Caught Between "Conventional" and Forced "Unconventional" Policy-making

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Tapering: costless strategy?

Monetary policy normalization will have costs regardless the way it is implemented

1) Disorderly exit

Long term inflation expect disanchoring

Oct. 13

2) Too late/too soon exit

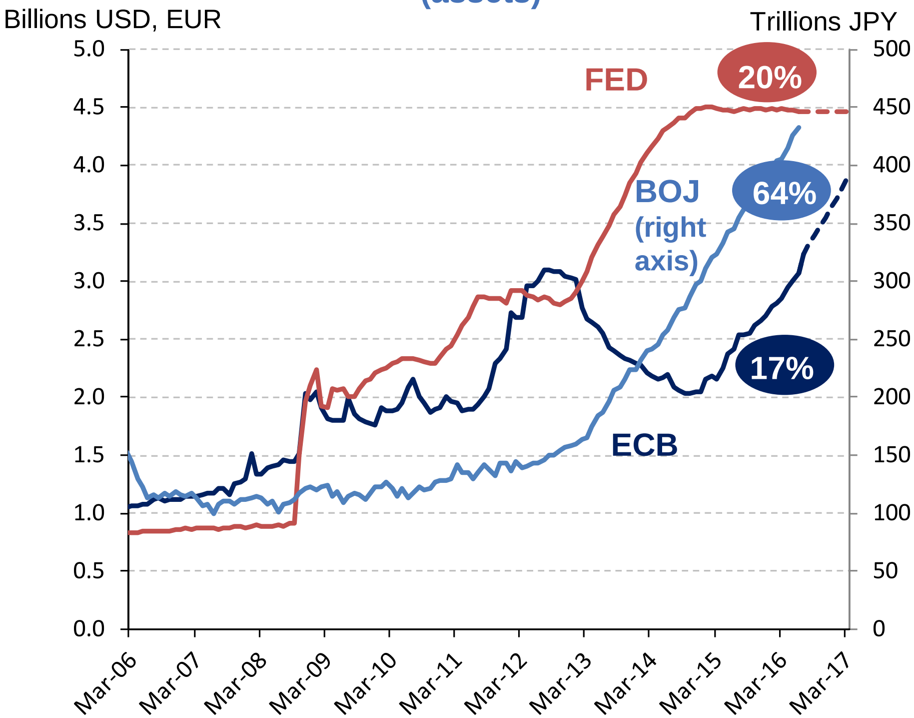
Permanent vs. transitory effect of financial crisis on potential growth

3) Right in time exit

- **Sunk costs: Fixed income bubble? Any other bubbles?**
- **Coordinated or uncoordinated (first mover disadvantage)**
- **Inefficient allocation of resources**
- **Impact on EMs**

Central Banks: from “lenders of last resort” to “buyers of first resort”

Central banks’ balance sheets
(assets)



Source: FED, ECB and BoJ

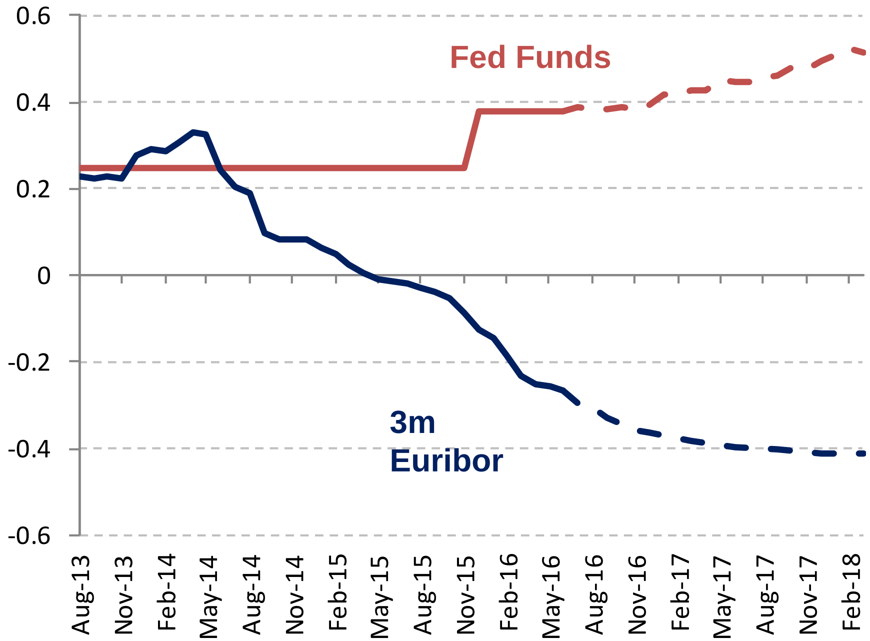
- Unusually dominant role of central banks in financial markets in recent years
- Potential build-up of financial imbalances in the form of excessive risk-taking and growing indebtedness since the crisis
- Possible overvaluation of assets
- Risk of unleashing a chain reaction of financial instability?

