



EUROPEAN CENTRAL BANK

EUROSYSTEM

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European Central Bank

## **How do rising rates in advanced economies impact emerging countries?**

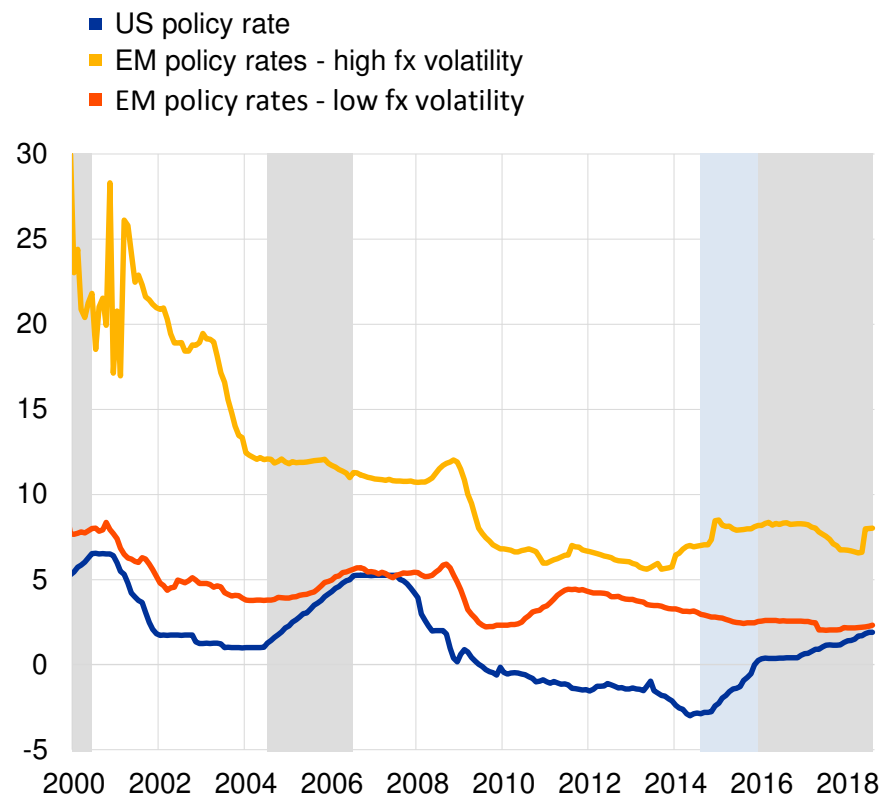
\* I thank A. Cap, G. Georgiadis, M. Habib, D. Lodge and A. Iovine for useful comments and input. The views expressed belong to the author only and are not necessarily shared by the ECB.

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- I will assume a *demand-driven* increase in ADV interest rates. Surely this should be good for EME?
- Well, maybe not
  - Interest rate correlation (due to fear of floating)
    - Or directly through EME corporates issuing foreign currency debt
  - Tightening of financial conditions (over and above short term risk free rates), maybe through a global financial cycle
- There is no consensus on either channel, rather a lot of open questions

# The interest rate correlation: no smoking gun

- Few hard pegs among the major EME, but fear of floating likely important
  - FX pass-through (Hausmann et al. 2000)
  - Net foreign currency debt (Georgiadis and Zhu, 2018)
- Fierce debate on dilemma vs. trilemma: reduced form evidence inconclusive



