

Bond Markets and Monetary Policy Dilemmas for the Emerging Markets.

The expansionary monetary policy pursued in the advanced economies (AE) during the global financial crisis (GFC), by way of cutting policy rates to near zero and buying long-term assets (or extended longer-term loans), made monetary policy dilemmas harder for emerging market (EM) central banks in the post crisis period.

With growing globalization of EM financial markets with global markets; their markets, monetary policy decisions and other policy choices have faced new set of constraints. With the objective of analysis of link between global long-term rates to monetary policy and to domestic bank lending in the EMs, the paper investigates these mechanisms to develop the exit route from QE and higher (and perhaps divergent) policy rates in advanced economies. The paper also examines how long-term rates in the EMs have become more sensitive to yields in the major bond markets.

Substantial liquidity injection in AE during GFC lead to increased foreign capital flows to EM economies in search of higher yields. Quantitative easing by AE encouraged EM borrowing on capital market -corporations in foreign currency on international markets and governments in local currency on domestic markets. EM non-financial companies also borrowed heavily in the international bond markets. This lead to a growth on an inventive asset management industry - which makes some illiquid bond markets liquid to end-investors through channel of daily redemption of spread of many bond funds. Consequently, these developments have enlarged the size of the aggregate balance sheet of the domestic banking system in many EMs through sharp rise in domestic bank credit in the post-crisis period on eased lending

conditions. These linkages are key factors behind rapid rise in bank credit/GDP ratios (This is a source of vulnerability in many EMs).

With sharp rise in aggregate borrowing in US dollar bond markets by non-banks outside the United States, dilemmas for EM central banks starts with how they are affected by changes in the stance of monetary policy in AE and by non-monetary forces acting on global real long-term interest rates. In early days of financial flows to the EMs, financial conditions in EM economies depends on movements in short-term dollar-interest rates (notably 3-month Libor) -which was under the close control of the Federal Reserve. But with growing global debt markets integration, a market-determined 'world' real long-term interest rate has gained greater importance. Though there is no uniqueness in measuring the 'world' interest rate, movements in the yield on 10-year US treasuries is used as proxy for this 'world' interest rate.

After outbreak of the GFC, the world real long-term interest rate has fallen for more than a decade and hovered around zero since mid-2011. The long-term interest rate, therefore has moved for reasons driven by a compression of the term premium (the reward for holding long-dated rather than short-dated bonds), rather than changes in expected future short-term rates. Massive central bank purchases of bonds have driven long-term rates down to zero as around short-term rates. Thus it can be summarized that non-monetary factors have depressed the new 'normal' level of the real long-term rate. Consequent effect of this development was on monetary policy actions in the EM as they lost some traction in changing regime of global market integration. Although monetary policy in the EM has continued

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to be guided by domestic objectives, financial conditions in the EM have become more dependent on the world's long-term interest rate, which has driven down by monetary policies in the advanced economies and by several non-monetary policy factors.

With stimuli of asset purchasing program by the Federal Reserve and the Bank of England on an exceptional scale with the explicit aim of lowering long-term rates in their currencies, there were sizeable capital inflows into local EM Bond markets and their yields' dependence (even short-term rates) on changes in the term premium in the US dollar markets. This risk profile generates dilemmas for EM central banks especially in scenario of monetary policy normalization in the advanced economy by raising policy rates and by reducing their balance sheets. This makes foreseeing of EM central banks' balance sheet adjustment complex in the years ahead. Though US monetary policy accommodation is on verge of liftoff, the Bank of Japan and the European Central Bank are still in expansionary mode and hence the US dollar long-term rates are susceptible to global shocks -including those of a non-monetary nature. Empirical data shows that long-term interest rates in EM currencies are likely to move in the same direction of the US dollar long-term rates. But an EM central bank will try to counter this by altering its short-term rate.

The unexpectedly virulent and persistent turbulence in EM bond markets in 2013 surprised many investors and generates various scenarios depending on when and how monetary policy normalization process progressed over periods. Conclusively, there is a near-zero 'world' real long-term interest rate for a long time in absence of consensus on the underlying factors behind it. This strategic change makes term premium changes more instrumental than expected

future short-term rates. Large scale bond purchases in some major advanced economies lowered the 'world' long-term real interest rate and pushed foreign investors into local government bond market in many EMs that offer higher yields. Easy borrowing conditions in global market in pretext of liquidity injection through QE invigorate foreign investors to increase their exposures to interest rate risk, to EM currency risk and to liquidity risk. But such developments will go through reversal process either gradually or abruptly at some point of time in future.

Once the process of global monetary normalization (perhaps led by the US) starts, it will affect the EMs through several channels. The uncertainty persisted on two major fronts -first when and how the Federal Reserve monetary normalization progress and second is uncertainty over what happens in bond markets, international and domestic. Any abrupt change in monetary policy decisions in major advanced economies will change the global debt market and subsequently will change business conditions in domestic banking markets. That may lead to illiquidity in EMs interbank markets. Monetary policy in the EM has lost some traction as hard-to-influence long-term rates have become more important in their financial systems. As the policy rate continues to be adjusted to meet domestic objectives, the monetary independence has been preserved. Hence, central banks (especially of EM) have to take greater account of the impact of domestic policy rates on their bond markets, on the exchange rate and on their banks. Obstfeld (2015) was right in his opinion that financial globalization has worsened the trade-offs monetary policy faces in navigating between multiple domestic objectives.

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