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BUSINESS SCHOOL
It’s a small work (after all)
Stephen G Cecchetti
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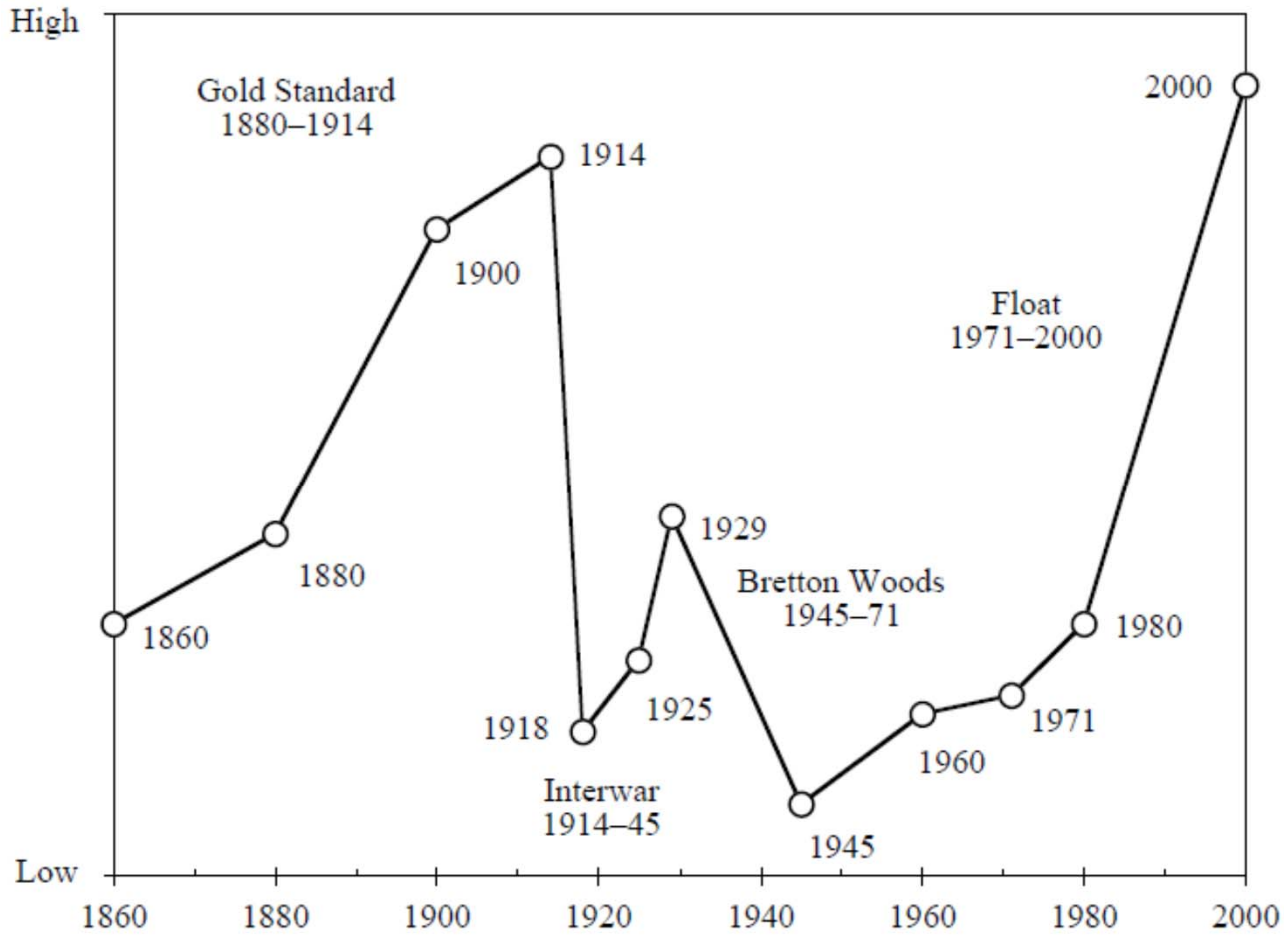
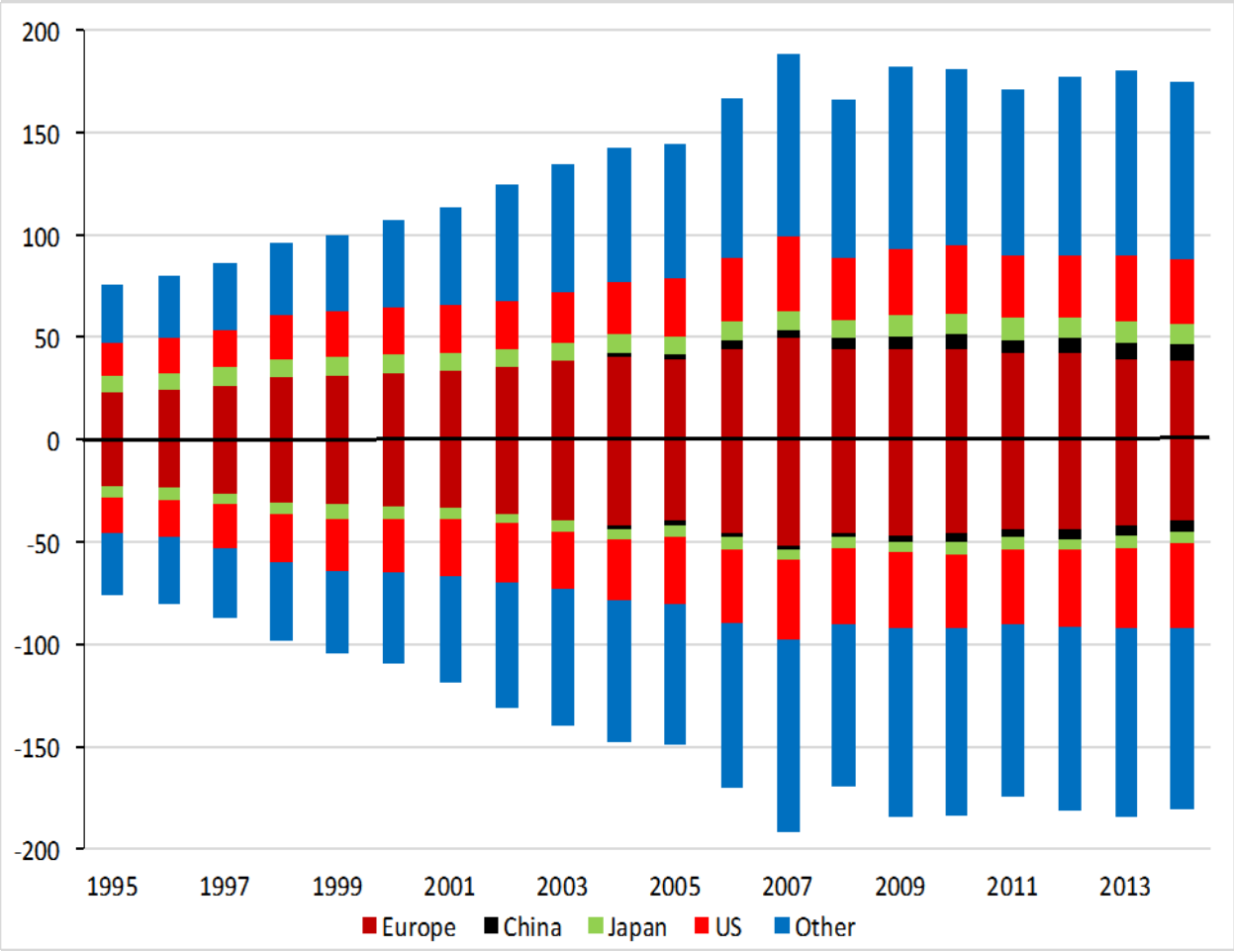
WORLD
READY