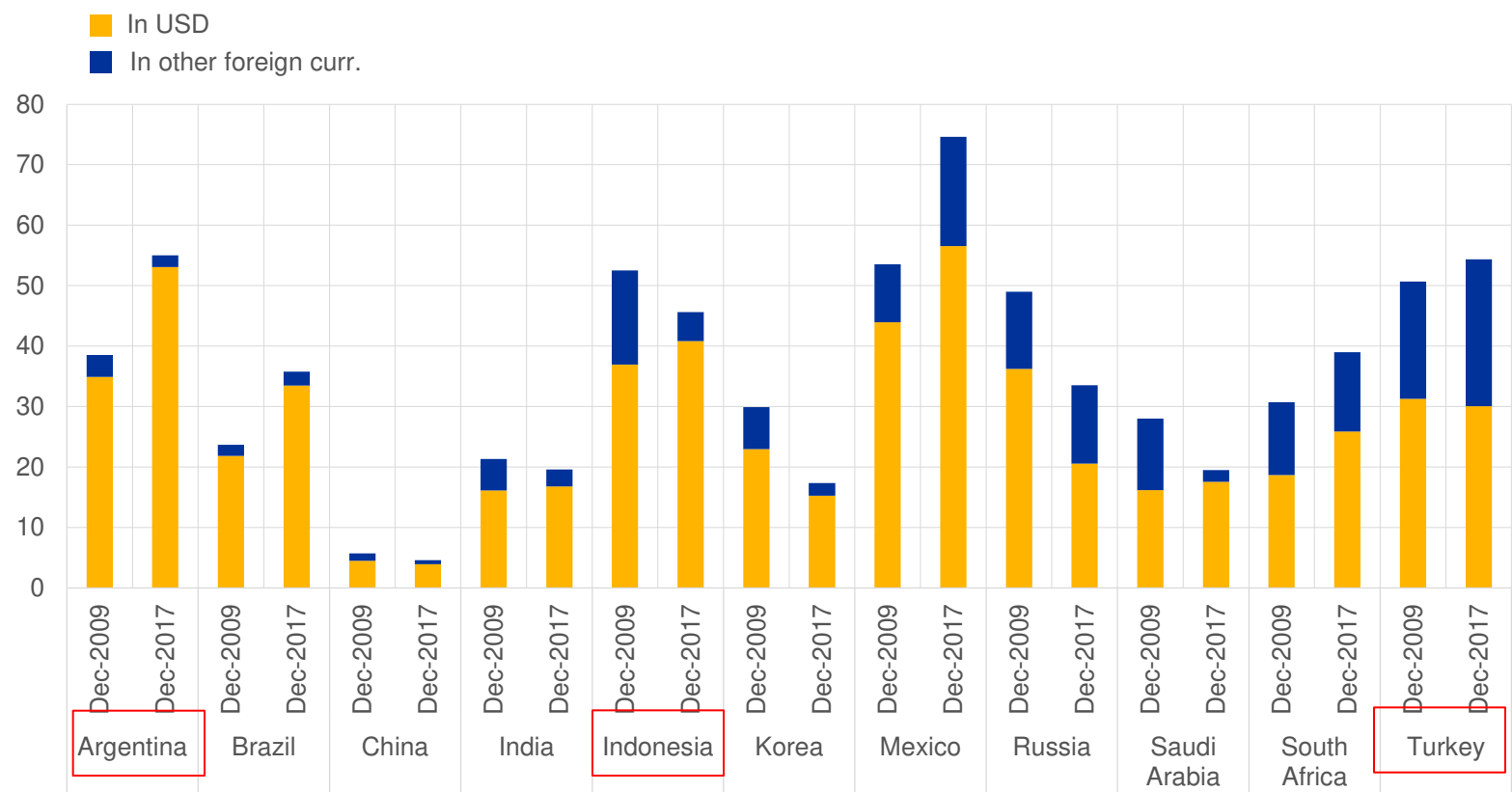
Note: US policy rate is shown as the Federal Funds rate extended using the Wu-Xia shadow rate in the period between 2009-2015. The emerging market economies policy rate is constructed as a simple weighted average. Policy rates above 100% were excluded from the average. Not all countries are available throughout the sample. Fixed composition exchange market volatility-based classification is constructed based on the LCU/USD exchange rate in the 2000-2018 period by splitting the country sample in two groups of the same size.

