Unconventional Monetary Policy in Emerging Markets and Developing Economies

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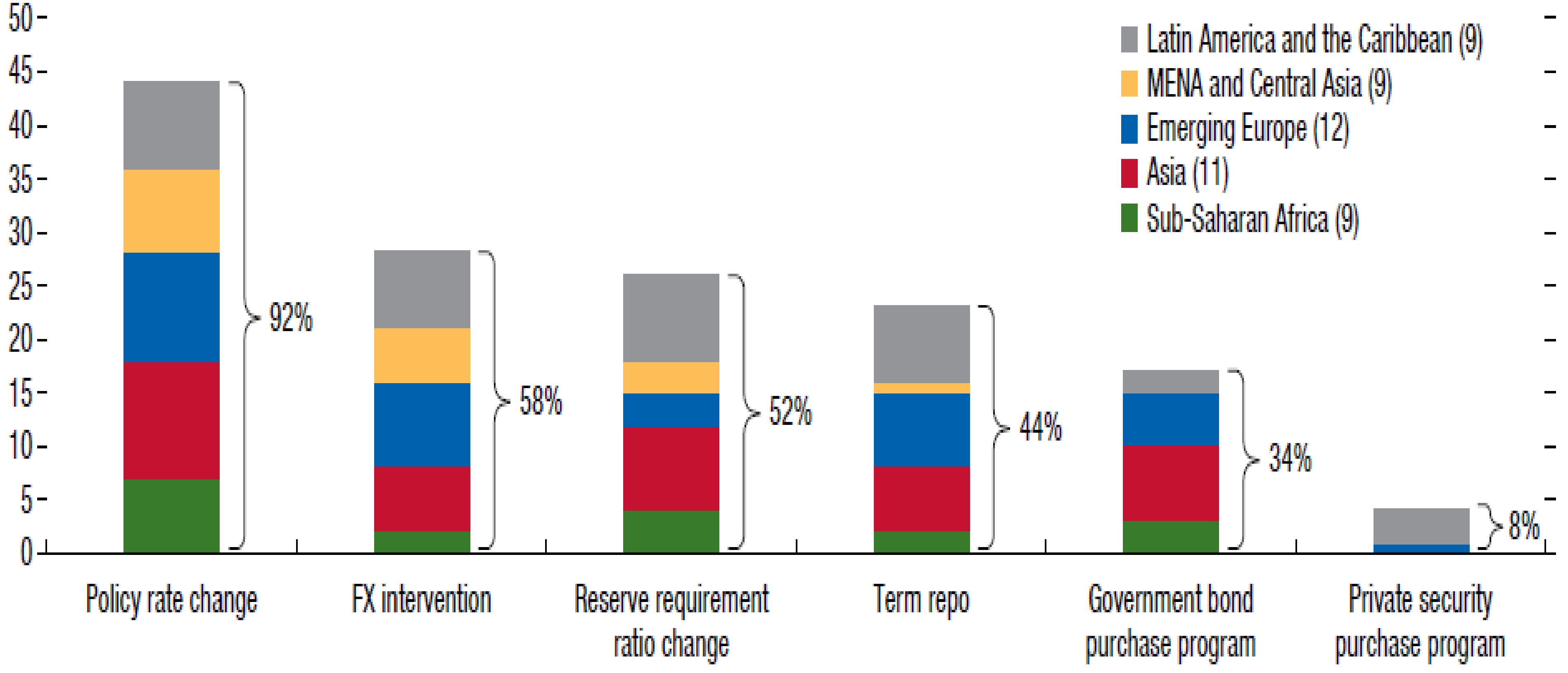
COVID Sell-off and Emerging Markets: Policy Response

Emerging Market Central Banks Policy Response

Central banks responded forcefully to the COVID-19 crisis, with an array of measures to stabilize economic conditions and boost liquidity, including asset purchases in close to 20 countries

Central Bank Policy Actions
(number of central banks; percent of sample in brackets)