Unwinding of extraordinary lax policies may be complex and risky in terms of price and financial stability

Fed: FIFO

Central Banks: At different stages of monetary easing

Short-term rates
(%)



Source: Bloomberg

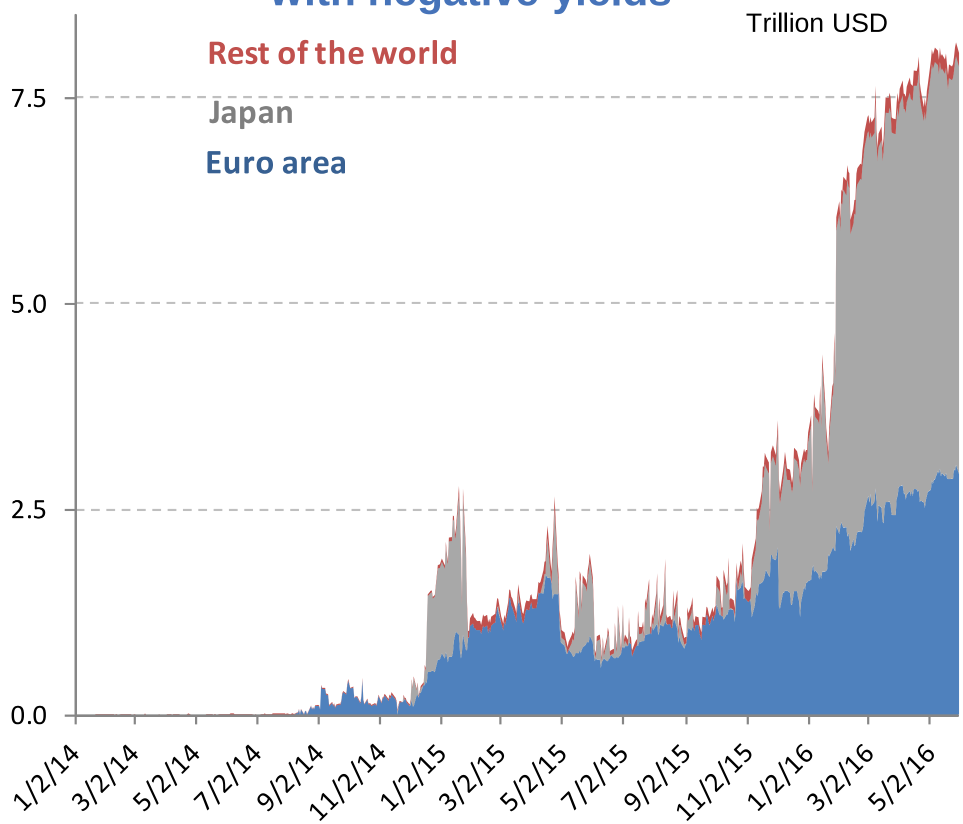
- US, when will it raise rates again?
- Euro Area and Japan, will they ease further?
- Divergent monetary policies in a highly economically and financially integrated world?
- Volatility of capital flows and uncertainty about the implications for exchange and interest rates

Volatility and uncertainty resulting from monetary policy divergence could further accentuate the perception of risk

Federal Reserve, more reluctant in this environment to "normalize" monetary conditions