Country sample: Brazil, Chile, China, Colombia, Indonesia, Israel, South Korea, Mexico, Peru, Philippines, Russia, South Africa, Thailand and Turkey

# EME have issued large amounts of USD corporate debt

## Share of foreign currency debt in total non-financial corporate debt

(share in 2009 and share in 2017)



Sources: IIF.

Notes: highlighted in red are countries with current account deficits.

# The financial channel

- Emphasis on capital flows to emerging markets – also in the policy debate (e.g., G20)
  - (But there are other potential channels, e.g. through asset prices)
- Two questions:
- **Are capital outflows really contractionary?**
  - Not in Mundell-Fleming – see Krugman (2014): a sudden stop should be expansionary!
  - Effect through the cost of financial intermediation?
  - Bond inflows are contractionary (FX appreciation), non-bond inflows are expansionary? (Blanchard et al. 2018)
  - Capital inflows good in the short term, detrimental in the medium term due to mis-allocation? (“Financial resource curse” literature)
- **Do ADV interest rates drive capital flows?**
  - Evidence mixed at best (Powell, 2018)
  - Possibly working through global banks (Brauning and Ivashina 2017)
  - Is it more about US interest rates or the USD?

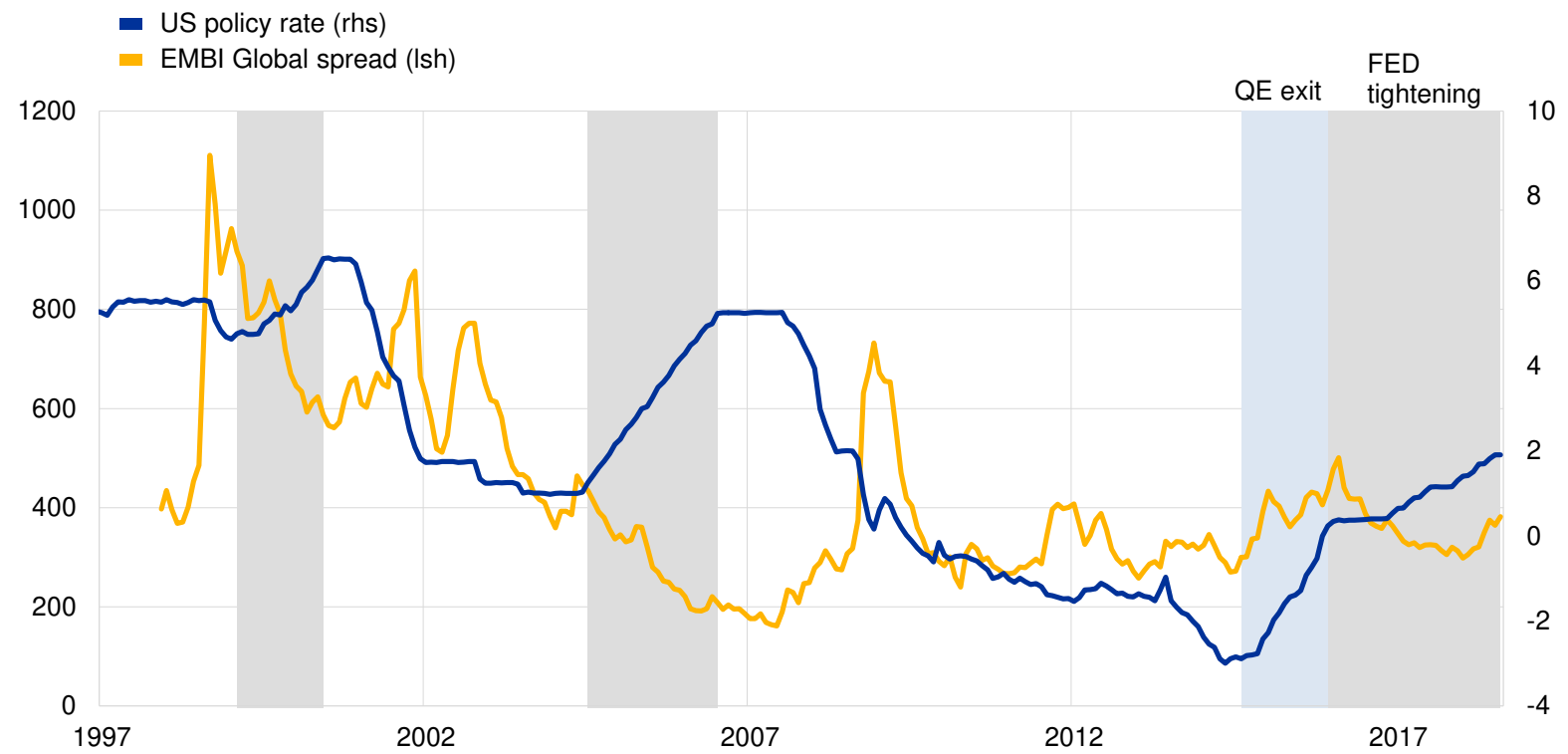
# Some useful quick regressions

- We did some internal work following Jay Powell's speech in Zurich in May 2018: Regress total capital flows to EME as % of EM GDP on US and global variables (USD, US interest rates, VIX, oil prices, global growth...)