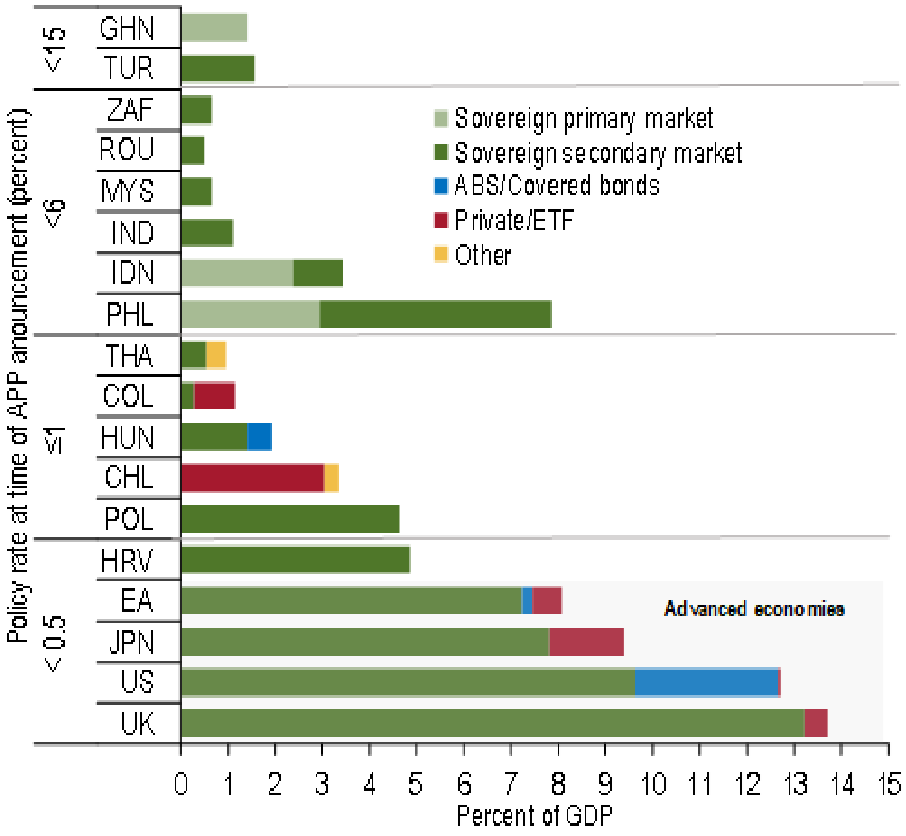


Central Bank Asset Purchases: New Policy Tool on the Block

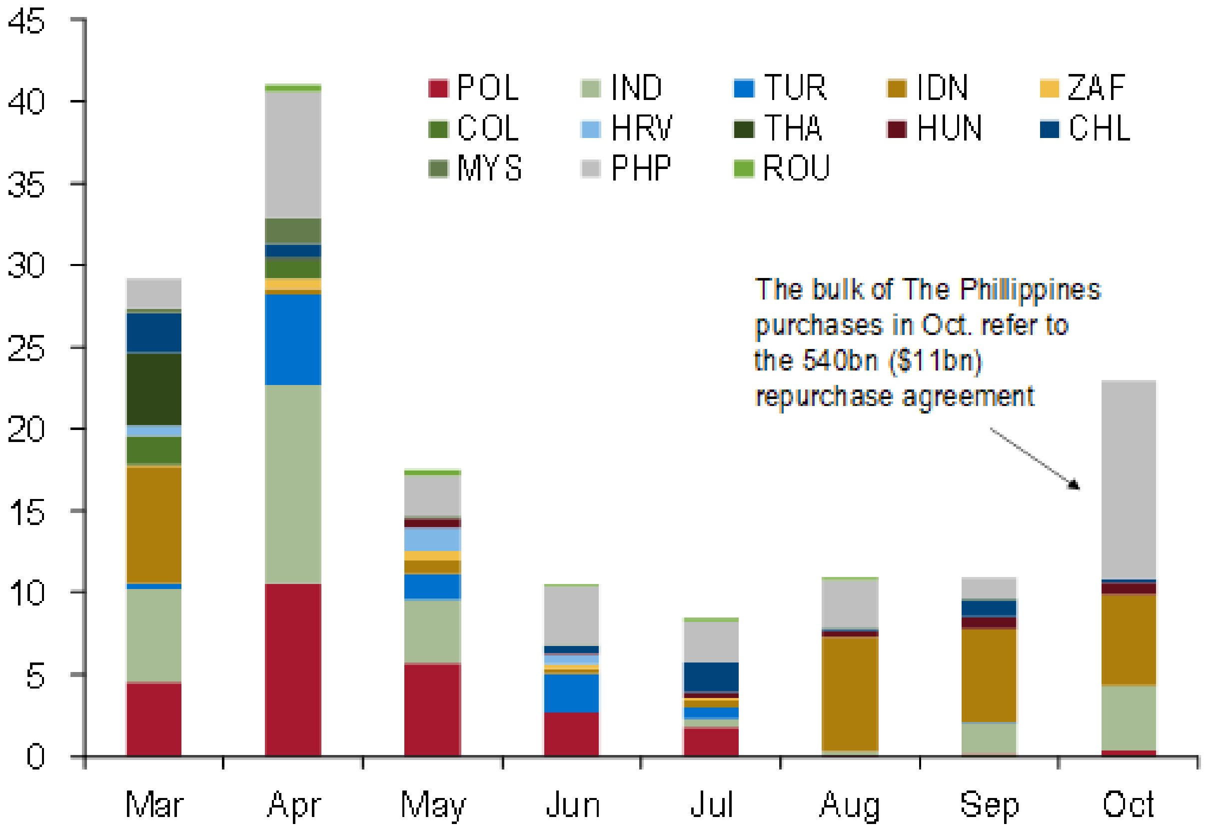
Asset purchase programs (APP) in emerging markets differ in scope, size, and duration from those in advanced economies and are often used with higher policy rates.

The pace of purchases has come down over time

Central Bank Asset Purchases through August (Percent of GDP)



Monthly Purchases (USD billions)

