Emerging Economies and the Monetary Tightening Path in the United States

Introduction
In tandem with a modest recovery in global commodity prices and international trade, the growth outlook for the emerging economies has improved since late 2016. Based on projections made in the World Economic Situation and Prospects as of mid-2017 report (United Nations, 2017), emerging economies are expected to experience a moderate pick-up in growth in 2017 and 2018, marking a reversal of the downward trend seen since 2010 (Figure 1). However, economic growth continues to be below the average for the period between 2000 and 2016, and emerging economies remain susceptible to external and domestic shocks, amid rising uncertainty in the international policy environment and structural weaknesses. More specifically, low commodity prices have affected investment in large commodity exporters, including Brazil, Chile, the Russian Federation and Saudi Arabia, while high political uncertainty is weighing on investor sentiments in Nigeria, South Africa and Turkey. In addition, some emerging economies, including China, are facing growing financial stability risks, arising from high asset prices and elevated debt levels.

Meanwhile, the United States Federal Reserve (Fed) has embarked on a monetary policy normalization path, as growth and labour market indicators continue to improve. In June 2017, the Fed raised its key policy rate for the fourth time since December 2015, and also announced plans to gradually reduce the size of its balance sheet. Amid high economic and policy uncertainty, however, rising interest rates by the Fed may pose considerable challenges for the emerging economies. Notably, countries with high borrowing needs, large dollar-denominated debt and fragile macroeconomic conditions are at a higher risk of experiencing large and potentially destabilising capital outflows. In this environment, policymakers will need to assess the various policy tools available that will most effectively mitigate the spillover effects of the Fed’s policy transition and enhance the economy’s resilience to shocks.

Are emerging economies at risk?
Against a backdrop of excess global liquidity, emerging economies experienced a surge in capital inflows in the aftermath of the global financial crisis (Figure 2). These inflows were driven by the widening of interest rates and growth prospects differentials between the advanced and emerging economies during that period. However, the slowdown in growth in emerging economies has affected investment in large commodity exporters, including Brazil, Chile, the Russian Federation and Saudi Arabia, while high political uncertainty is weighing on investor sentiments in Nigeria, South Africa and Turkey. In addition, some emerging economies, including China, are facing growing financial stability risks, arising from high asset prices and elevated debt levels.

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Summary
In June 2017, the Fed raised its key policy rate for the fourth time since December 2015, and announced plans to gradually reduce the size of its balance sheet. Amid high economic and policy uncertainty, however, rising interest rates by the Fed may pose considerable challenges for the emerging economies. Notably, countries with high borrowing needs, large dollar-denominated debt and fragile macroeconomic conditions are at a higher risk of experiencing large and potentially destabilising capital outflows. In this environment, policymakers will need to assess the various policy tools available that will most effectively mitigate the spillover effects of the Fed’s policy transition and enhance the economy’s resilience to shocks.

Figure 1
GDP Growth in Emerging Economies

Note: Emerging economies includes Argentina, Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Lebanon, Malaysia, Mexico, Nigeria, Philippines, Poland, the Russian Federation, South Africa, Saudi Arabia, Republic of Korea, Thailand, Turkey, Ukraine, United Arab Emirates and Bolivarian Republic of Venezuela. Figures for 2017 and 2018 are forecasts based on World Economic Situation and Prospects as of mid-2017 (United Nations, 2017). The contribution of each country’s real GDP growth to the EM aggregates was obtained using PPP weights.

Source: Authors’ own elaboration.
economies, coupled with the sharp decline in commodity prices, weaker global trade and high political turbulences in some countries, significantly reduced capital inflows in recent years. In 2015 and 2016, emerging economies experienced a significant net outflow of capital (Figure 2), and portfolio flows declined visibly in most emerging regions with respect to the flows observed in 2010-2014 (Figure 3).