- Some interesting findings:
  - Negative relationship with VIX (also excluding global financial crisis)
  - Negative relationship with USD driven by 2008-09 global financial crisis, not visible elsewhere
  - Oil price coefficient unstable, turns positive after the crisis (but one should distinguish between oil/commodity exporters and importers)
  - US interest rates insignificant (but significant for *portfolio* flows)

# US monetary policy and EMBI spreads: no smoking gun

## US policy rate and EMBI Global spread

(monthly data, in basis points (lhs), in percent (rhs))



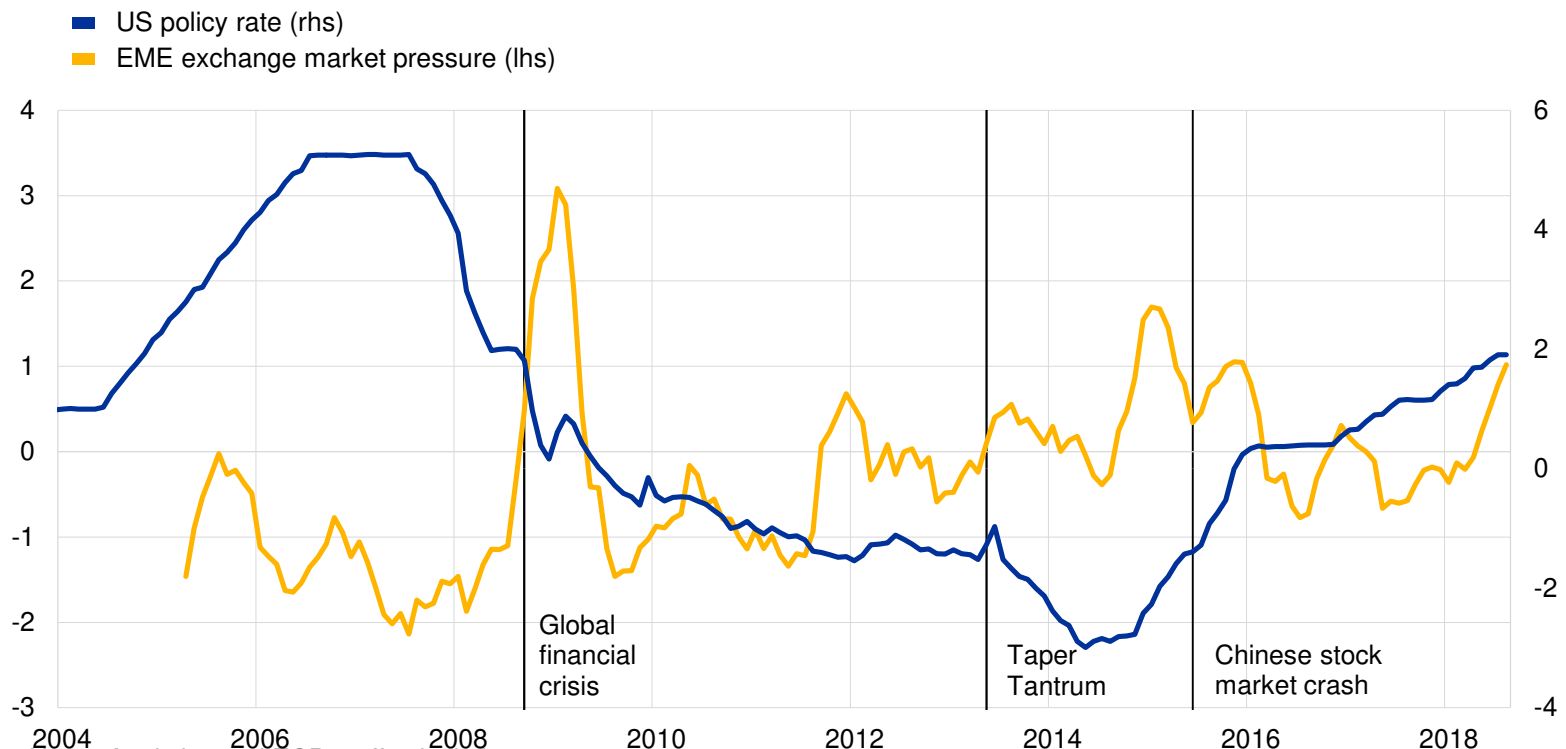
Sources: Haver Analytics and ECB staff calculations.

