Vulnerabilities in Emerging Market Economies

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Background

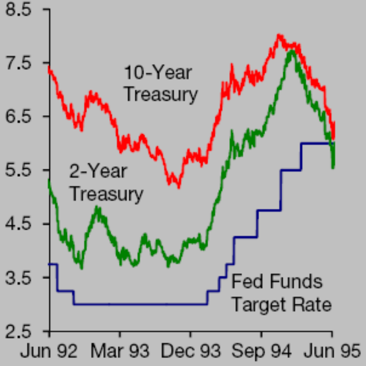
- US interest cycle critical for emerging market economies.
  - Tightening cycle 1994;
  - Quantitative easing: capital inflows into emerging market economies;
- Monetary policy in the centre of the international monetary system is one of the driver of global financial cycle in capital flows, asset prices and credit growth. (Bruno and Shin (2013), Miranda-Agrippino and Rey, (2014), Forbes and Warnock, (2012)).
- Central Role in the transmission mechanism of global financial cycle is given by financial intermediaries (Shin (2013), Bruno and Shin (2014))
- Policy challenges (policy trade-offs, Obstfeld 2014)
- Sudden stops (Calvo and Reinhart (1998), Mendoza (2010))

Chart 11
Fed's 1994 Exit and EM Equity Performance

percent *index, Jun 92 =100*

Chart 12
Fed's 1994 Exit and Bond Yields

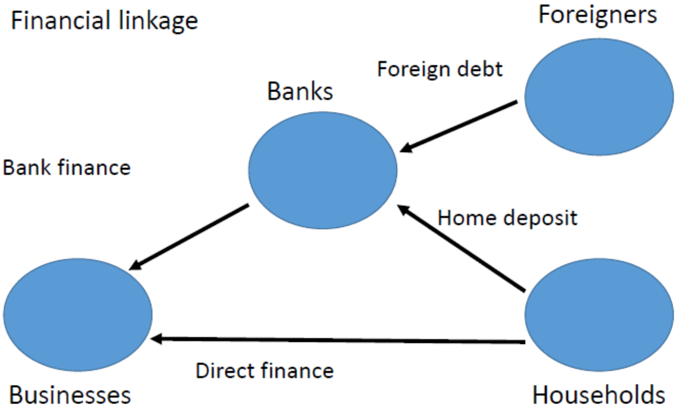
percent, generic bonds



Outline

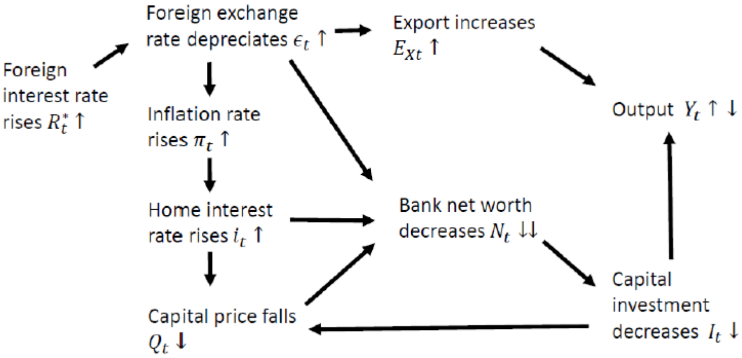
- Examine two aspects of interest rate cycle
- New Keynesian open economy model with financial intermediation (Aoki, Benigno and Kiyotaki, 2016)
    - transmission mechanism;
    - policy implications (interaction between monetary and financial policies).
- How to assess vulnerabilities in emerging market economies?

Financial Intermediation



Transmission mechanism

Transmission of external financial shocks



Key aspect of transmission mechanism

- Role of exchange rate
- Distinction between financial and non-financial shocks in terms of transmission mechanism
- Price flexibility amplify the effects of external financial shocks.

Transmission mechanism

- Role of the exchange rate
  - Cost channel (monetary and real)
  - Financial channel (financial)
  - Expenditure switching channel (real)

Policy Implications

- Distinction between financial and non-financial shocks affects scope for financial policies.
  - Financial shocks $\rightarrow$ cyclical tax on foreign borrowing;
  - Non financial shocks $\rightarrow$ permanent tax on risky assets held by banks
- Monetary and cyclical financial policies are complementary when external financial shocks are dominant.

Vulnerabilities in emerging market economies

- Usual way of looking at it: current account deficit
- Background: intertemporal approach to the current account. How to stabilize external debt to GDP ratio?

Vulnerabilities

- Financial dimension of external sustainability
- Four issues in assessing vulnerabilities:
  - Composition of capital flows;
  - Currency mismatch;
  - International financial integration (gross position matters) and valuation channel;
  - Policy (Foreign Reserve Accumulation, capital controls).
- Real dimension: allocation of resources (financial resource curse)

Vulnerabilities

- Where do these vulnerabilities arise?
  - Banks;
  - Corporate sector;
  - Household;
  - Public Sector.

Conclusion

- Financial integration creates challenges in terms of policy trade-offs
- Financial Vulnerabilities: how to make assessment?
- Endogeneity of Global Financial Cycle