Is the sky the limit? Monetary policy as a XXI century economic snake-oil

Stock of government bonds with negative yields



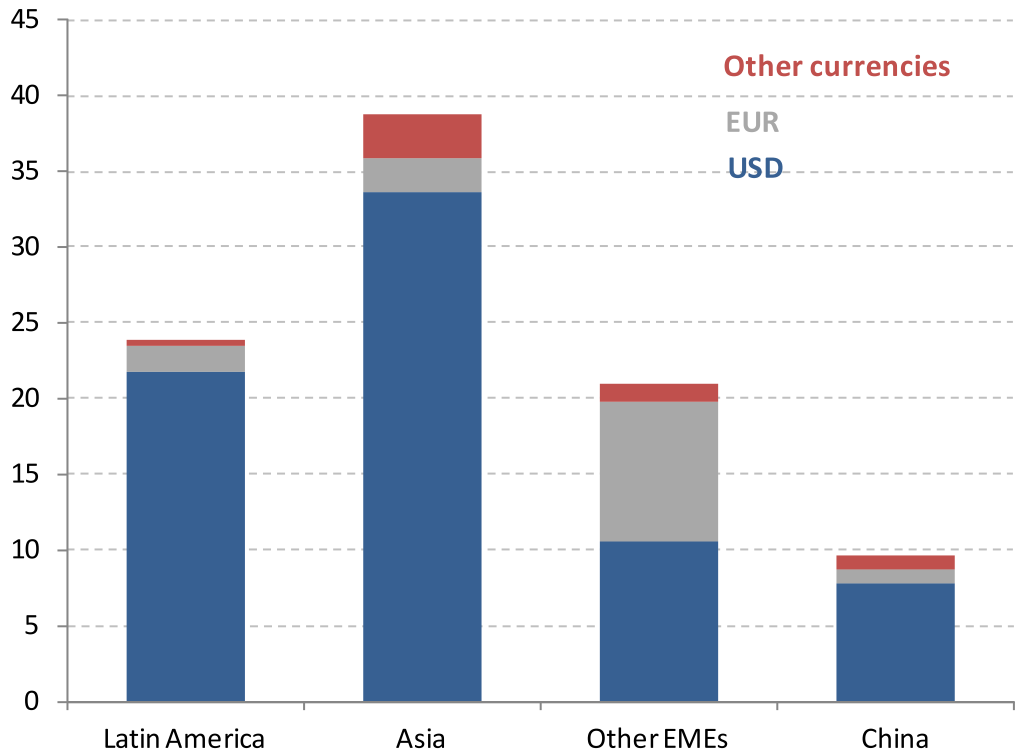
Source: BIS

- Too many unknowns in the equation:
  - Limits of monetary policy close to the zero lower bound
  - Declining trend in real interest rates, structural or cyclical?
  - Negative rates. Will benefits outweigh costs? Unchartered waters (banking system, money market-funds, insurance companies, savers in general)
- Why not go farther into unchartered territory? Long-term interest rate targeting and/or fiscal deficit monetary financing

Returns to expansionary policies seem to be decreasing. Loss of credibility?

Fed is what matters for EMs

Ratio of total foreign currency debt to GDP
(USD billion)



Source: BIS

- Divergence hardly provide some breathing space for EMs (dominance of the US dollar in international financial markets)
- Impact of US shocks in EMs is much larger than other shocks
- Indirect effects of divergence:
  - Fed may delay normalization
  - Big countries, as China, moving away from US peg (significant impact on financial markets)

Expectations of Fed policy is what drives EMs, but those expectations are affected by other Central Banks' actions

Fed policy and channels of transmission to EMs

Impact of Fed tightening

1. Exchange rate channel

USD appreciation vs EMs currencies

- Trade effect (+)
- Balance-sheet effect (-)
- Risk of pass-through?

2. Effect on international financial conditions

- Impact on capital flows, term premia, asset valuations
- Usually associated with higher market volatility and risk aversion

- A concern particularly for countries with large financing needs and/or imbalances