Global capital mobility since 1860



Source: M Obstfeld and A Taylor, "Globalization and Capital Markets," NBER WP 8846, March 2002

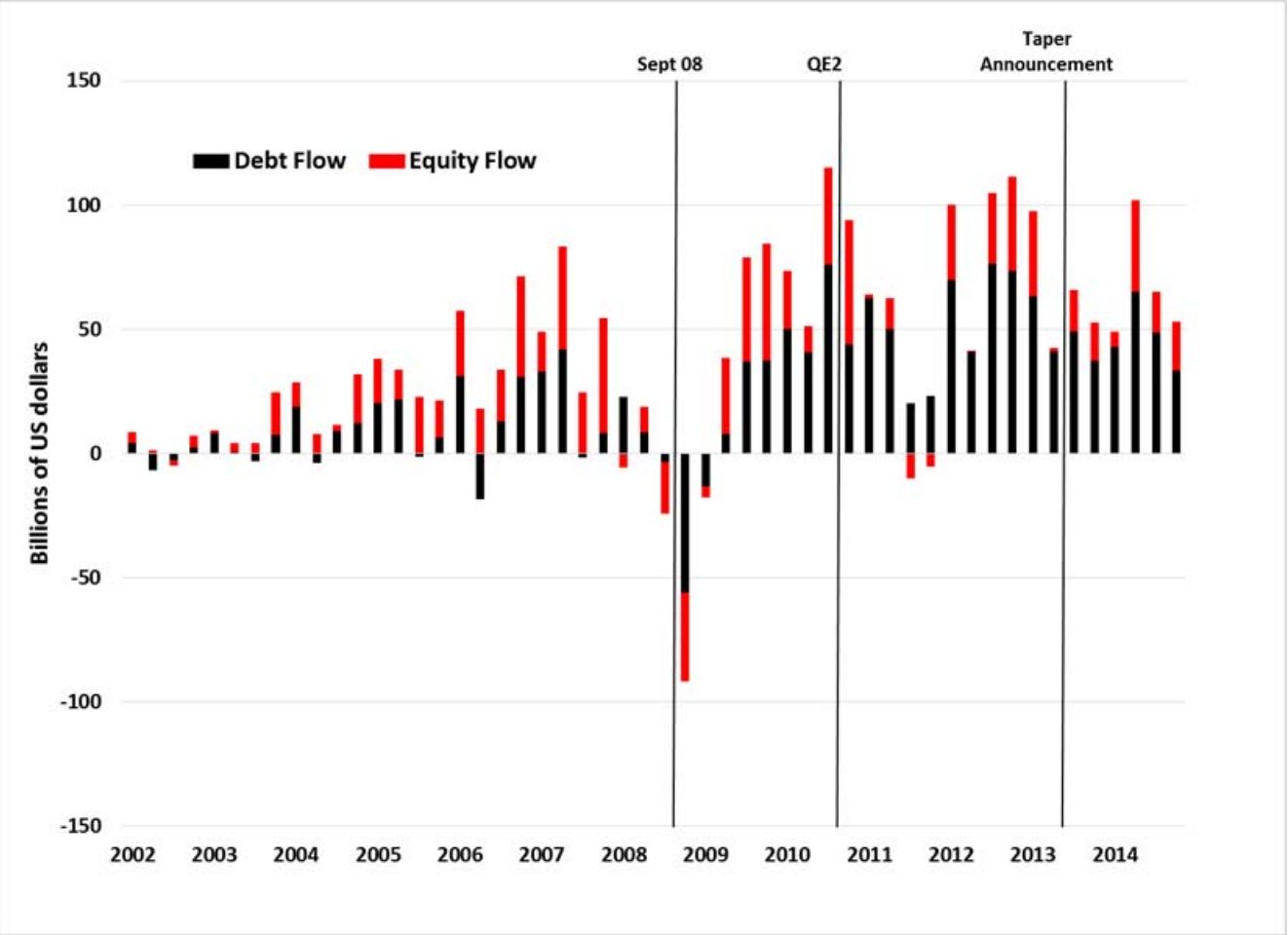
Gross cross-border asset & liability positions
(percent of world GDP)



Growth from $25 trillion to $140 trillion!

