

Transmitting Global Liquidity to East Asia: Policy Rates, Bond Yields, Currencies and Dollar Credit

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Summary

This paper analyses the transmission of major economies' monetary policy to Northeast Asia, focusing on China, Hong Kong SAR and Korea. We divide the transmission into five somewhat overlapping channels. The first three are price channels and the latter two are quantity channels.

1. Central banks set lower policy rates than they would otherwise in response to very low interest rates in key currencies in order to lessen pressure for currency appreciation.
2. Large scale bond purchases reduce bond yields not only in the bond market where the purchases are made but also to a varying extent in other bond markets through portfolio balance effects.
3. Higher interest rates in Northeast Asian economies than in key currencies lead to upward pressure on regional exchange rates.
4. Low yields in key currencies lead to easier regional financial conditions given stocks of foreign currency credit and spur a shift of liabilities into foreign currency, especially if the domestic currency is expected to appreciate.
5. Capital flows cross-border into local-currency bond and equity markets.

We review extant work on the price channels and make an original contribution to the work on foreign currency credit. We do not discuss cross-border capital flows into local currency bond and equity markets, which is the focus of most work.

Indeed, the focus of debate on capital flows has often left the other channels neglected. It is worth noting that the four channels that we analyse may, but need not, involve capital flows.

Our review of existing work leads us to the following three conclusions regarding policy rates, bond yields and currency appreciation. First, the finding that emerging market policy rates no longer track Taylor rules with standard parameters is consistent with the interpretation that regional central banks have kept policy rates low in response to global monetary accommodation. Estimated open economy Taylor rules also suggest that central banks in Asia react to the federal funds rate.

Second, lower bond yields from large scale central bank bond purchases in major markets seem to be transmitted in part to lower bond yields in local currency bond markets that are integrated into global bond markets.

Third, the more that the yield curve of the local currency moves down with the yield curves in the major economies, the less the upward pressure on the exchange rate of the local currency. Thus, currency appreciation is not a summary measure of the transmission of accommodative monetary policy.

Analysis of foreign currency credit growth in mainland China, Hong Kong SAR and Korea leads to three conclusions. First, low interest rates in major currencies make for immediately easier financial conditions where there is a substantial stock of foreign currency credit. And, to the extent that domestic currencies are expected to appreciate against major foreign currencies, currency expectations reinforce interest rate differentials in encouraging firms to borrow in foreign currency.

Second, analogous to our typology of the offshore market, foreign currency loans can be financed entirely with local deposits (Hong Kong), largely with local deposits (Mainland China) or mostly with cross-border interbank funding (Korea). Especially in the last case, the nationality composition of international banking and home factors condition the transmission of global impulses. In particular, the shrinkage since 2008 of European banks' role in intermediating dollars to East Asia could only have slowed foreign currency lending.

Third, policy leans against the incentives provided by low yields in major currencies for firms to substitute foreign currency credit, mostly dollar-denominated, for local currency credit. Not only may monetary policy seek to limit the policy rate gap, but capital controls (China) and macroprudential policy (Hong Kong and Korea) can in effect raise the effective interest rate on dollars within the economy. Thus both

demand-supply imbalances in particular economies and policy help to explain the paradox of expensive dollars that yield practically zero at their source.

Despite policy efforts, foreign currency credit may still give rise to substantial financial stability risks, not so much currency mismatch risks but rather maturity and liquidity risks associated with dollar funding. The experience of dollar shortage and dislocation of the dollar funding markets in late 2008 and early 2009 was particularly telling. It is also worth recalling that the deflationary shock from the currency depreciations during the Asian financial crisis in 1997-98 interrupted the tightening phase of the Federal Reserve, with implications for asset markets. The already difficult exit from very accommodative policy over the next few years would prove more challenging in the event of financial instability in East Asia, which today has stronger trade links to North America and Europe than it had 15 years ago. Spillovers of monetary accommodation merit attention because any instability arising from them carries a risk of blowback effects to major economies.