in MAEs?

- What can domestic macroprudential (MaP) policies, possibly combined with other policies, do to mitigate these risks?

- Given what is known about the effectiveness of MaP instruments, what are the most appropriate tools to deploy?

What are the Risks that Normalization creates for SMICs?

- SMICs: largely spared by the GFC.

- Post-GFC financial reforms (incl Basel III) and broadening of MaP frameworks have strengthened the banking system.

- Also build-up of reserves, greater exchange rate flexibility.

- Many SMICs: are better placed to confront financial stress now than they were before the GFC.

- But post-GFC: domestic currency appreciation, excessive foreign-currency borrowing, and build-up of domestic financial imbalances in some countries.

- Strong increases in private sector credit and property prices.

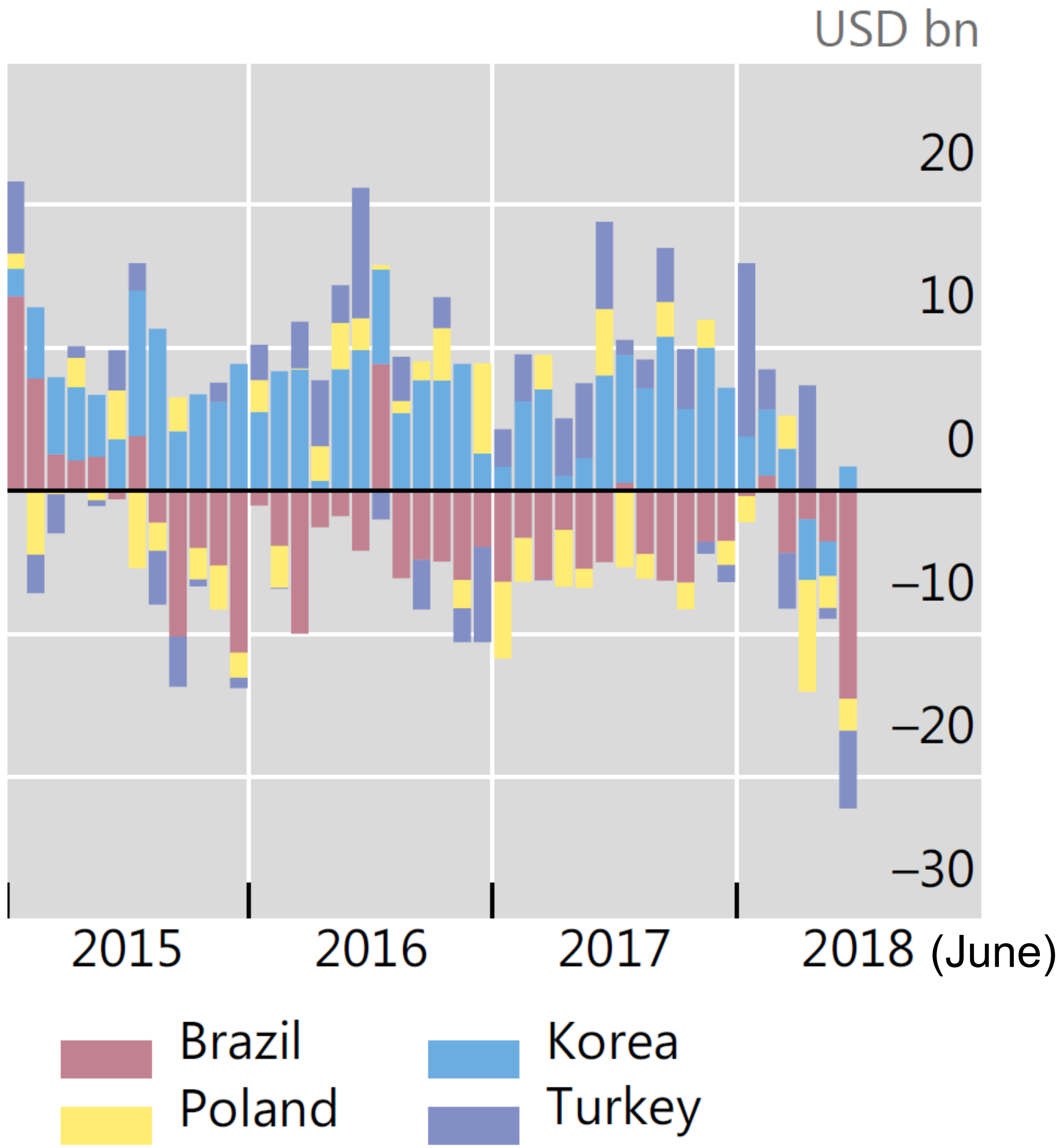
- These countries are vulnerable to monetary policy normalization in MAEs.