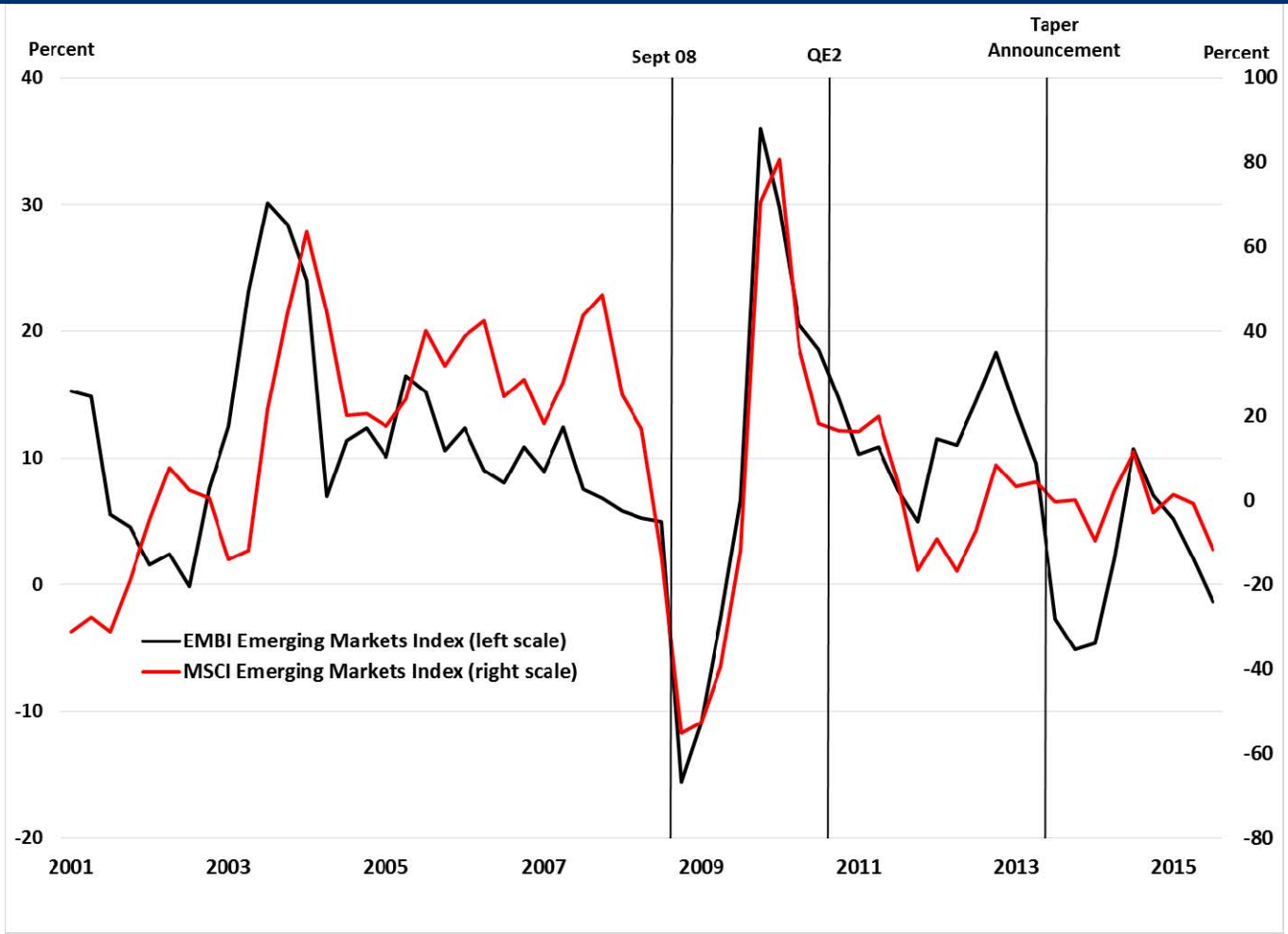
EME fund flows

(flows to EME-dedicated bond & equity funds, inflows positive)



