

The Fed, Monetary Policy, And the Effects on Emerging Economies

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At the time of this writing, the U.S. Federal Reserve (Fed) is the world's most closely watched and feared central bank. Its decisions over the coming months will have direct, adverse repercussions for emerging economies, particularly those most indebted in dollars and in international financial markets. The importance of these decisions resides in the worldwide acceptance of the dollar as the main currency for commercial, financial, and reserve transactions.

All eyes are on what will happen in December and whether the Fed, the world's biggest central bank, will fulfill the much-announced "return to monetary normalcy" putting an "end to taper tantrum"; this would make for a drop in monthly bond issues and a future rise in federal fund interest rates,¹ which during the Great Crisis have remained close

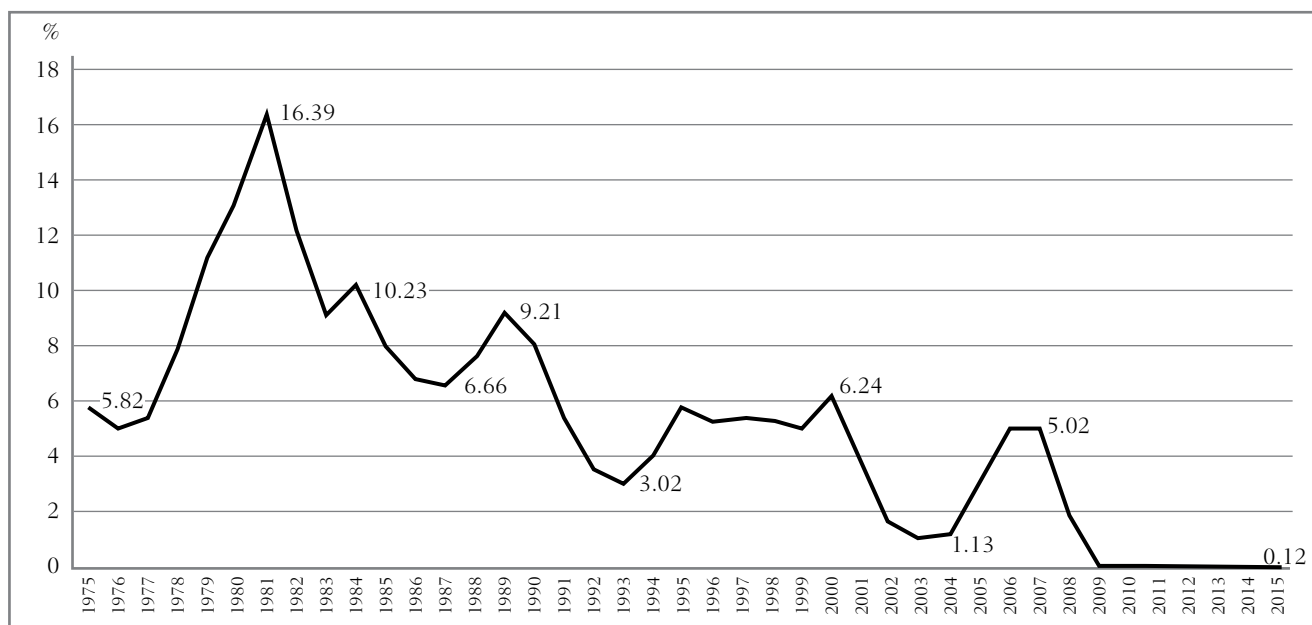
to zero (see Graph 1). This rate lift-off was postponed in June and September of 2015, justified by the weak rise in domestic prices and the country's precarious job and economic growth numbers.²

The expectation is by no means irrelevant. History justifies the fears in the face of an eventual change in the Federal Reserve's economic policy; the Fed has decided to restrict its monetary policy (increasing the interest rate) four times in the last four decades. On every occasion, this unleashed processes that cut employment and production much more than analysts had initially foreseen both inside and outside the United States. Today, given the possible interest rate adjustment, the living memory of financial havoc, particularly in the emerging markets of Latin America, warns of the threat that history could repeat itself, above all in these highly dollar-exposed economies with strong capital flows.

In the last 35 years, the Fed's monetary policy decisions have changed the course of capital flows toward Latin Amer-

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GRAPH 1
FEDERAL FUNDS RATE (1975-2015)



Source: <http://www.federalreserve.gov/releases/h15/data.htm>.

ica's emerging economies, encouraging massive capital inflows or flight. Graph 2 shows how the 2008 financial crisis sparked huge portfolio investment in the emerging economies, reaching historic records of US\$150.5 billion in 2011 and US\$127.67 billion in 2015.

