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# Federal Reserve Policy and Emerging Markets

Prepared statement by

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Thank you Chairman Campbell, Ranking Member Clay, and members of the Subcommittee for the opportunity to present to you this morning my views on the effect of U.S. monetary policy actions on emerging markets.

The U.S. dollar plays a unique role in the global economy. Though the United States accounts for only 23% of global output, the dollar accounts for over 60% of global foreign exchange reserves and 75% of global imports from countries other than the United States. For emerging markets in particular, economic interaction with the wider world takes place overwhelmingly in dollars. Changes in the stance of U.S. monetary policy can have a significant impact on emerging-market capital inflows and outflows, and the resulting exchange rate movements against the dollar can have large and rapid effects on the level of inflation and exports. Monetary sovereignty in such countries is therefore often more symbolic than real. Ecuador and El Salvador, recognizing this reality, went so far as to eliminate their national currencies entirely in 2000 and 2001, and now use the U.S. dollar domestically in the same way that we do here in the United States.

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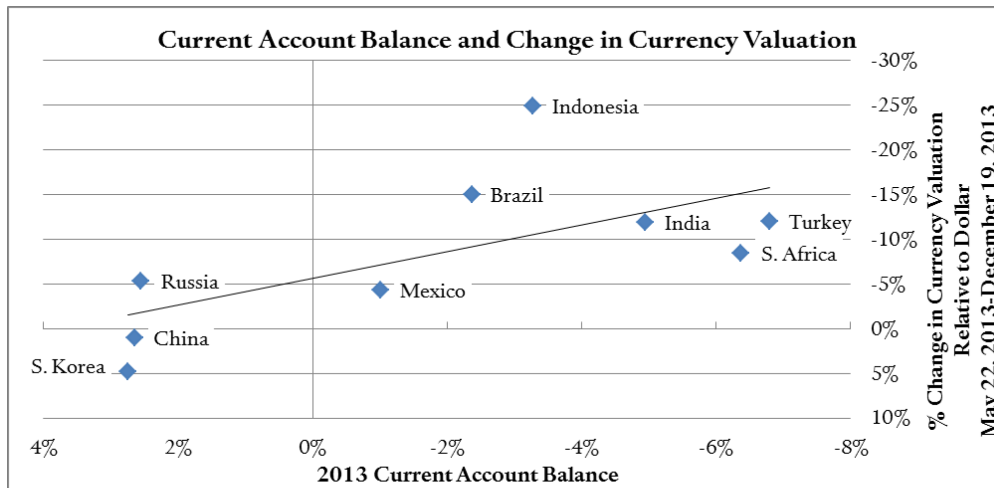
Since the financial crisis in 2008, actions taken by the Federal Reserve to increase liquidity in the U.S. financial system have had a major impact outside the borders of the United States. Quantitative easing, through which the Fed increases the monetary base by buying longer-term financial assets with newly conjured dollars, thereby pushing down their yield, was undertaken partly to encourage, and indeed has encouraged, investors to shift resources into riskier assets. Though wholly unintended by the Fed, however, this shift has at times encompassed the bonds and stocks of emerging-market countries.

A recent International Monetary Fund study found that the Fed's first round of quantitative easing from January 2009 to March 2010 resulted in $250 billion being withdrawn from emerging-market bond markets (under the logic that QE would drive the U.S. out of recession), while QE3 had the opposite effect, causing $91 billion to flow in (as U.S. asset prices had turned frothy). The net effect of so-called "Unconventional Monetary Policy" in the U.S., U.K., Japan, and Europe on emerging-market bond flows since 2008 has been trivial: a mere 0.22% of GDP.[1] The volatility of such flows, however, with its attendant effects on currency, trade, and investment, has been considerable.

Anticipation of the Fed's withdrawal from QE3, though it will only begin with a modest tapering of monthly asset purchases this month, has already had a substantial impact on the currency and bond markets of a number of important emerging-market economies – in particular, India, Indonesia, Turkey, and Brazil. My own analysis with Dinah Walker has found that the hardest-hit countries have been those running large current account deficits – countries which had been comfortably financing excesses of consumption over production for several years with dollars scouring the globe in search of return.[2] Economic growth in such countries and the investment returns coming with it, reliant as they have been on short-term capital flows from abroad, have always been the most at risk of a change in the trajectory of Fed policy from accommodation to tightening.