- Because of spillovers, monetary policy trade-offs can be exacerbated and financial vulnerabilities exposed.

- Increases in US interest rates, US dollar appreciation since April: capital flows have begun to reverse; large depreciations of domestic currencies.

- Brazil, Turkey.

Selected Countries: Net portfolio and other investment flows, 2015-18



Source: BIS.

- 2 channels of transmission.
  - Depreciation weakens balance sheets of highly-indebted borrowers.
  - Attempts to mitigate capital outflows have led to higher interest rates (starting in May).
- Higher domestic spreads due to weaker balance sheets, and higher bank borrowing costs.
- Both lead to tighter domestic financial conditions.

- Important because credit is highly correlated with activity (working capital needs).
- Business and financial cycles are more closely correlated than in AEs.
- Adverse supply-side effects, even with some currency appreciation could, at least in the short run, lead to higher inflation.
- Trade-offs limit scope for easing monetary conditions.

- Global spillovers may also have implications for the countries from which the spillovers originate.
- What happens in SMICs could have significant feedback effects.
- Even if they act alone, spillbacks should be internalized by MAEs; consistent with domestic mandates.
- But can international coordination, in some form, generate a superior outcome?

What can Macroprudential Policies do?

- If central banks in SMICs raise interest rates to slow capital outflows…
- The resulting currency appreciation will reduce the foreign-currency debt burden and ease domestic financial conditions.
- Improvement in borrowers’ creditworthiness: positive effect on lending.
- However, if the effect of higher funding costs dominates, the net effect may be a reduction in lending and a contraction in activity.

- May exacerbate domestic financial imbalances.
- Policy trade-offs may worsen.
- With 2 objectives, 2 instruments are needed (Tinbergen's rule).
- Can MaP policies mitigate spillover risks?
- Evidence: mixed; more effective in strengthening financial system resilience (building up buffers) than in preventing the development of financial imbalances themselves.

- BIS (2018, Chapter 4): as deployed so far, restraining impact of MaP policies on financial booms has not always prevented the emergence of familiar signs of financial imbalances.

- However, targeted instruments (e.g. sectoral tools) have proved effective in many countries.