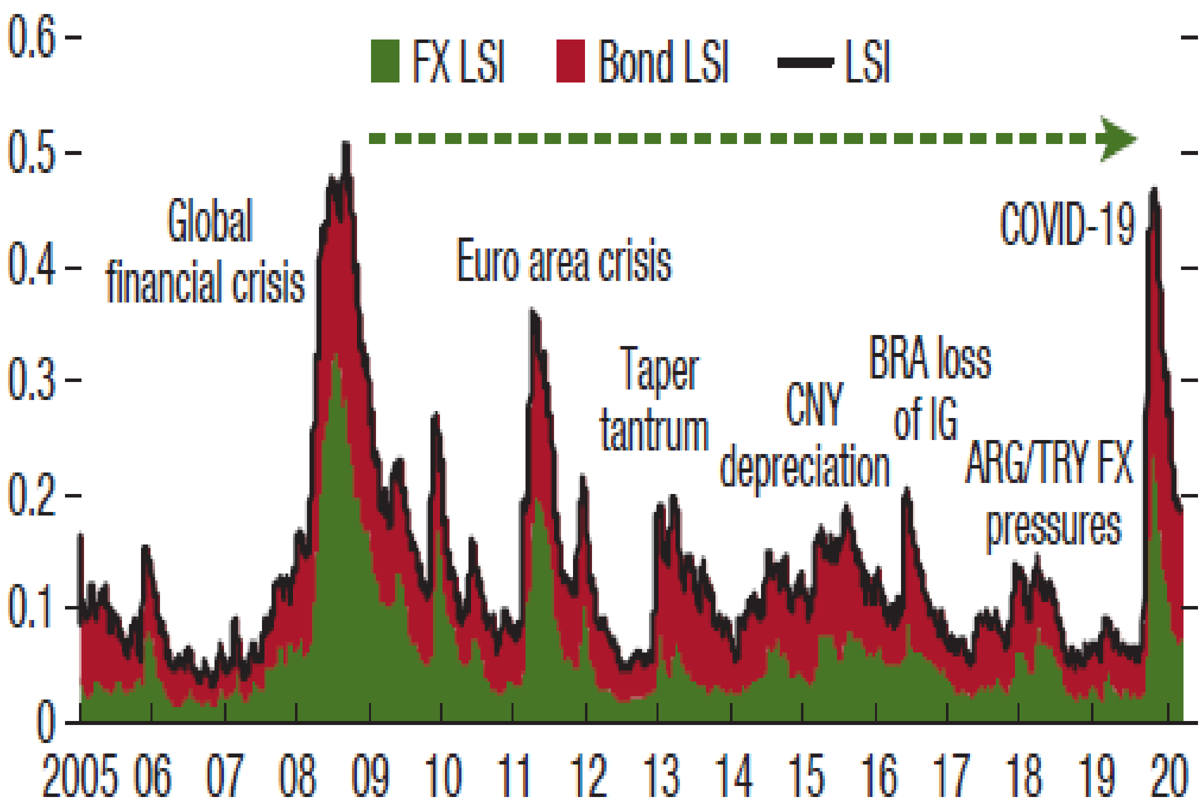


New Index to understand the market stress

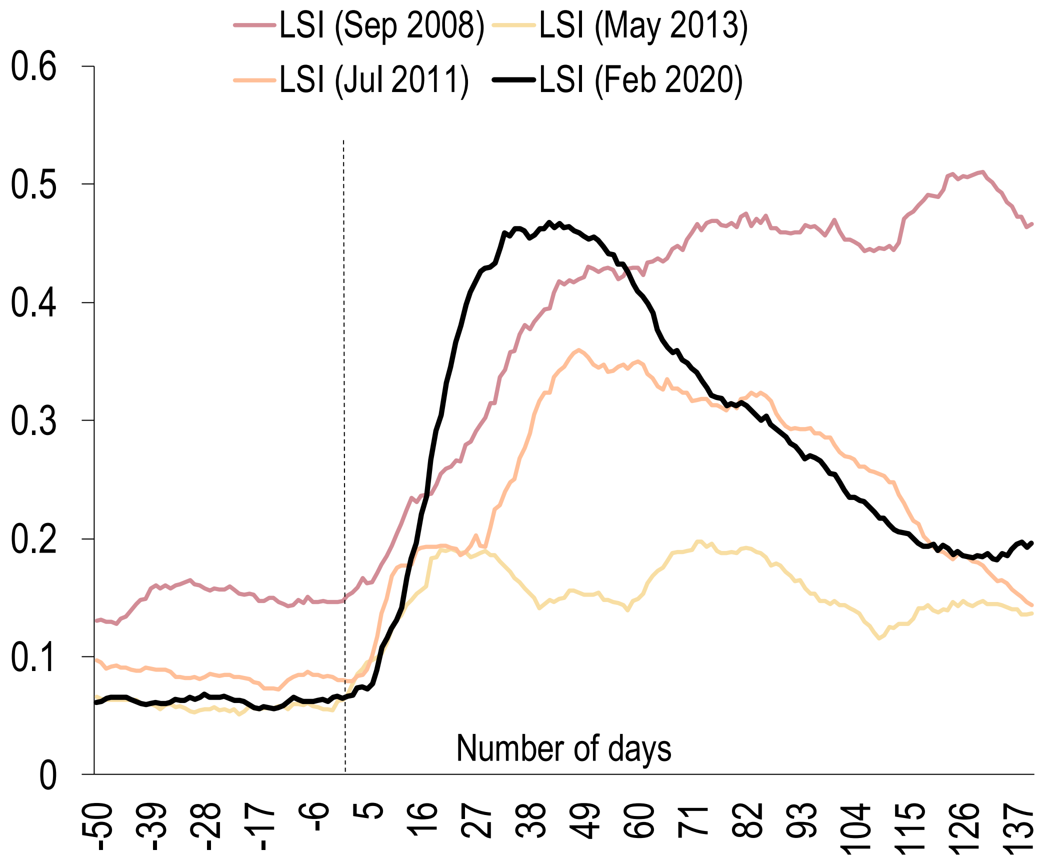
The COVID-19 shock led to significant market dysfunction comparable to that of the 2008 global financial crisis …

… while stress dissipated faster than in previous episodes, it remains elevated

Emerging Market Local Stress Index
(Index)



Emerging Market Local Stress Index
(Dates in parentheses correspond to day = 0)