The facts show the close correspondence between changes in the Fed's monetary policy, mainly interest rate variations, and financial crises in the region. The first episode was the "debt crisis" of 1982, when Paul Volcker, then head of the Fed, promoted the increase in federal fund rates to reduce domestic inflation and avoid "the economy's overheating"; the rate went from 11.2 percent in 1979 to 16.39 percent in 1981, with the resulting financial and economic debacle for Mexico and the rest of Latin America.

The next critical episode came in the mid-1990s with Allan Greenspan piloting the Fed. He promoted the creation of financial instruments known as securities linked to all manner of assets by institutional investors and investment banks, creating a huge bond bubble with expectations of very short-term profitability in local markets like Mexico, thus prompting the first great crisis of financial securities on a world level in December 1994, or the first crisis of the twenty-first century and the successive capital flight and GDP reduction in the second half of the 1990s.

When Greenspan put the brakes on monetary policy, he proved that even a small hike of 0.25 percent in the interest rate could have a huge effect on the prices of short- and long-term financial assets, as well as the costs of local companies holding dollar-denominated debt. The emerging countries were devastated by this action when the corporations with large foreign-currency-denominated debt went into bankruptcy in the 1990s.

The most recent episode was in 2007 with devastating effects mainly for the developed countries, with its epicenter in the United States, as a result of the long process of financial deregulation, added to the commercialization of huge volumes of financial transactions based on the unprecedented securitization of mortgage assets in conditions of high risk and volatility that the Fed's own policies fostered. The big investment banks, institutional investors, and other financial insti-

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tutions brought the world to its knees in the face of global financial collapse.

Although the Fed always talks about putting domestic considerations first, the decision-making with regard to monetary policy is actually carried out in favor of institutional investors and Wall Street. It is obvious that with the dollar as the world's reserve currency, any movement in its value will affect all the economies on the planet. According to the UNCTAD, the 2015 drop in world trade and last summer's financial crisis with the volatility in world stock markets at historic highs, surpassed only by the collapse of Lehman Brothers in 2008, forced the Fed to be more cautious in its monetary policy changes.

Last September was the seventh anniversary of the Lehman Brothers bankruptcy, which threw into high relief one of the Fed's greatest historic errors, and which, in the opinion of many experts, caused the worst world recession since the Great Depression. After that, the Fed decided to implement an extraordinary monetary policy to reactivate the economy and avoid a generalized collapse. These extraordinary—or less orthodox—measures were implemented in an

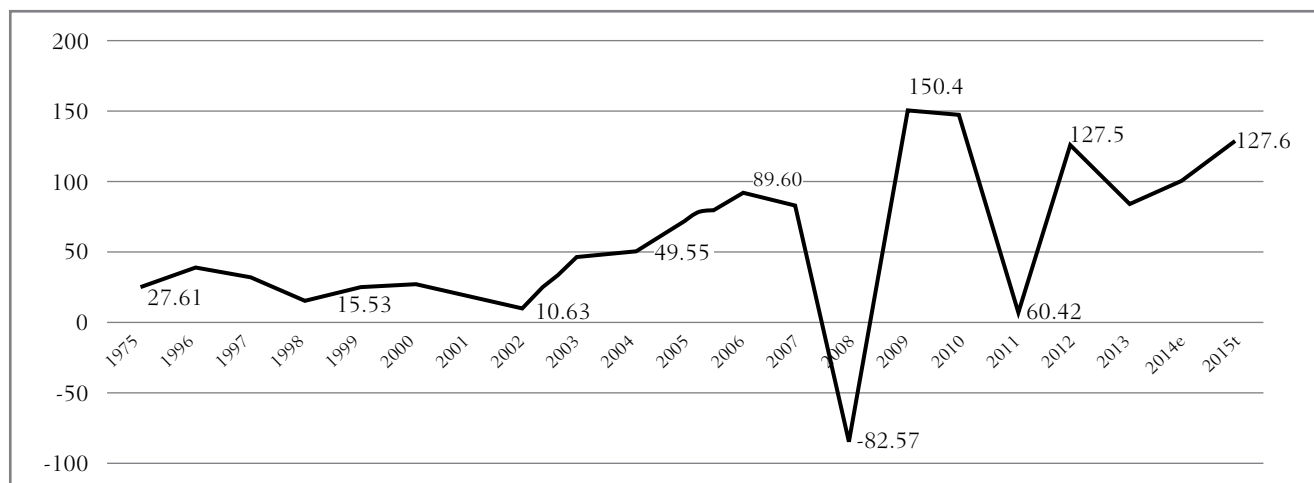
attempt to contain the deflation of assets and a generalized collapse of financial institutions with big problems on their balance sheets due to their interconnections with other firms on the verge of total insolvency.