3. US domestic demand channel

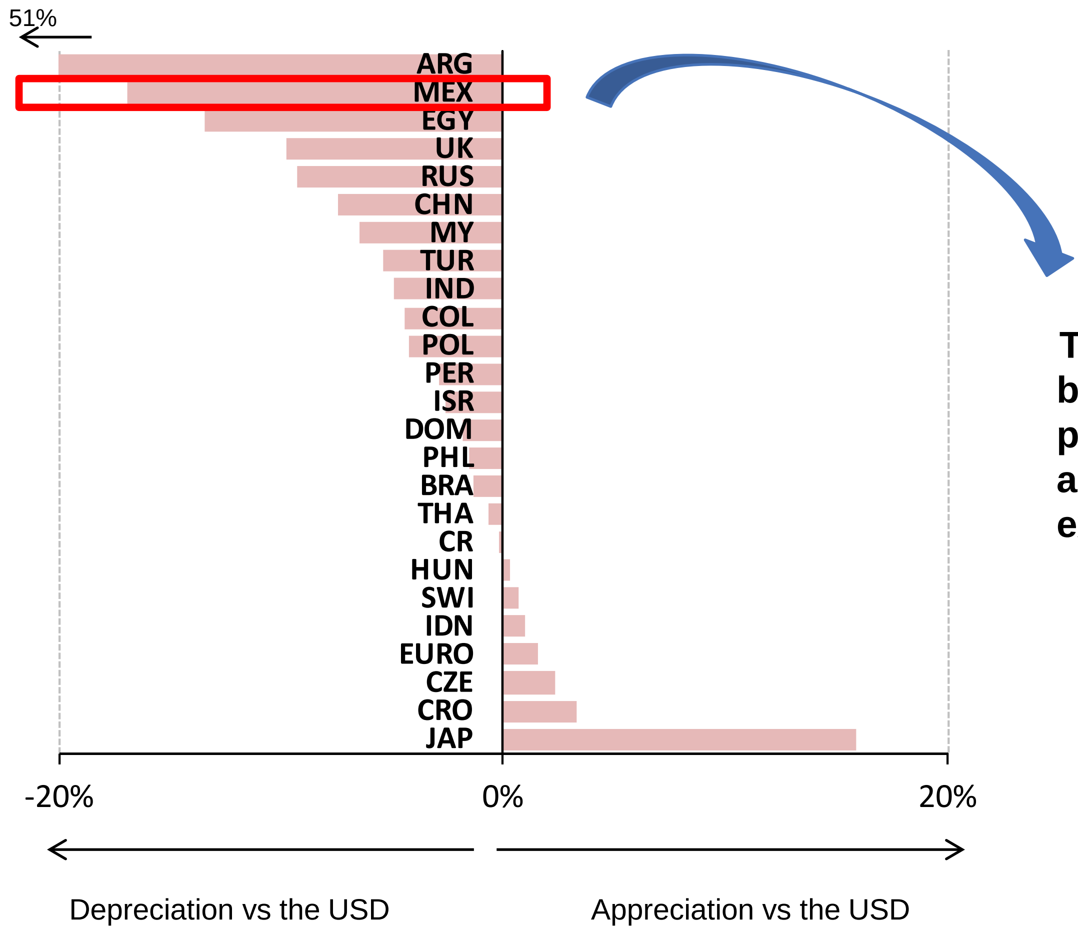
Rate hikes justified by a underlying strength of US economy => mitigate negative impacts

External factors also play a role (China)

How much farther can the Dollar go?

1. Exchange rate channel

Exchange rate vs USD since Aug-2015

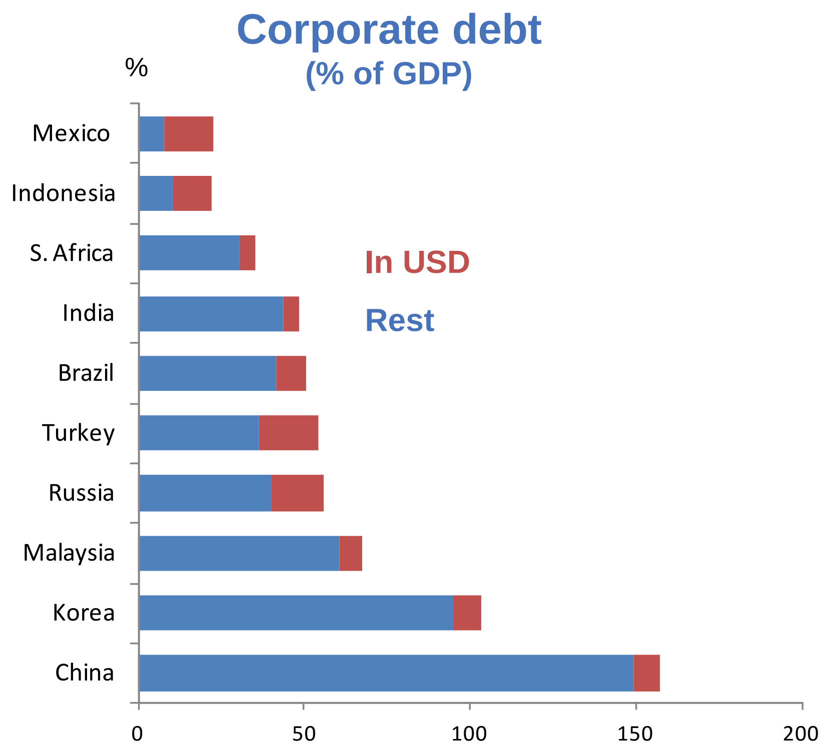


The Mexican peso has been the worst performing currency among the flexible exchange rates

Source: Datastream

Balance-sheet effect: too much corporate debt in foreign currency ?