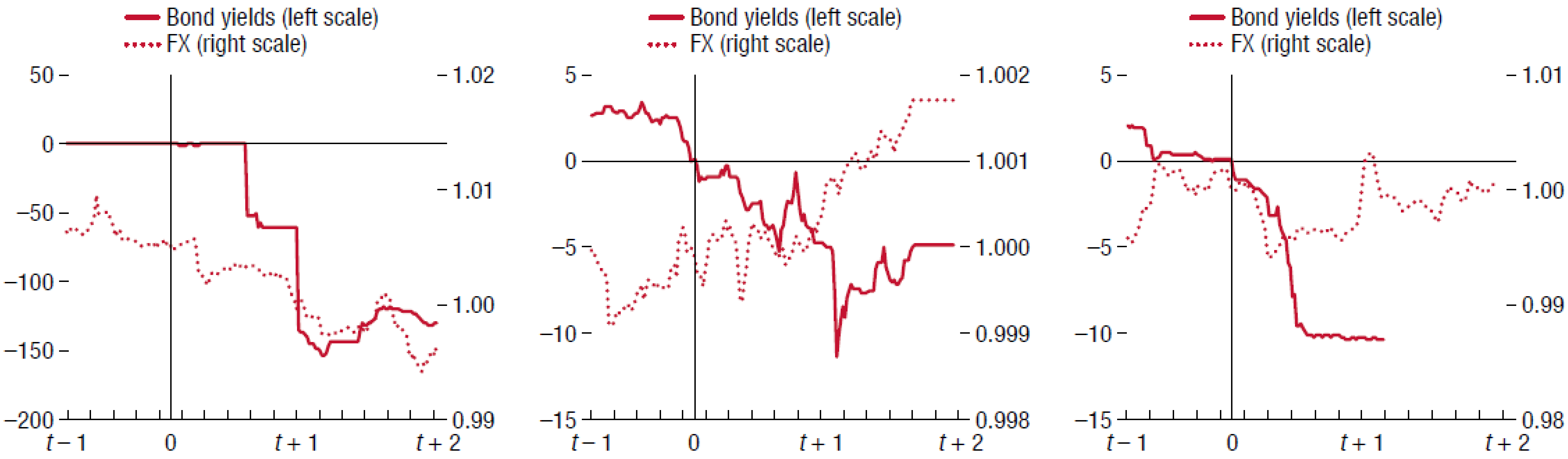


Effectiveness and Impact of the Policy Measures

Asset Purchases and impact on domestic financial markets

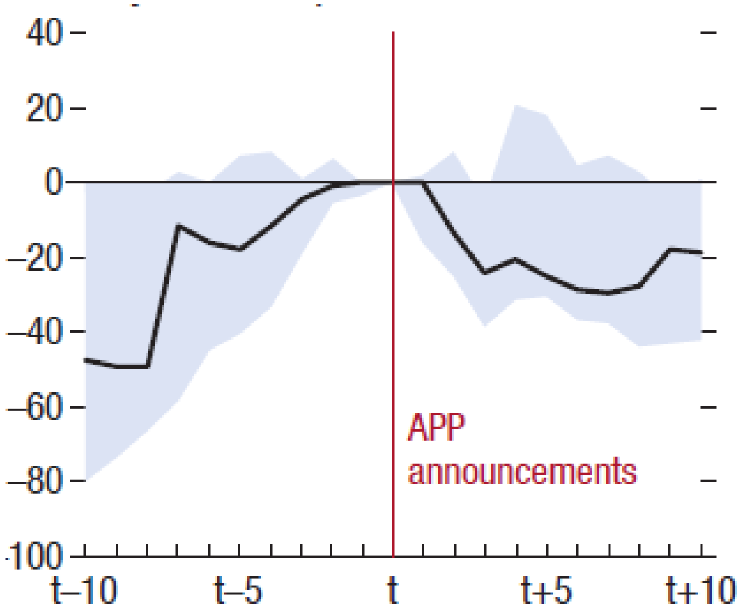
Intraday price reaction showed a similar trend, with government yields reacting very sharply, but relatively limited impact on emerging market currencies.

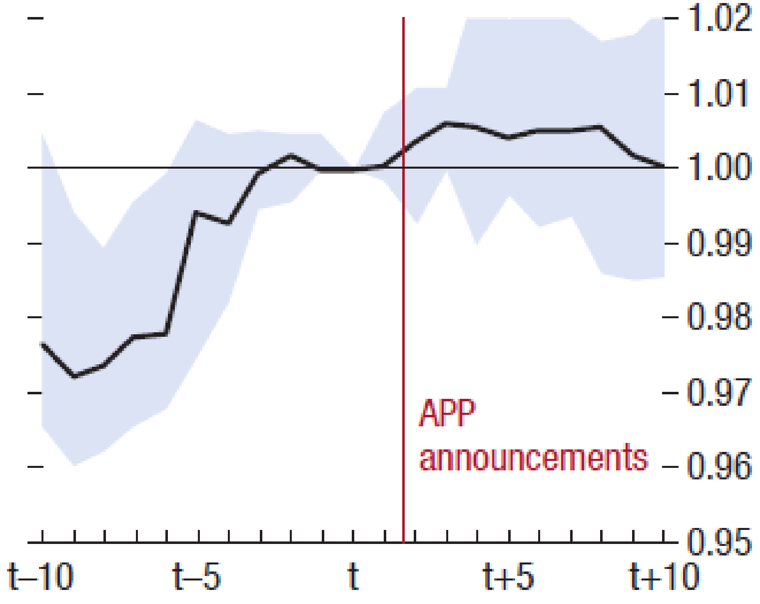
4. Intraday Asset Price Movement on the Days of Asset Purchase Program Announcements for Selected EMs

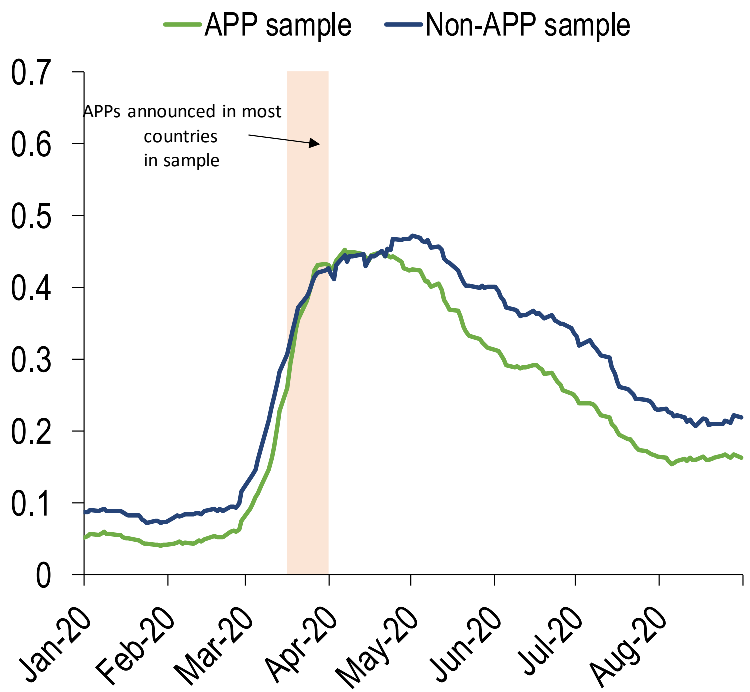


EM Asset Purchase Programs and Impact on Domestic Markets

Asset purchase programs lowered bond yields and term premia,
had little effect on currencies, and reduced market stress (eventually)