At the beginning of the crisis, and given the obstruction of financial markets, the Fed channeled enormous quantities of liquidity into the U.S. financial system and cut the benchmark rate to 0.25 in December 2008. Also, the authorities launched different bailout programs for the financial institutions at risk of bankruptcy or insolvency.

Concretely, the Fed implemented three extraordinary measures:

1. Injection of liquidity or quantitative easing. This increased the central bank's balance sheet by upping the monetary base without growing the risk; that is, the central bank injected liquidity by purchasing public debt from financial bodies.
2. Qualitative expansion of the balance sheet. This policy transfers risk to the central bank at the time of purchasing assets from corporations, reducing the possibility of insolvency. That is, the central bank offers "clean" loans to financial institutions in exchange for lower quality assets.
3. Directly purchasing debt from corporations by printing money, thus increasing the amount of currency in circulation and reducing the interest rate starting in October 2008.

GRAPH 2
PORTFOLIO INVESTMENT IN EMERGING MARKETS (BILLIONS OF USD)



Source: <https://www.iif.com/publication/em-debt-monitor/emerging-market-debt-monitor>.

When interest rates were reduced, the holders of that liquidity sought greater yields elsewhere, like the emerging markets, particularly Mexico, to place their capital.

Since that time, the Fed has carried out an extraordinarily accommodative monetary policy, by pumping liquidity into the market and financial institutions as they need it, attempting to maintain the interest rate close to zero, as mentioned above. With this, it has helped preserve the value of financial assets by purchasing low-quality assets and —not very successfully— creating incentives for economic recovery. However, some authors think that its quantitative easing policy has also fostered unprecedented indebtedness of non-financial sectors.

Another big problem created by Fed decisions is the propagation of large pro-cyclical flows of capital as a result of the abundant injection of liquidity. When interest rates were reduced, the holders of that liquidity sought greater yields elsewhere, like the emerging markets, particularly Mexico, to place their capital, giving rise to an accelerated process of trans-

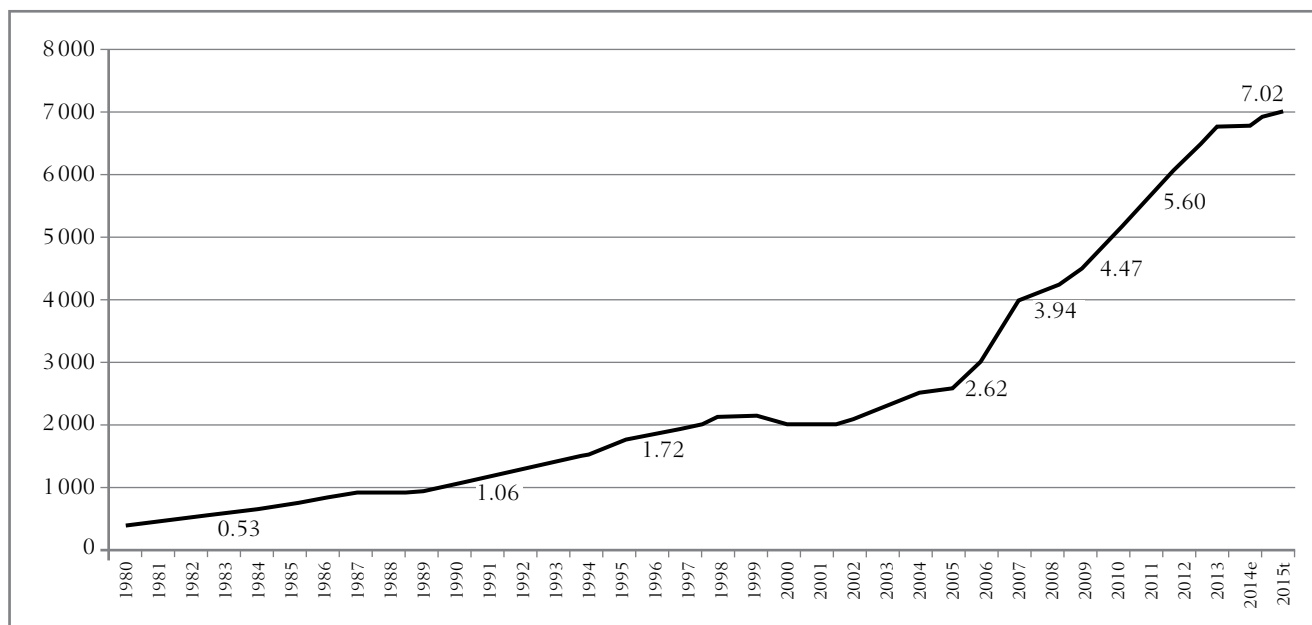
border carry trade. This strategy consists of using money loaned in dollars to fund investments in more profitable assets in other currencies and other markets, taking advantage of exchange-rate and interest-rate, differentials, thus fostering leveraged speculation, financial asset bubbles, and the assumption of risk by financial institutions without those resources being used for loans for productive activities.