Note: US policy rate is shown as the Federal Funds rate extended using the Wu-Xia shadow rate in the period between 2009-2015.

# EME Exchange Market Pressure: no smoking gun either

## US policy rate and EMEs Exchange Market Pressure index

(monthly data, index (lhs), in percent (rhs))



Sources: Haver Analytics and ECB staff calculations.

Notes: Changes in reserves (-), exchange rates (-) and policy rates (+) are standardized by the 2 year rolling average standard deviation. An increase in the index implies depreciation pressure on the currency. The index is constructed as a PPP GDP weighted average of EM countries. Not all countries are available throughout the sample. The series displayed is the 6-month moving average of the index. US policy rate is shown as the Federal Funds rate extended using the Wu-Xia shadow rate in the period between 2009-2015.

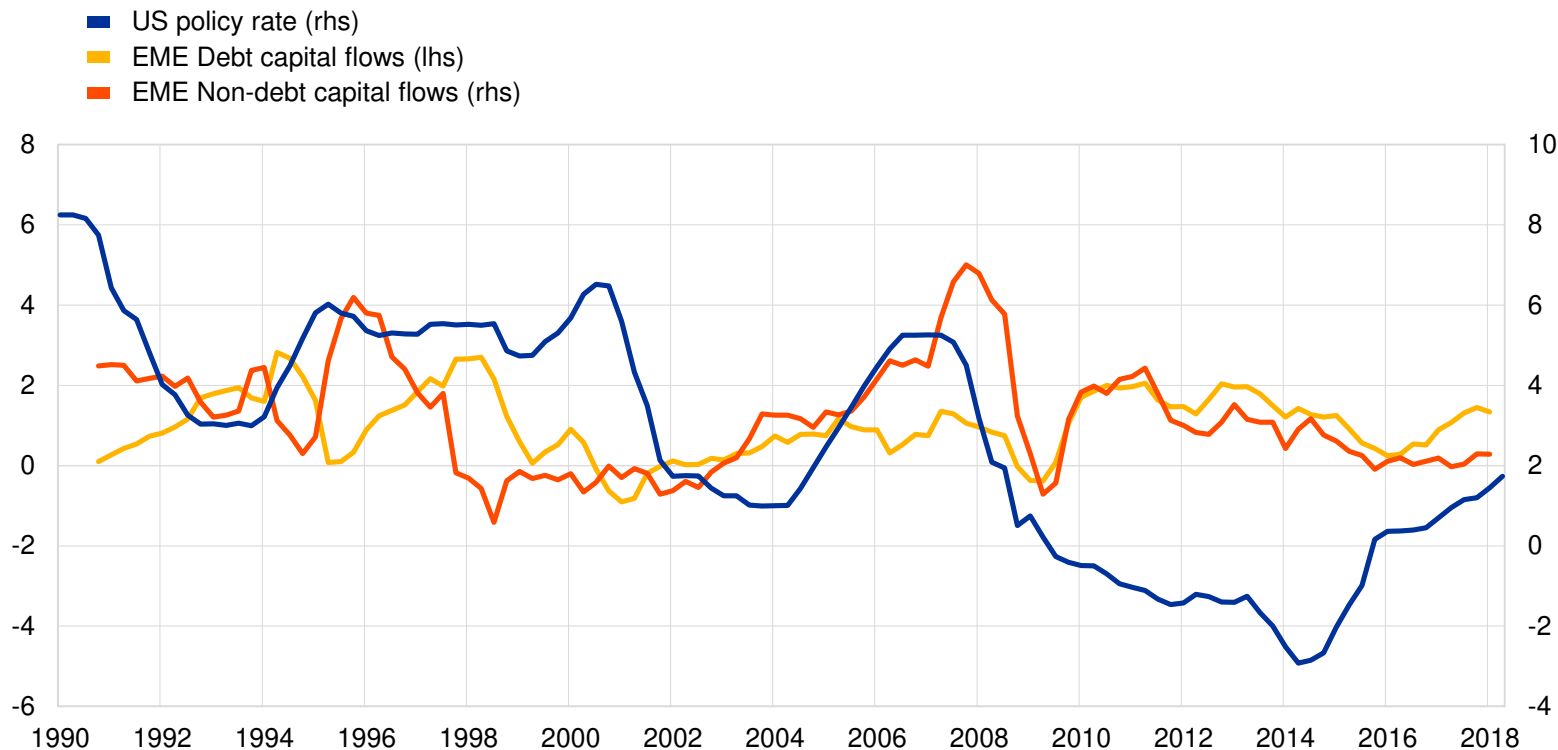
Country sample: Brazil, Chile, Czech Republic, Hungary, Indonesia, Malaysia, South Korea, Mexico, Philippines, Poland, Romania, Russia, South Africa, Thailand and Turkey.



# Fed fund rate loosely correlated with capital flow to EMEs

## Emerging markets capital inflows vs US policy rate

(quarterly data, in % of GDP (lhs), in percent (rhs))



Sources: Haver Analytics, IMF Balance of Payments Statistic and ECB staff calculations.