1. Exchange rate channel



Source: BIS

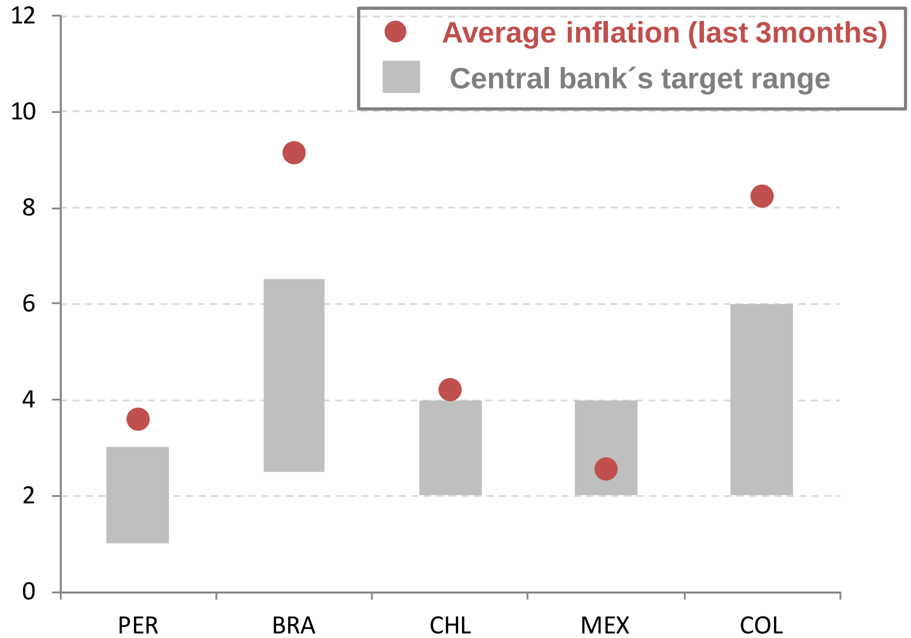
- Contrary to other crisis, no signs of severe currency mismatches in the banking sector and/or government borrowing (lessons from other crisis)
- The main pressure point could be offshore foreign-currency borrowing by emerging market corporations

Difficult to see how large is the risk associated to corporate debt

Risk of pass-through to inflation reduces the autonomy of monetary policy

1. Exchange rate channel

Inflation and CB´s target range



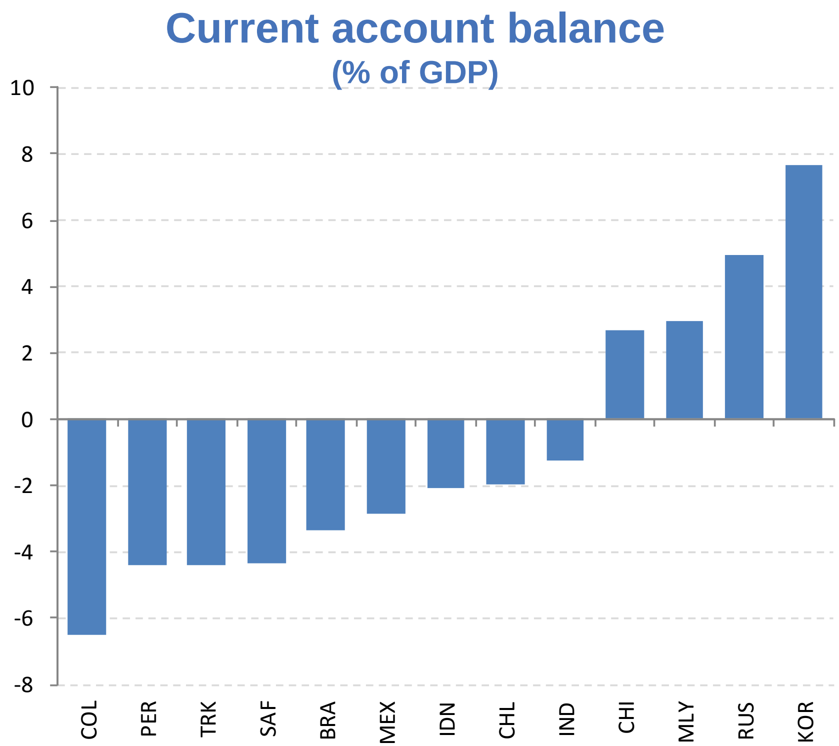
Source: National Central Banks

- Exchange rate pass-through heightens the inflationary risk
- Traditional dilemma: above target inflation and slow growth
- The magnitude of the pass-through in several countries suggests that output gap was less negative than previously thought
- In Mexico, no sign of pass-through despite the large depreciation. Positive impact of structural reforms in prices (telecom, electricity, gasoline).