For all these reasons, just by announcing a drop in monthly bond purchases and a future hike in the federal funds rate, the Fed has shaken the financial markets fed by these pro-cyclical capital flows that are seeking places with greater profitability, pushed by the conditions of the Great Crisis.

CONSEQUENCES FOR THE EMERGING ECONOMIES

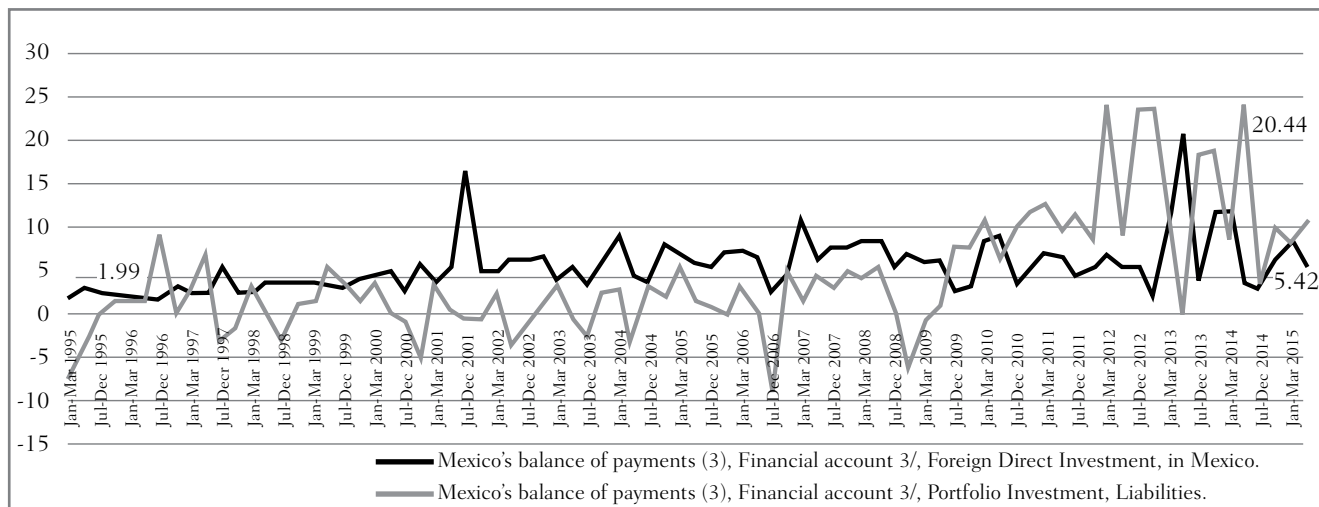
According to the International Monetary Fund (IMF), as U.S. interest rates rise, the future normalization of U.S. monetary policy has two possible scenarios: in the best of cases —though this is unlikely—, we could expect a relatively harmonious, streamlined withdrawal of capital in an atmosphere of growing financial volatility. The other scenario, which is more likely, would be an abrupt exodus of capital from the emerging economies, encouraged by a rapid rise in yields in the advanced economies, a big strengthening of the dollar, and accelerated

GRAPH 3
TOTAL EXTERNAL DEBT OF THE EMERGING ECONOMIES (TRILLIONS OF USD)



Source: <https://www.iif.com/publication/em-debt-monitor/emerging-market-debt-monitor>.

GRAPH 4
FOREIGN INVESTMENT IN MEXICO (BILLIONS OF USD)



Source: Developed by the author using data from <http://www.banxico.org.mx/SieInternet/consultarDirectorioInternetAction.do?accion=consultarDirectorioCuadros§or=1§orDescripcion=Balanza>.

financial instability.³ In fact, liquidity in fixed-income markets both in the United States and other economies could drop.

What is more, as pointed out in the April 2015 edition of the *World Economic Outlook* report, the events in Russia and the Ukraine, the Middle East, and part of Africa could create greater tensions for trade and financial transactions worldwide. Direct financial links could increase the risks of world financial instability, demonstrating that geopolitical risks also contribute to instability.