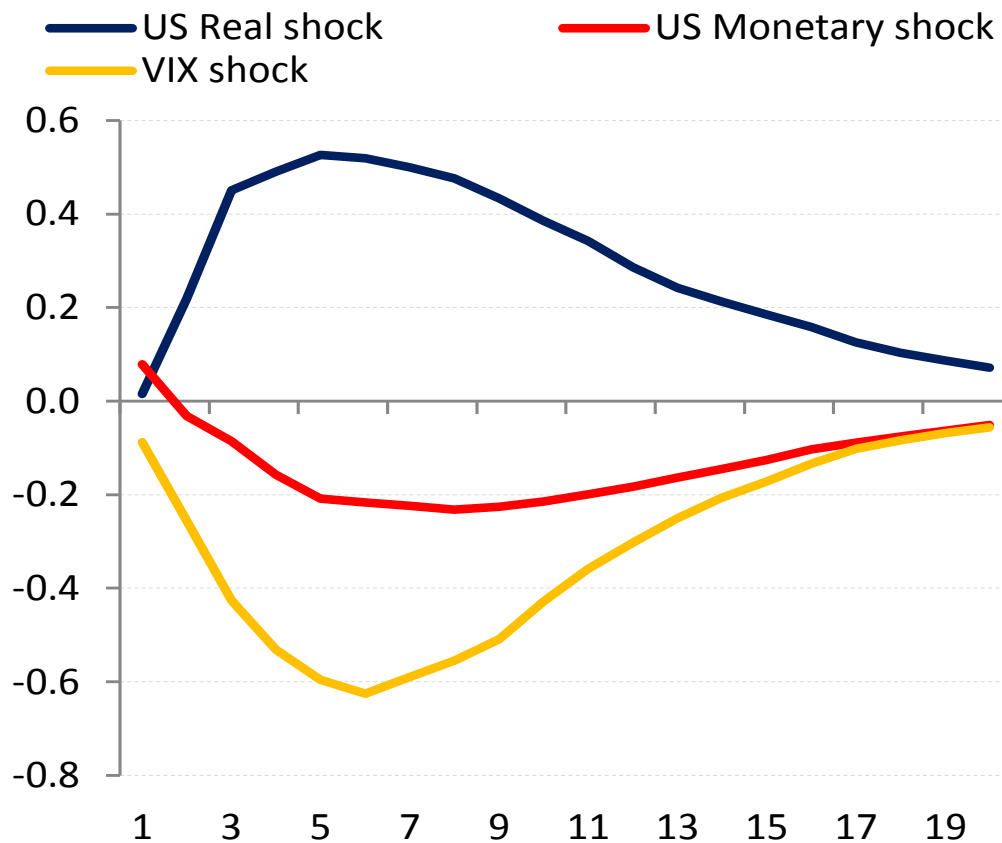
Notes: Capital inflows refer to net purchases of domestic assets by foreign investors. Non-debt flows include equity portfolio investments and other investments. Capital flows in the chart are calculated as the 4-quarters moving average. US policy rate is shown as the Federal Funds rate extended using the Wu-Xia shadow rate in the period between 2009-2015.

Country sample: Brazil, Chile, Czech Republic, Colombia, Hungary, Indonesia, Malaysia, South Korea, Mexico, Peru, Philippines, Poland, Romania, Russia, South Africa, Thailand and Turkey.

# Higher demand in ADV positive for EME despite interest rates

## Impulse response of EME industrial production to US shocks from a BVAR

(median impulse responses of year-on-year growth in EME industrial production to US shocks)