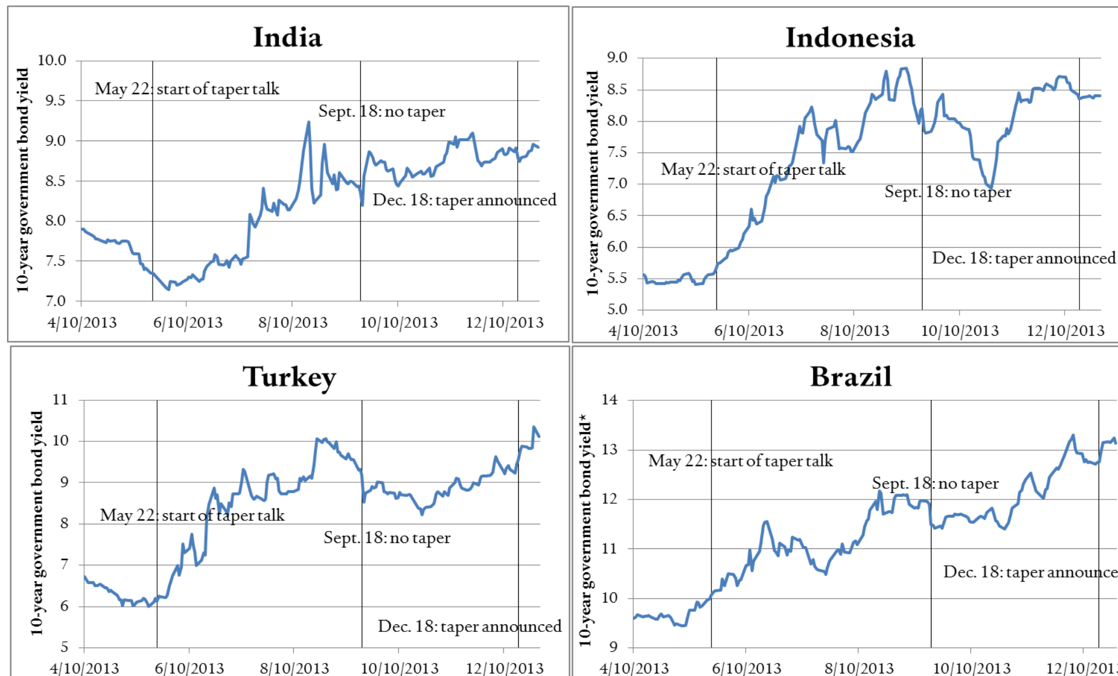
[1] "Global Impact and Challenges of Unconventional Monetary Policies," IMF Policy Paper, October 7, 2013.
[2] http://online.wsj.com/news/articles/SB10001424052702303914304579193901796521312?KEYWORDS=benn+steil

Figure 1: Countries with large current account deficits have experienced the largest currency depreciations since the start of taper talk in May




Data sources: International Monetary Fund and Bloomberg

Figure 2: Bond yields have also climbed in countries with large current account deficits




Data source: Bloomberg

*Because of missing data, Brazil chart shows 10-year bond yield through July 2, 2013 and 9-year bond yield thereafter.

Fed Chairman Ben Bernanke's carefully worded statement on the future of the Fed's asset purchase program last May, widely interpreted in the markets as an indication that a taper might begin as early as September, unleashed a wave of selling in these countries' bonds and currencies. Taper talk was particularly traumatic for India, where the central bank was obliged to raise interest rates to counter capital outflows and imported inflation from a plummeting rupee, despite the country's slowing growth.

So how can emerging markets protect themselves in advance of a tightening of Fed policy? The IMF study found that countries with a lower share of foreign ownership of domestic assets, a trade surplus, and large foreign-exchange reserves have been more resilient; they have experienced far less volatility in their currency and domestic asset markets.

This has policy implications: In good times, developing countries should apply a firm hand to keep their imports and currency down, and their exports and dollar reserves up.

Unfortunately, such policies are apt to constitute what many observers in this country would call "currency manipulation." Economists Jared Bernstein and Dean Baker recently called for the United States to impose taxes on foreign holdings of Treasurys and tariffs on imports precisely to counteract them.[3] This is, in my view, a misguided recipe for raising global trade tensions and political conflict. But the very fact that prominent commentators are calling for such action illustrates the importance of considering how the functioning, or malfunctioning, of the global monetary system can encourage a spiral of damaging policy actions. China's agreements with Brazil, Russia, Turkey, and Japan to move away from dollar-based trade, for example, have the potential to undermine the multilateral trading system, as countries that don't want to stockpile each other's currencies will use trade discrimination to prevent trade imbalances.

So what can be done?