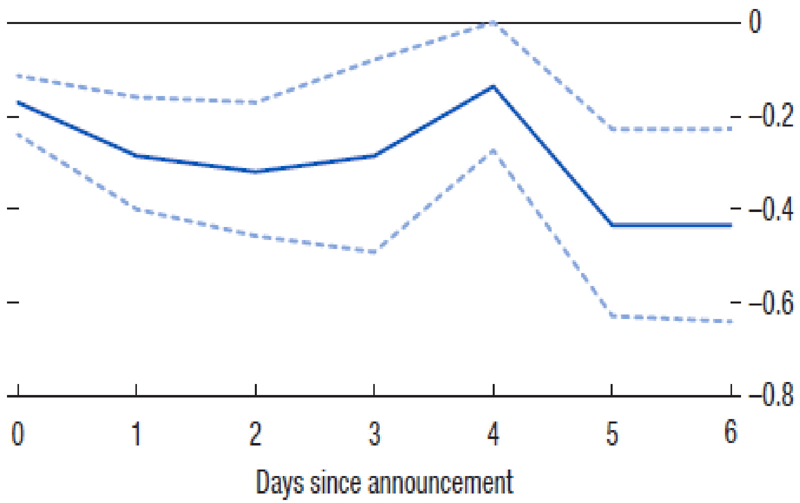
APP Announcements and Bond Yields: Controlling for the VIX

Domestic APP announcements led to a decline in EM bond yields…

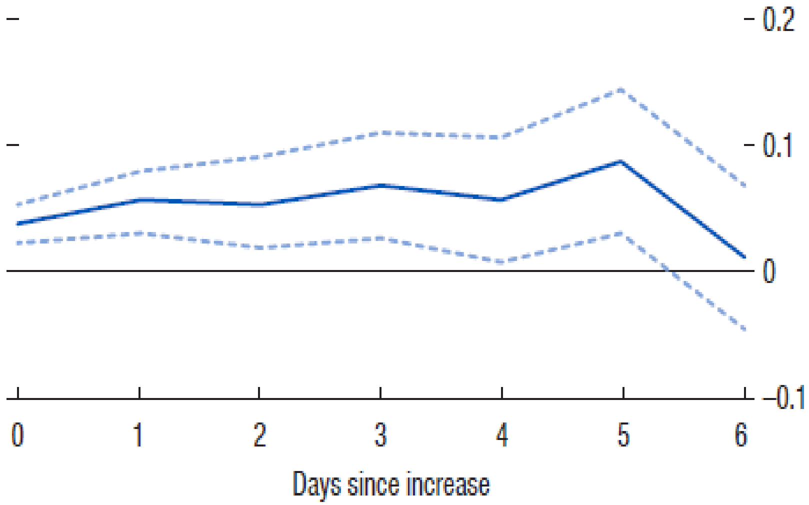
…where a higher VIX increased EM bond yields…

…but domestic rate cuts did not have much effect on yields.

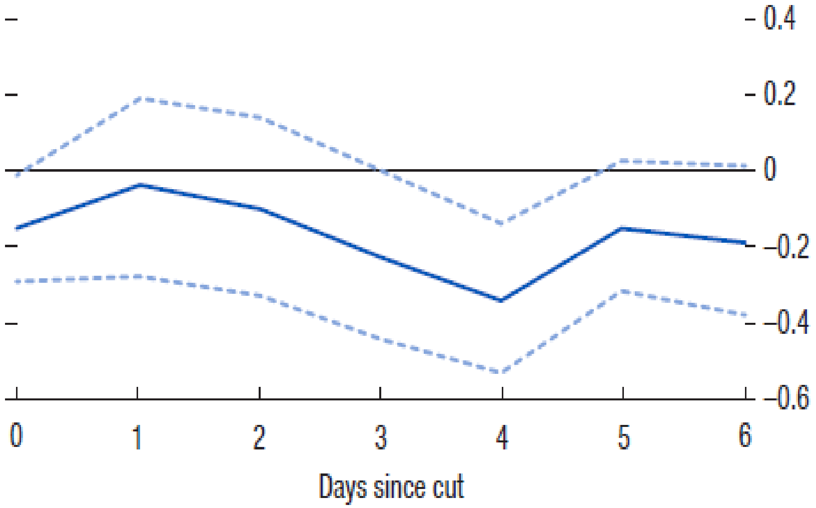
Domestic APP announcements
(pp change in yield)



10 points increase in VIX
(pp change in yield)



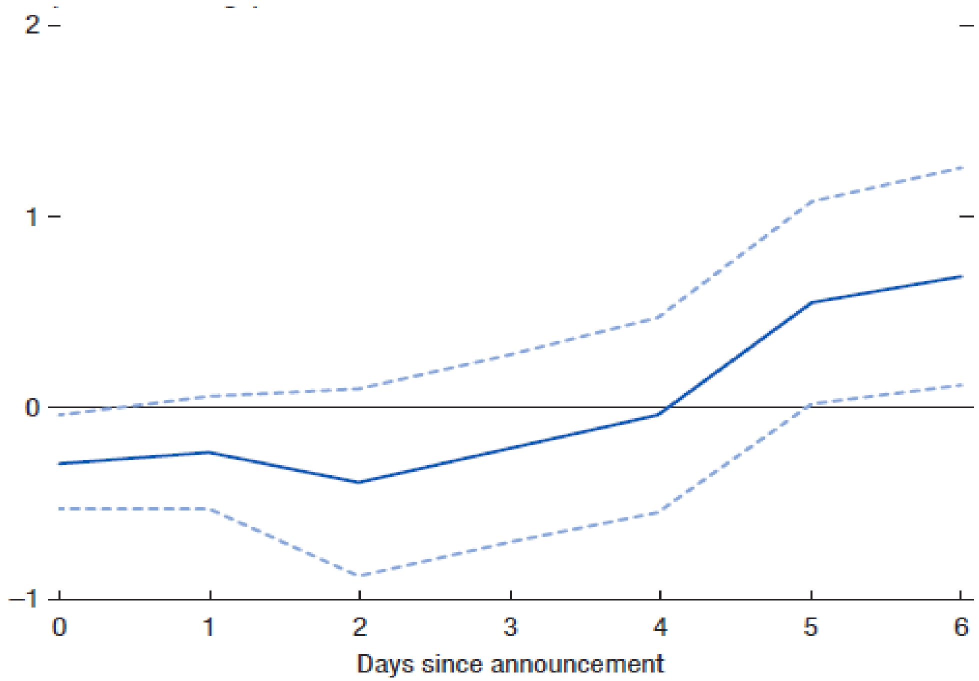
1 pp domestic rate cut
(pp change in yield)