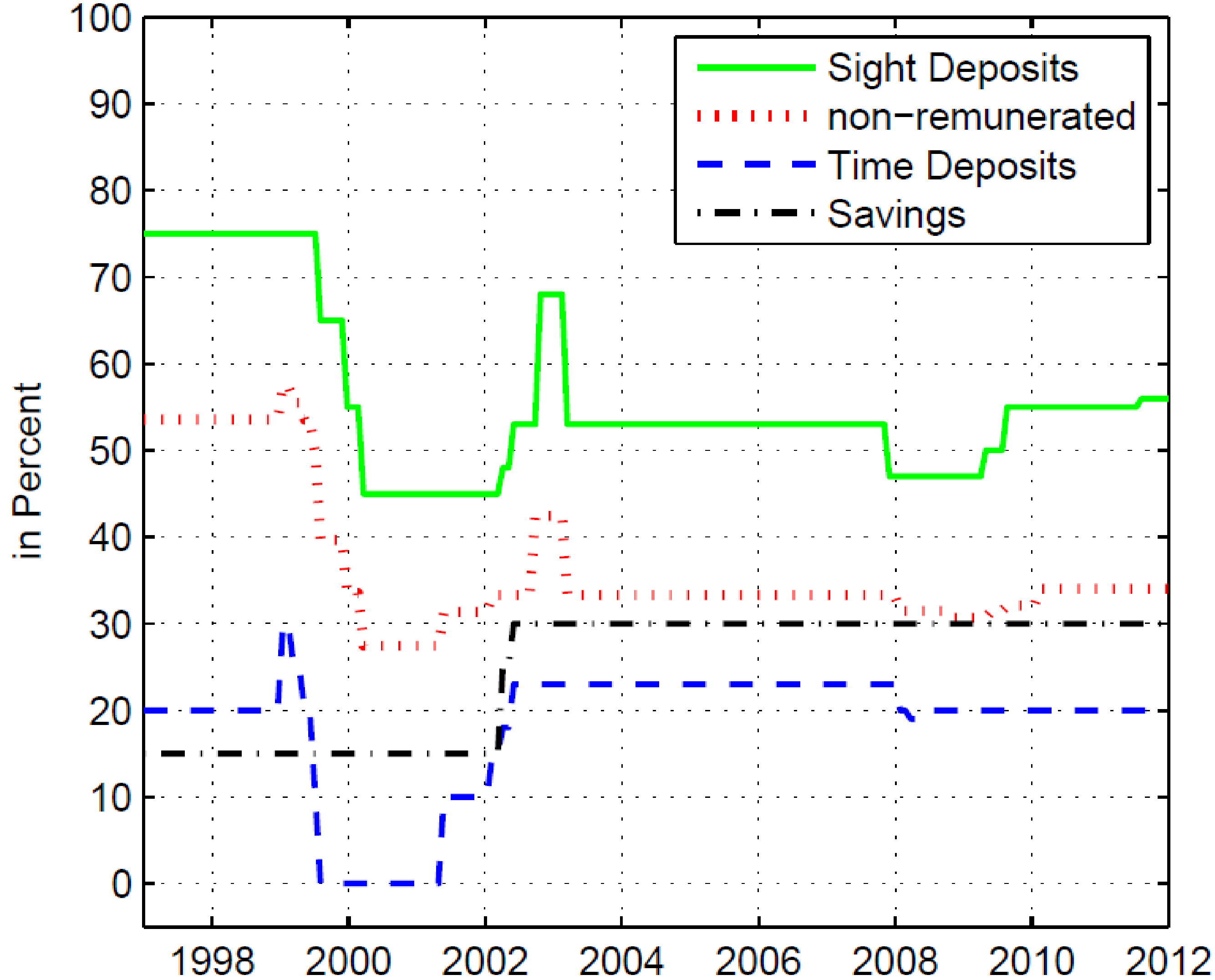
- Impact of DTI, LTV ratios on mortgage loans and house prices.

- Scope for more aggressive use of some other countercyclical tools.

Which Specific Instruments are most appropriate as countercyclical Tools?

- Countercyclical capital buffers: not easy to implement quickly (MAEs and SMICs).
- Potentially more effective countercyclical tools in SMICs: reserve requirements (RRs) and dynamic provisions (DPs).
- RRs: more flexible tool; used in many MICs in Latin America, especially since 2004. China, Turkey, etc.
- Example: Brazil. Substitute for monetary policy, rather than a countercyclical MaP tool.

Brazil: Total Reserve Requirements by Type of Deposits, 1998-2012



Source: BIS.

- DPs: put in place after 2007-08 in several SMICs.
- See Agénor and Pereira da Silva (2017).
- Active use of both policies can help to stabilize the business and financial cycles and allow them to act as a complement to monetary policy.
- Challenge: joint calibration of both instruments, given two objectives.

Reserve Requirements and Loan Loss Provisions as Countercyclical Macroprudential Instruments:

A Perspective from Latin America

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Concluding remarks

- Path to normalization is a narrow one for MAEs.
- Spillovers from normalization are also a major challenge for SMICs…
- …especially those already facing large domestic financial imbalances.
- Limited room for manoeuvre with monetary policy.

- MaP policies can help address policy trade-offs.
- Sterilized FX intervention can also help, by offsetting some of the undesirable appreciation associated with higher interest rates.
- Regardless of the policy mix, central banks may need more flexibility in pursuing inflation targets, especially if the normalization process in MAEs becomes disorderly.
- At the int’l level greater coordination of MaP policies can help to stabilize capital flows induced by regulatory arbitrage. Superior outcome for all?

BANK FOR INTERNATIONAL SETTLEMENTS

Global Banking, Financial Spillovers, and Macroprudential Policy Coordination

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