The continued appreciation of the dollar and a brusque increase in U.S. interest rates, together with the worsening of geopolitical risks could exert more pressure on the currencies of the emerging economies and stock markets. After a prolonged period of capital flows into emerging economies, capital from abroad could abruptly reduce its tendency to take on debt in local currency, thus exacerbating the turbulence and creating difficulties for refinancing public and private debt in foreign currency.

Given the seriousness of the matter, a consensus has developed among the biggest economies and multilateral financial agencies like China, the World Bank, and the IMF, shown in their recommendation to the Fed not to increase its interest rate. The main argument is the slow growth in the developed countries and the stagnation of the emerging economies. Having the dollar as the main reserve currency implies that an increase in interest rates would bring with it a hike in the

cost of international loans and the re-appreciation of the dollar *vis-à-vis* other currencies, as well as the massive withdrawal of capital from the emerging markets and its redirection to the United States in search of higher yields through exchange-rate differentials.

What is clear today is the continual appearance of financial risk and the structural shifts in credit markets toward securitization.³ These developments are transferring attention from risks to the advanced economies toward the emerging economies and from the traditional banking sector to the parallel or shadow banking sector.⁴ For its part, the continual appearance of financial risk due to a quest for greater yields continues to raise the values of certain assets. A context of low interest rates also poses challenges for long-term assets, particularly in Europe's weaker life insurance companies.

One of the repercussions of the Fed decisions is that corporate indebtedness in the emerging economies has increased in the last decade. As Graph 3 shows, the total debt of the emerging economies (China not included) soared from

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US\$530.31 billion in 1983 to US\$4.46 trillion in 2008 and 7.02 trillion in 2015. According to the IMF's 2015 report, the debt of non-financial firms in the main emerging markets, including China, reached US\$18 trillion in 2014, when in 2004 it had only been US\$4 trillion. Indebtedness grew in construction and the energy sector, like oil and gas, due to the drop in international prices.

Low interest rates in the advanced economies, particularly the United States, Europe, and Japan, have favored this indebtedness. Companies' leveraging has included a large proportion of liabilities in dollars.⁵ While leveraging can facilitate investment, it can also increase the risk of default and the lack of liquidity. IMF estimates of corporate leveraging show that it underwent an important increase in China, Turkey, Chile, Brazil, Peru, Mexico, and Colombia, the countries most vulnerable in the case of a change in U.S. monetary policy.

Many of the loans have been provided by banks, but, to a large extent, corporate debt has been created through bond issues. The dependence on international financial conditions is a source of vulnerability for corporations and the emerging economies themselves, above all when financial markets are shaky.

Fed decisions have had a decisive influence on capital flows to Mexico. Graph 4 shows how foreign portfolio investment there has increased more than foreign direct investment due to the Fed's 2008 quantitative easing policy. This has accelerated external indebtedness, leaving us highly exposed. On the other hand, since the last quarter of 2014, macroeconomic and financial variables have evolved negatively. Prospects for growth in 2015 and 2016 have contracted, partially as a result of plummeting oil and raw material prices, trends that may continue until 2016. Continual fluctuations in the real exchange rate have generally reflected constant withdrawal of pro-cyclical capital since December 2014, increasing the risk of financial instability in the country.

CONCLUDING THOUGHTS

The threat of another devastating financial crisis continues to exist. Nevertheless, the conditions for it to come about in the emerging economies exist now due to their economic and financial vulnerability, mainly because of their huge foreign-currency private and public debts. A move to raise interest rates by the Fed could bring financial disaster for these economies. We have to be prepared. However, it is imperative that

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we put forward a change in the growth model adopted by these emerging economies, leaving behind the dependence on foreign capital at a time that the advanced economies are inhibiting the growth and mobility of that very capital. ■■

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NOTES

- ¹ The federal funds rate is the interest rate that banks charge each other for short-term or overnight loans. It has been used as a point of reference or target rate for monetary policy.
- ² Since then Fed interest rates have risen only twice, the first at the beginning and the latter at the end of 2016.
- ³ IMF, "Global Financial Stability Report 2015," <https://www.imf.org/external/pubs/ft/gfsr/>.
- ⁴ That is, securitized debt and bond issues are increasingly replacing bank loans to corporations.
- ⁵ A deregulated banking system that operates parallel to the regulated banking system.
- ⁶ "Leveraging" refers to an increase in companies' ratio of debt *vis-à-vis* assets.