APP Announcements and EM Currencies

Domestic APP announcements did not lead to a depreciation in EM currencies.

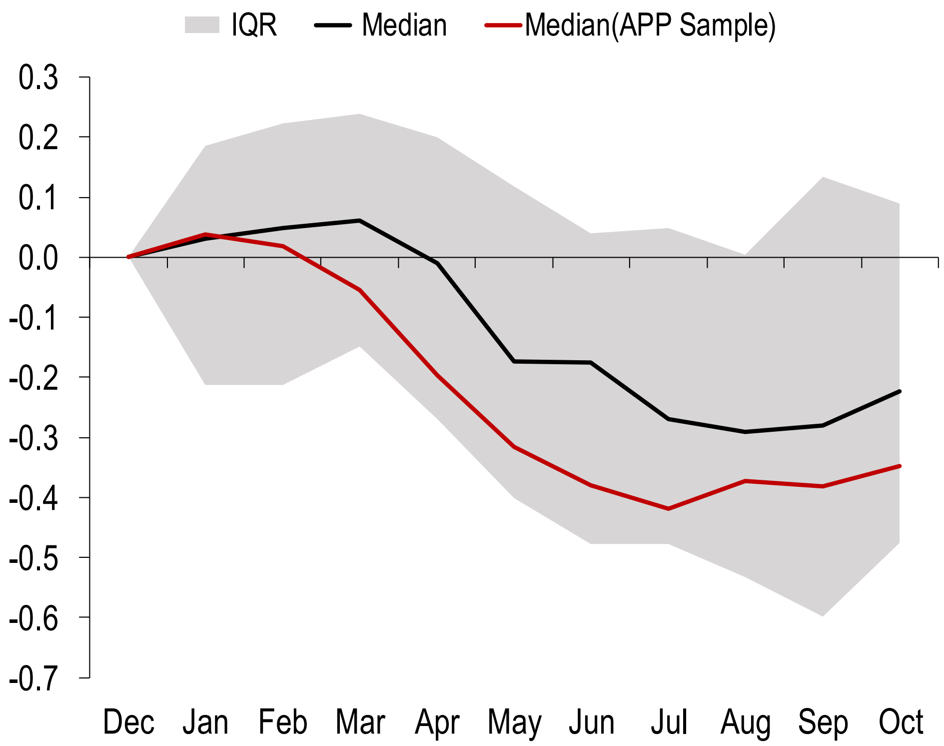
Domestic APP announcements
(% change in currency)



Limited Imminent Shocks but Risks Persist

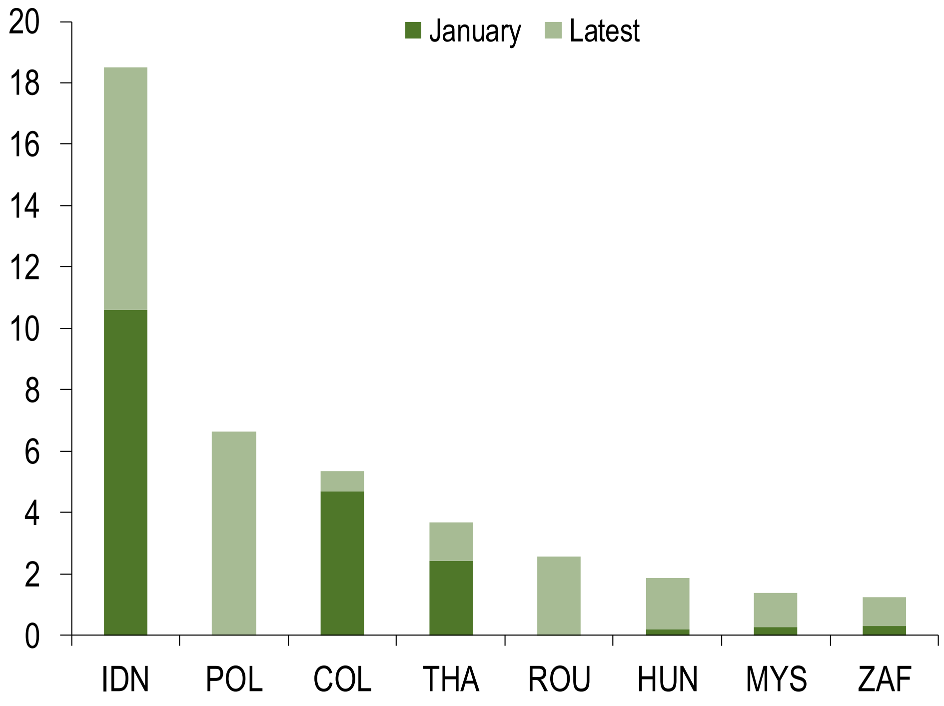
Market inflation forecasts for APP countries have not deteriorated versus an EM baseline.

Change in One Year Ahead Inflation Forecasts
(Interquartile range, median, cumulative since January 2020)



Central bank share of domestic bond holdings remains modest in most cases but has increased since January.