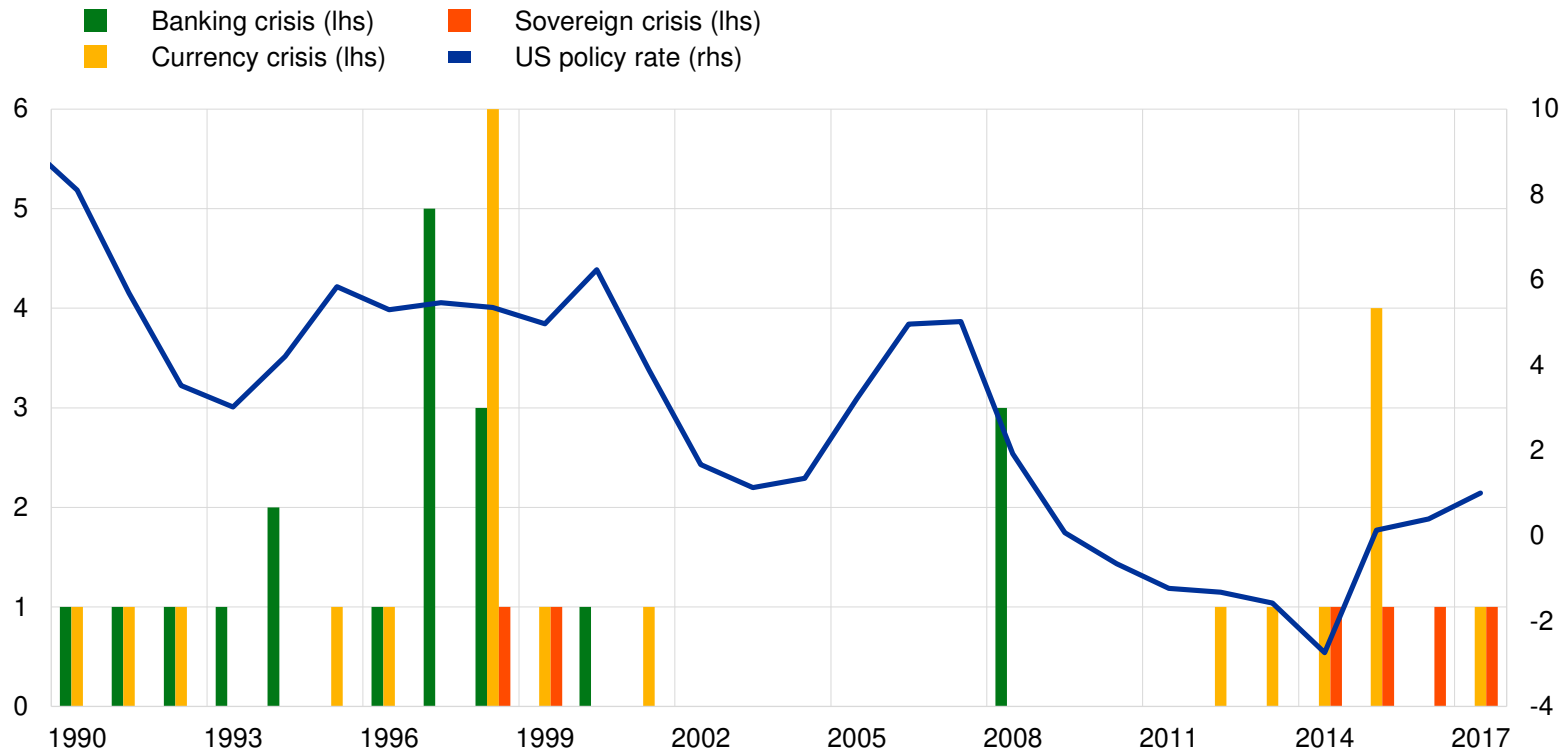


US shocks identified using a SVAR with sign restrictions are incorporated as exogenous regressors in BVARs for 16 large emerging economies. The BVAR models are estimated separately for each EME with monthly data from 2000-2014 and include a measure of global uncertainty (the VIX) and EME country-specific variables – industrial production, the nominal effective exchange rate, stock prices and 10-year bond yields. Spillovers are evaluated by examining impulse responses to US real and monetary shocks.

# Still, no reason to relax

## Emerging markets crises vs US policy rate

(number of crises (lhs), in percent (rhs))



Source: Haver Analytics, Laeven and Valencia (2013) and ECB staff calculations

Notes: the chart shows the number of crises for 20 selected major EMEs based on the methodology of Laeven and Valencia(2013), data are available up to 2017. US policy rate is shown as the Federal Funds rate extended using the Wu-Xia shadow rate in the period between 2009-2015.

Country sample: Brazil, Chile, Czech Republic, Colombia, Hungary, Indonesia, Malaysia, South Korea, Mexico, Peru, Philippines, Poland, Romania, Russia, South Africa, Thailand and Turkey.

# Where do we go from here?

- No “smoking gun” evidence that interest rates in ADV have major effects on EME on their own and if they do, it is mainly via EME fear of floating and (probably mostly) dollarization
- Evidence for the financial channel mixed at best, but research inconclusive and on-going
- Policy recommendations based on what we know:
  - Stronger EME fundamentals and GFSN will certainly do no harm; in particular, reducing foreign currency debt
  - Risk attitude of lenders matters (see G20 Eminent Persons Group report) for financing conditions in EME, driven by many factors, interest rates being just one of them
  - A system limiting this volatility will help for cushioning the effect of changes in ADV interest rates too, along with other (and probably more important) sources of risk