Pass-through to inflation? Yes in some. Not in others, but be aware

Higher exposure of those countries with higher financing needs

2. International financial conditions



Source: IMF

- In some countries (Brazil, Chile) the current account adjustment is quite advanced (imports contraction)

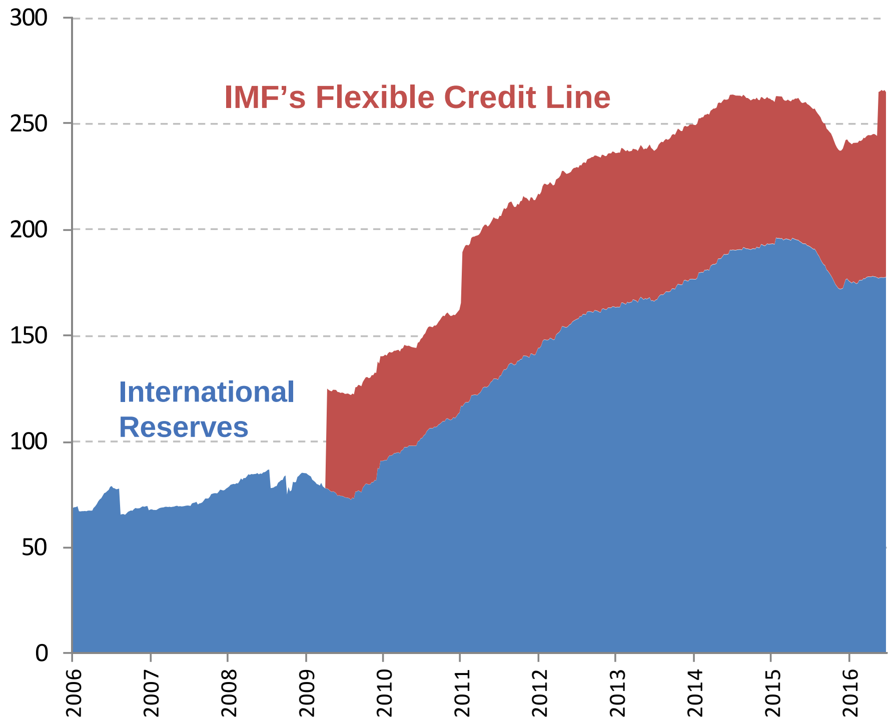
- In others (such Colombia) it is clearly a source of risk

- In Mexico, no room for comfort (downward pressure from oil balance will continue – production weakness – and fiscal adjustment is proceeding too slowly -)

EMs central banks could be required to become “unconventional”

How can EMs central banks deal with this situation? Pseudo-independent Central Banks

Mexico: International Reserves
(Billion USD)



Source: Banco de Mexico

- EMs should:
  - monitor closely their monetary policy stance relative to advanced economies, to minimize the potential of capital outflows
  - strengthened macroeconomic fundamentals and structural reforms to compensate the decompresion of term premia

- Global safety nets are insufficient to deal with massive capital outflows (work to be done on this).

- Large FX reserves accumulation by Ems (complemented, in some countries, with the IMF´s FCL).

Reserves cannot be the ultimate solution, but they can buy time

Monetary policy in EMs conditioned by Fed policy

How about Banxico?

17-12-15	+25bp following the FED hike	Anticipated
17-02-16	Discretionary intervention in FX markets End of regular USD auctions +50 bp	Non anticipated Not scheduled meeting
30-06-16	+50 bp	Non anticipated

- Part of a “Coordinated” response to “strengthen fundamentals”
- Volatility in MXN accentuated by automated mechanisms for high-frequency trading
- Banxico becomes **unconventional**

1. Despite “apparently” sound economic fundamentals, the Mexican peso has been the worst performing currency this year

- No significant impact of FX depreciation on exports (integrated value chains, weak US demand)
- Non-negligible share of corporate-debt in USD
- No pass-through to inflation, yet (producer prices are increasing)

2. Vulnerability of Mexico to financial distress episodes

- Very open and highly integrated financial market (use as proxy to emerging market)
- Large share of government bonds in hands of non-residents (%)
- Fiscal consolidation still ongoing

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