Central Bank Share of Local Currency Bonds Outstanding
(Holdings as share of total)



Summary

- Experience so far is broadly positive – across event studies and empirical analysis
  - Helped bring down long term yields, controlling for both VIX and Fed's QE announcement
  - Did not lead to a depreciation in EM currencies
  - Led to an eventual decline of the bond market stress

- Central bank communication and benign market perception in terms of the scope, timing, and temporary nature of these programs were essential in containing perceived risks of fiscal dominance

- However, risks could still arise especially during the next crisis (and driven in part by the benign experience this time around)

Looking ahead

Central bank purchases of government assets

When is it monetary financing?

Simon Gray, IMF
June 2022

Asset purchases and COVID

- The economic impact of COVID means that most governments globally have seen a fall in tax revenues, and an increase in expenditures.
- Bigger deficits mean more financing is required.
- For many EMDEs, international markets closed the doors for a period, and underdeveloped domestic financial markets struggled to cover the financing gap.
- In these circumstances, when central banks were seen buying government securities, markets inevitably asked: (i) is this monetary financing; and (ii) does it matter if it is?

Monetary and Capital Markets Department

Asset Purchases and Direct Financing

Guiding Principles for Emerging Markets and Developing Economies during COVID-19 and Beyond

Prepared by Tobias Adrian, Christopher Erceg, Simon Gray, and Ratna Sahay

DP/2021/023

Distinguishing APs from MF

Not enough to identify credit to government in the central bank's assets. Need to ask:

- Is the financing initiated by the government, or by the central bank *in pursuit of its mandate*?
- Is the central bank still free to set interest rates *at the appropriate level* to achieve its mandated objectives?
- Does governance of the process support the independence of monetary policy formulation and implementation?
- Is the balance sheet expansion expected to lead to excessive inflation, or pressures on the exchange rate?

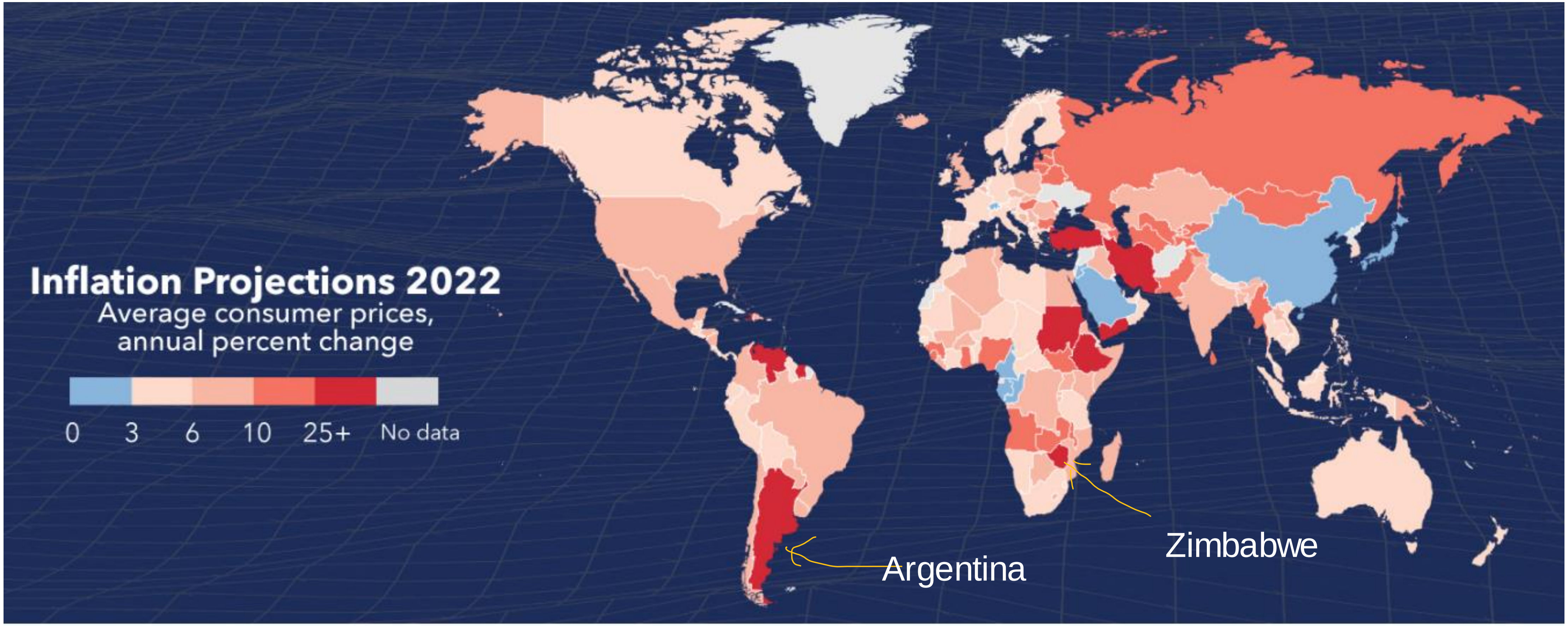
Government or central bank initiation?

- **Secondary market purchase** could be undertaken:
  - To provide long-term backing for currency in circulation (CIC; for portfolio management)
  - To flatten the yield curve (QE: monetary policy)
  - To tackle market dysfunction (market and financial stability)
  - To evade legal prohibition on primary market purchases (fiscal dominance)
- **Primary market purchase** of government securities likely to be motivated by goal of keeping down financing cost – i.e. fiscal goal.
  - Why might a central bank initiate primary market purchase? Portfolio management including reinvestment? Absence of a secondary market?
- Use of an **overdraft** clearly initiated by government

Central bank asset purchases

- Balance sheet expansion undertaken for monetary and financial stability purposes is likely to coincide with a period when government financing is under pressure.
  - So important that the central bank should be able to demonstrate good governance of the process.
- Experience in Japan, the US and Europe, suggest that Quantitative Easing (QE) does not lead to high inflation *provided the central bank sets its policy rate appropriately*.
  - Do we still believe this, as inflation in most QE countries surges?
- Where the driver for asset purchases is fiscal dominance, monetary stability has suffered as the central bank's willingness or ability to implement monetary policy, particularly tightening policy rates when needed, has been constrained, from Argentina to Zimbabwe.
- High inflation/rapid exchange rate depreciation is strongly associated with financial sector fragility.