While the US’ monetary normalization process is expected to proceed on a gradual path, a significant pick-up in inflationary pressures could force the Fed to raise interest rates at a faster-than-expected pace. This will in turn trigger heightened risk aversion and global financial volatility. A sudden surge in capital outflows from emerging economies will adversely impact equity prices and currencies, while significantly raising external borrowing costs and reducing monetary policy space.

The current monetary tightening process in the United States could have large spillovers on the emerging economies for several reasons. For one, the rapid rise in corporate debt post-crisis is a growing source of vulnerability for the emerging economies. Driven by cheap funds, the outstanding corporate debt of non-financial corporates has increased from 61 per cent of GDP in 2008 to 102 per cent of GDP in 2016 (Figure 4). In particular, China has seen the sharpest rise in corporate debt, with debt levels standing at over 160 per cent of GDP in 2016, while debt levels in Turkey, Chile and the Russian Federation have also increased visibly (Figure 5). High corporate leverage not only constrains capital expenditure, but also poses a risk to financial stability. As the Fed raises rates, there is a risk of an abrupt tightening of global financing conditions, forcing corporates to deleverage sharply.

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The fragility of corporate balance sheets in emerging economies has also been exacerbated by the rise in dollar-denominated debt (Figure 6). In particular, offshore borrowing by large emerging market firms through subsidiaries abroad has visibly increased in Brazil, China, the Russian Federation and Turkey. Notably, corporate debt in foreign currency has risen not only in the tradable sector, but also in non-tradable sectors, such as construction and real estate, where currency mismatches are more prominent.

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1 See the World Economic Situation and Prospects Monthly Briefing No. 96 (November 2016).
Developed by the “financialization” of the corporate sector in order to exploit carry trade opportunities has contributed to a rapid expansion of credit and a build-up of financial vulnerabilities in some countries. Moreover, a significant part of corporate debt was neither channelled to productive investments nor to high-productivity sectors in recent years (Bruno and Song, 2015). This resource misallocation not only adversely impact medium-term growth, but also raises concerns over debt sustainability (Pitterle et al., 2015).

The spillover effects from the US’ monetary tightening path on emerging economies could be considerably amplified depending on the evolution of commodity prices, the value of the dollar and the potential implementation of trade protectionism policies. Renewed weakness in commodity prices would weigh on the terms of trade of commodity exporting countries, further undermining profitability and credit worthiness of the corporate sector. While global commodity prices have recovered modestly from the record-lows seen in early 2016, prices have remained well below pre-crisis levels. This has left many commodity-dependent economies in Africa, Latin America and Western Asia with subdued growth, fragile export earnings and relatively weak fiscal positions. Meanwhile, a significant appreciation of the dollar could exacerbate the difficulties in rolling over dollar-denominated corporate debt. The Federal Reserve Economic Data (FRED) Broad Trade Weighted US Dollar Index has appreciated by almost 20 per cent since early 2014, and a further appreciation could significantly increase the risks of corporate distress and default. Noticeably, Alfaro et al. (2017) shows that while corporate balance sheets are in general less levered than during the build-up to the Asian Financial Crisis, corporates in emerging economies remain highly vulnerable to financial shocks, particularly sharp exchange rate devaluations. Also, further protectionist policies could increase pressures on the balance of payments through capital outflows and a worsening trade balance in some economies.

Overall, while there is limited risk of a widespread emerging market debt crisis, the feedback loops between tightening global financial conditions and the real economy could significantly undermine the growth outlook in emerging economies. Given the strength in macroeconomic fundamentals, the prospects across emerging economies vary significantly. Notably, however, emerging economies with high borrowing needs, large dollar-denominated debt and fragile macroeconomic conditions will likely be the most susceptible to large and potentially destabilising capital outflows. Against this backdrop, the implementation of an appropriate policy mix in emerging economies encompasses significant challenges.