International central bank cooperation can help at the margins by mitigating short-term liquidity problems, most notably through currency swap arrangements. The Federal Reserve recently made permanent the previously ad hoc arrangements with the European Central Bank, the Bank of Japan, the Bank of England, the Bank of Canada, and the Swiss National Bank. (The Fed extended swap lines to Brazil, Mexico, South Korea, and Singapore in October 2008, but these arrangements were allowed to expire in 2010.) Initiatives within the Asia-Pacific region have received much attention, but to date have been more for public display than for actual sharing of reserves or lending of local currency.[4] Not surprisingly, governments in the region are hesitant to extend credit to each other in a crisis, which is the only time it is actually needed.

Regarding Federal Reserve monetary policy actions, anything that makes them more predictable will, all else being equal, attenuate market volatility globally. Over the past fifteen months, the Fed has tried to do this through the formal use of so-called forward guidance. Initially, this was implemented through the setting of date-based markers for the raising of interest rate targets. These were quickly abandoned, however, in favor of data-based markers for both the raising of interest rate targets and the tapering of monthly asset

[3] http://www.nytimes.com/2013/11/07/opinion/taking-aim-at-the-wrong-deficit.html
[4] http://www.voxeu.org/article/chiang-mai-initiative-designed-not-be-used

purchases.

Both approaches are challenging to carry out in practice.

Date-based guidance is problematic in that date markers are ultimately justified by the Fed's expectations of economic conditions years into the future, and, as I have documented elsewhere, the Fed's forecasting record over the past quarter century has been poor.[5]

Data-based guidance can also create rather than reduce market turbulence when the data markers themselves are volatile, such as monthly employment figures. Asset purchases in particular are not a precision tool, so trying to calibrate them continuously to volatile economic data is fraught with difficulties.[6] It is worth recalling that Chairman Bernanke had in June suggested that asset purchases would *end* with the unemployment rate at around 7 percent; in fact, tapering is only now just *starting* with unemployment at this level.[7] Assuming the Fed had good reason to abandon the chairman's June guidance, it would have been advisable not to issue it in the first place. Finally, it should be noted that the Fed has been unsuccessful in persuading markets that a tapering of asset purchases would not in itself merit materially higher Treasury bond and mortgage rates – the latter of which rocketed in June to levels a full percentage point above those prevailing when QE3 was initiated in September of 2012 with the aim of reducing them.

New ideas for Fed data-targeting abound. Since 2009, there has been a notable coalescing of economic commentators on the left and right of the spectrum around the belief that both U.S. and global economic stability would be well served by a new rules-based approach to monetary-policy making that would commit the Federal Reserve to targeting the level of nominal spending, or NGDP (nominal gross domestic product), rather than, say, inflation. The technical merits of such a regime notwithstanding, it is my belief that the consensus supporting it will melt away the moment a future NGDP reading suggests that policy should be tightened in an environment of contained inflation and/or elevated unemployment, which it invariably will at some point.[8]

In short, rules, targets, and forward guidance for U.S. monetary-policy action will not significantly mitigate the challenges that emerging markets will face going forward in adapting to market perturbations triggered by such action, or inaction. Broadly speaking, the inevitable inconsistency that will open up between the Fed's rules, targets, and guidance, on the one hand, and unexpected economic developments, on the other, will lead either to inappropriate policy stances or a falling away of the credibility of such rules, targets, and guidance as they are abandoned or amended.

[5] http://www.cfr.org/monetary-policy/why-we-cant-believe-fed/p27425
[6] http://www.cfr.org/monetary-policy/bernanke-calibrating-markets-into-fits/p31040
[7] http://www.federalreserve.gov/mediacenter/files/FOMCpresconf20130619.pdf
[8] http://www.cfr.org/monetary-policy/facts-change-change-my-target-you-sir/p30584

It is therefore in our national interest to accept, openly, that emerging-market governments be able to implement prudent controls on short-term portfolio inflows in order to shield their economies from sudden, extreme, and unpredictable shocks, some of which may be triggered by decisions of our own Federal Reserve, taken in good-faith pursuit of the mandates assigned to it by Congress. Chile, which has been a model of prudent macroeconomic management over many years, used modest one-year unremunerated reserve requirements on capital inflows with some apparent success during the crisis-marked 1990s.[9] As major serial foreign financial crises over the past four decades have illustrated, we here in the United States also bear real costs when overexposed and underprotected banks and governments find themselves, in the face of rapid and large-scale shifts in the flows of capital internationally, quite suddenly unable to pay their bills.

I thank you again for the opportunity to participate in these important discussions here today.

[9] http://www.voxeu.org/article/do-capital-controls-work