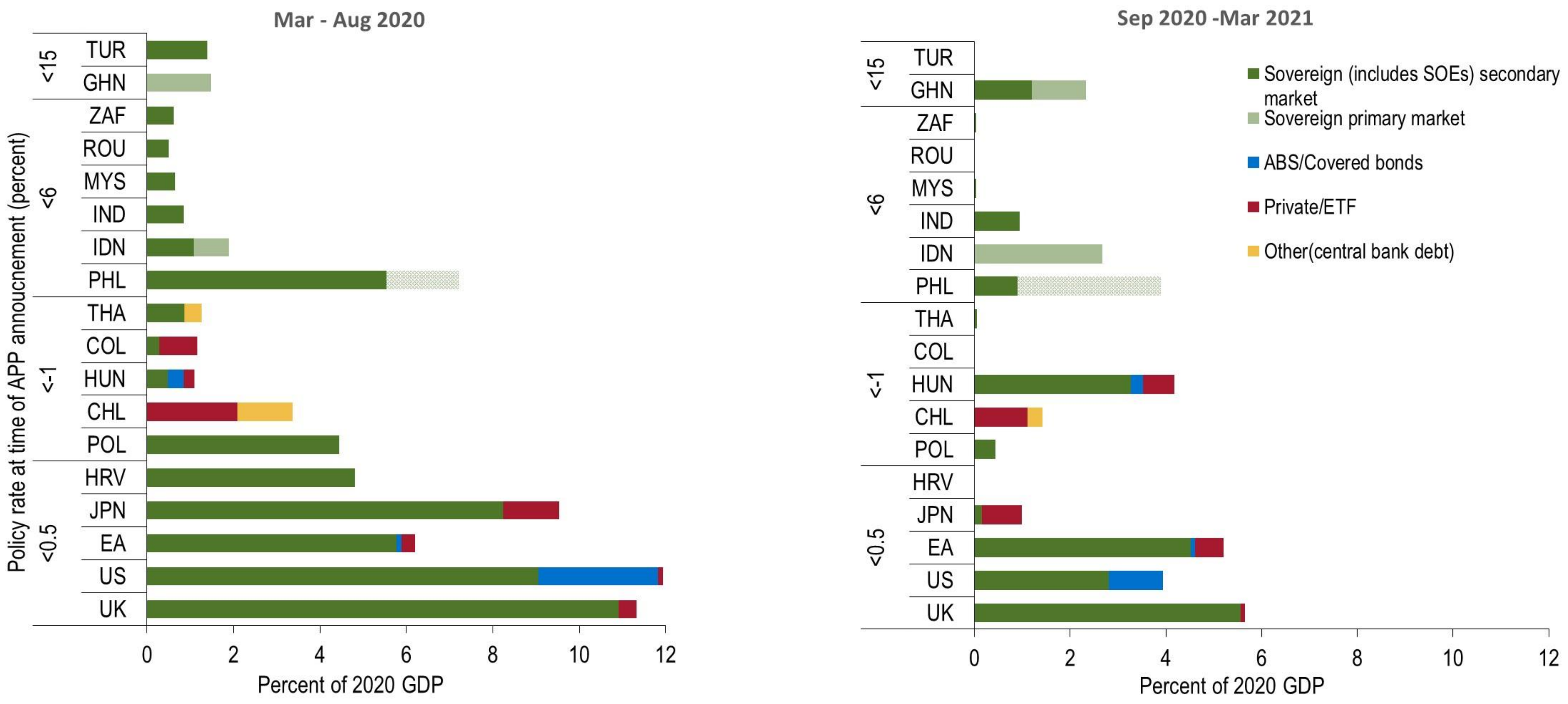
Recent inflation projections



Large-scale and Small-scale Asset Purchases

- **LSAPs:** If further monetary easing is required after reaching the Zero/Effective Lower Bound (ZLB/ELB), (i) expand the balance sheet by purchasing government securities in the secondary market, and (ii) communicate clearly how the central bank will continue to implement monetary policy.
    - “There is a limit to central bank purchases, especially if you are an emerging market. The likes of the U.S., U.K. and Japan can embark on quantitative easing with the knowledge that their currencies are reserve currencies and because they are reserve currencies, people will continue to hold them.”
- **SSAPs:** In addressing securities market dysfunction, well-targeted and communicated SSAPs can be effective.
    - “The trouble is that liquidity problems are not the only factor affecting the domestic bond market. There are also problems of fiscal sustainability in the mix, which requires us to act, and to communicate, with caution.”

Most EMDE asset purchases in first half of 2020



Overdrafts

- **ODs:** Government overdraft facilities with the central bank are not new, but the temptation to abuse them may be heightened in times of crisis.
- Legislation should set clear boundaries on the amount and maturity, and the cost should be *at least* at the same level as the central bank's policy rate.
  - Is it a cash-management backstop, or permanent funding "on the cheap"?
  - Might it be a bridge to nowhere?
  - Legal limits: a speed-bump rather than a barrier – but still useful?
  - What about the Old Lady's Ways & Means account?
- There are limits beyond which creation of reserve money may have negative value-added: some countries are close to or at those limits.

Questions

- Can you think of a case where (substantial) monetary financing has clearly delivered benefits that outweigh the costs?
- Can a mandate to support price stability justify funding government to keep food price inflation low?
- Can a mandate to support financial stability justify funding government so its suppliers do not default on bank loans?
- If your government has no other financing source, how would you, as central bank governor, respond today?