US Monetary Policy and Emerging Markets

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The one thing on which everyone agrees is unhappiness with US monetary policy.
They complain about Fed loosening that leads to dollar depreciation

- This prompts capital inflows into EMs.
- It fans inflation due to excess demand
- It leads to frothy asset markets
- It causes loss of competitiveness and Dutch Disease problems.
- The impacts on output vary, but the general view, I think, is that the impact on most EMs is positive.
- But it also sets up the economy on the receiving end for problems if and when the Fed and the dollar reverse direction.
They complain about Fed tightening that leads to dollar appreciation

• This increases the cost of servicing dollar-denominated debts
• It increases the difficulty of meeting dollar funding requirements.
• The impacts on output vary, but the general view, I think, is that the impact on most EMs is negative.
• And can be sharply negative if it precipitates a sudden stop.
• So, to put it in technical terms that economists prefer, EMs are screwed either way.
• So, to put it in technical terms that economists prefer, EMs are screwed either way.
• Actually, there are serious literatures on these subject that, among other things, raise questions about this conventional formulation.
• To whit....
Consider first the problems created by dollar depreciation

- In a range of standard models, dollar depreciation causes capital inflows, loss of export competitiveness and frothy asset markets in emerging economies.

- But these models also raise uncomfortable questions, as I have emphasized elsewhere.
  - Would EMs really have been better off had the US avoided QE after 2008, producing an even deeper global recession?
  - If the problem is overheating, why not just tighten fiscal (and macroprudential) policies in response?
  - Is the real problem not US monetary policy but political constraints on the requisite policy adjustments in EMs?
Models of the global liquidity traps similarly raise troubling questions

- In these models, the US is stuck at the ZLB. The Fed therefore resorts to QE and dollar depreciation to spring the liquidity trap.
- But since the liquidity trap is global, the policy is purely beggar-thy-neighbor. It just shifts the liquidity trap to other countries, through a combination of currency appreciation and declining export demand.
- But again, there are troubling questions.
  - Are or were EMs ever really at the ZLB?
  - If they are, why not respond, in this case, with fiscal expansion?
  - Again, would EMs really have been better off had the US avoided QE after 2008?
  - And again, is the problem really, in fact, political constraints on the requisite policy adjustments in EMs?

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Consider now the problems created by dollar appreciation

• To be sure, Fed tightening is off the table for the moment.

• But it is worth reminding ourselves how disruptive its effects can be.

• As Poonam Gupta and I do in a recent paper.

Emerging Market Selloffs: India and the World
Barry Eichengreen and Poonam Gupta

1. Introduction

In this paper we review India’s experience with capital flows, analyzing their evolution and placing them in comparative perspective.

We establish the following stylized facts about capital flows to emerging markets. First, they are volatile. Portfolio capital flows are more volatile than FDI flows, while portfolio debt flows and bank-related flows are more even volatile than portfolio equity flows. Second, portfolio flows fluctuate at least as closely with external as domestic factors. Third, this volatility is reflected in periods sudden stops when capital inflows dry up abruptly, with negative real and financial effects. Fourth, sudden stops also fluctuate closely with external as well as domestic factors.

Capital flows to India fit these stylized facts. The pattern of flows mirrors those in other emerging economies. External, or common, factors play a significant role. The relative volatility of different kinds of capital flows resembles that in other emerging markets.

Prior to the global financial crisis, India had not experienced a full-fledged sudden stop since 1991, the episode that occasioned the country’s far-reaching economic reforms. This quiet period ended with the global financial crisis of 2008-9. Since then, India has experienced two milder episodes of domestic and external financial volatility. These did not rise to the level of sudden stops as conventionally defined, but they featured declines in capital inflows and asset prices. Both were marked by depreciating currencies, widening bond spreads and falling reserves. We refer to them as “financial selloffs.”

These two selloffs were in 2013, at the time of the taper tantrum, when then-Federal Reserve Chair Ben Bernanke mooted the possibility that the U.S. central bank might begin to reduce its asset purchases, and in 2018, a period of Federal Reserve interest rate normalization, when it became clear that the Fed was intent on raising rates. We ask three questions about these episodes: (i) How did the impact on India compare with that in other emerging markets? (ii) What country-specific factors shaped that impact? (iii) How effective were the policies adopted in response?

In Eichengreen and Gupta (2014) we found that countries with large financial sectors, large current deficits and appreciated exchange rates were most strongly affected by the 2013 tapering event. Here we use a similar framework to analyze the 2018 selloff. As for 2013, we show that there is a positive correlation between the size of financial markets, prior capital inflows, the current
Rather than from a country perspective, we can look at this from a global perspective.

- We looked for episodes since 2000 when the MSCI Emerging Market Currency Index fell below its two-year rolling average for at least three months and when the size of that decline was at least 1.8 standard deviations.
- (The episode then ends when the series returns to the prior two-year rolling average.)
- We can think of these as “global stops” or “emerging market selloffs.”
- We identify 7 such episodes since 2000.

<table>
<thead>
<tr>
<th>Episode</th>
<th>Time Period</th>
<th>Duration</th>
<th>% change in MSCI Index (Trough to Peak)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Jan 2004 to May 2004</td>
<td>5 months</td>
<td>-2.45</td>
</tr>
<tr>
<td>2</td>
<td>August 2011 to December 2011</td>
<td>5 months</td>
<td>-7.35</td>
</tr>
<tr>
<td>3</td>
<td>May 2013 to August 2013</td>
<td>4 months</td>
<td>-7.79</td>
</tr>
<tr>
<td>4</td>
<td>August 2014 to March 2015</td>
<td>8 months</td>
<td>-8.49</td>
</tr>
<tr>
<td>5</td>
<td>June 2015 to September 2015</td>
<td>4 months</td>
<td>-7.13</td>
</tr>
<tr>
<td>6</td>
<td>March 2018 to September 2018</td>
<td>7 months</td>
<td>-7.34</td>
</tr>
<tr>
<td>7*</td>
<td>August 2008 to November 2008</td>
<td>4 months</td>
<td>-15.52</td>
</tr>
</tbody>
</table>

Note: Trough is the lowest level of MSCI EM Currency Index during the episode. Peak is the value of MSCI EM Currency Index in period t-1. * denotes a global sudden stop.
Revealingly, all but 1 of these episodes were associated with advanced country tightening*

1. Fed expected to raise interest rates after post 9/11 recovery.
2. 2011 monetary tightening in Euro Area.
3. Taper Tantrum
4. Fed announces end of QE.
5. Expectations of Fed “liftoff” (and problems in China).

* Maybe 2008 as well, if you consider ECB tightening, though to my mind the events of that year are somewhat different.
So what to do?
The BIS in its most recent annual report insists that EMs are making progress

• Owing to the inflation targeting, supplemented by:
  – Selective intervention in foreign exchange markets to prevent excessive fluctuations
  – And greater use of macroprudential policies.
• I would agree.
• Inflation targeting means that monetary policy adjusts to (partially) offset the impact on inflation and demand of capital flows.
• A more flexible exchange rate makes this possible.
• While selective intervention prevents the exchange rate from moving excessively, with potentially destabilizing repercussions.
• And macroprudential policy addresses the impact on the credit cycle as opposed to inflation per se.
But what’s still missing?

• But I would add that there is still a disturbing reluctance to use fiscal policy.

• And there is the need to make countercyclical use of macroprudential policies more aggressively.

• I therefore conclude that the problem of dollar-induced instability in EMs is still very much with us.
• Thank you.