**Policy Challenges**

Recent decades have shown that global financial cycles and capital flows amplify business cycles in emerging economies, encompassing significant policy challenges. In turn, empirical evidence suggests that strong macroeconomic fundamentals tend to provide little insulation to sudden changes in global financing conditions, and that “sudden stops” episodes continue to have real economy effects in emerging economies (Eichengreen and Gupta, 2016). In recent years, however, emerging economies have also become more prepared to utilise a wider, and more heterodox, policy toolkit in facing external shocks through the
use of monetary, fiscal, exchange rate, macro-prudential policies and capital controls (Gosh et al., 2017).

However, the implementation of policies often entails significant trade-offs. In addition, despite the availability of a wider policy toolkit, it appears that emerging markets have become more sensitive to global financial conditions after the global financial crisis of 2007/08, as a result of larger financial shocks and stronger interconnectedness with global financial markets. For instance, Ahmed and Zlate (2014) and Brandão-Marques et al. (2015) show that, after the financial crisis, portfolio flows to emerging economies have become more sensitive to interest rate differentials and to global financial conditions. Given the persistently challenging external environment, emerging economies need to carefully calibrate the policy mix to strengthen growth prospects and create an enabling macroeconomic environment in order to make significant progress towards achieving the Sustainable Development Goals.

In the near term emerging economies need to deploy a more effective use of fiscal policy and progress further on structural reforms to promote investment demand, lift potential growth and encourage a sustained and inclusive growth. As highlighted in the World Economic Situation and Prospects 2017 (United Nations, 2017), a balanced policy mix is required to achieve stronger and more sustainable growth. In particular, fiscal policy should play a key role in managing domestic demand by altering the level and composition of public expenditures and implementing income policies. Fiscal policy should also act as a catalyst for private investment through public-private partnerships and other policy instruments to boost the private engagement in innovation, infrastructure, renewables and green energies, among others. In addition, policymakers should prioritize reforms that address structural bottlenecks which are constraining investment and productivity growth. The revival of investment is a key challenge going forward, even in emerging economies with a relatively solid outlook. A sustained recovery of private investment is necessary to boost productivity growth, which is a long-term determinant of income and living standards.

Monetary policy has played a key role in promoting macroeconomic stability in recent years, as emerging economies coped with domestic turbulences and external headwinds, including high financial volatility and the collapse in commodity prices. In the short to medium-term outlook, however, the role of monetary policy in supporting growth in emerging economies will be constrained by the tightening cycle in the United States. Also, the potential effects on growth from further easing are likely to be limited, given that loose monetary policies have been relatively ineffective in boosting domestic demand in recent years. Notably, private investment has remained largely subdued in many emerging economies. Also, recent empirical evidence has shown that global financial conditions tend to generate large spillovers into local financial markets and to disrupt domestic monetary policy efforts to manage financial conditions. For instance, Rey (2015) highlights the existence of a global financial cycle in capital flows, asset prices and credit growth that co-moves with volatility, uncertainty and risk aversion, which is not aligned with countries’ specific macroeconomic conditions. As a result of this global cycle, monetary policies, especially in highly integrated capital markets, become independent “if and only if the capital account is managed”.

Looking ahead, emerging economies need to strengthen the design, implementation and evaluation of macro-prudential policies to limit the excessive credit growth, avoid risky currency mismatches and promote an analogous increase in productive investments. The implementation of prudential measures constitutes a major policy tool to contain financial fragilities (Hanson et al., 2011, Hahm et al., 2012). However, each country needs to evaluate and assess the policy tools available in order to implement a policy mix that most effectively addresses its priorities. For example, broad-based capital tools, including counter-cyclical capital buffers and dynamic provisioning requirements, can alter credit growth, while the implementation of sectoral tools, such as loan-to-value and debt-to-income ratios and capital requirements can target vulnerabilities in specific sectors, such as corporates and households. Meanwhile, liquidity and structural tools can also increase the strength of the financial sector through reserve requirements, funding ratios or capital surcharges to large banks. The activation and duration of these measures should be calibrated to country specific circumstances and coordinated with the monetary policy stance. Moreover, understanding the complementarities of these measures with other macroeconomic policies and capital controls constitute a major area for future research, especially in emerging economies where financial markets are developing rapidly.
References