Surge plus shift to debt

EME equity and bond returns
(annual returns in the MSCI and EMBI)



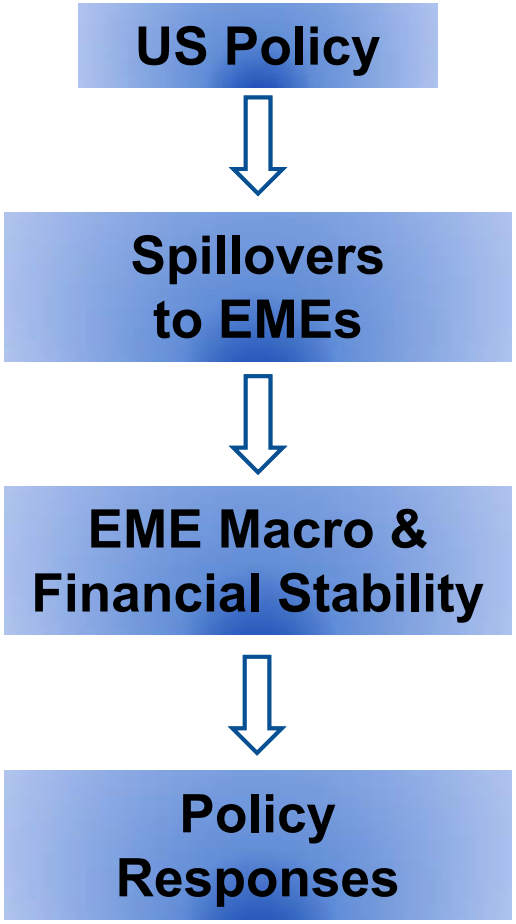
Volatility up, equity returns (rhs) >> bond returns (lhs)

Setting the stage

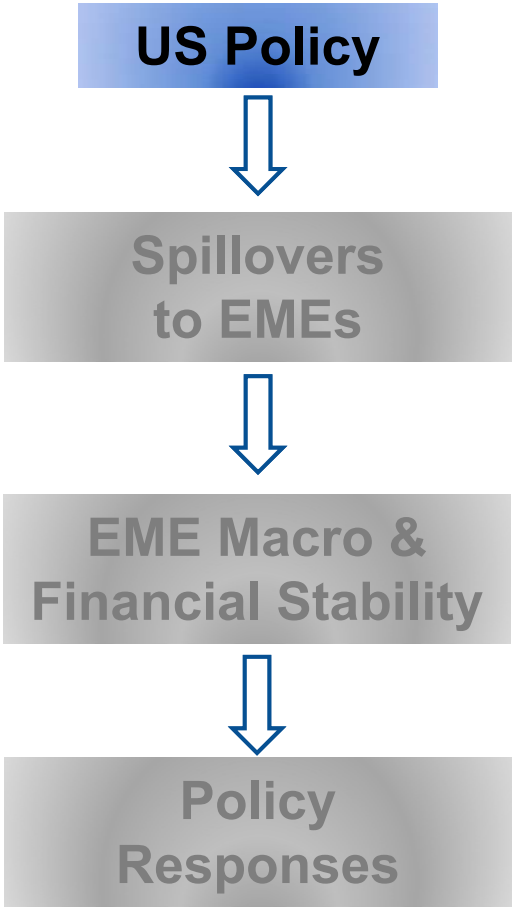
- Cross-border positions are way up
- Portfolio flows to EMEs have increased dramatically
- Debt flows have increased by more than equity
- Returns positive during QE, negative following taper

  (But still not as positive as pre crisis)

Linkages


US Policy
Spillovers to EMEs
EME Macro & Financial Stability
Policy Responses

Linkages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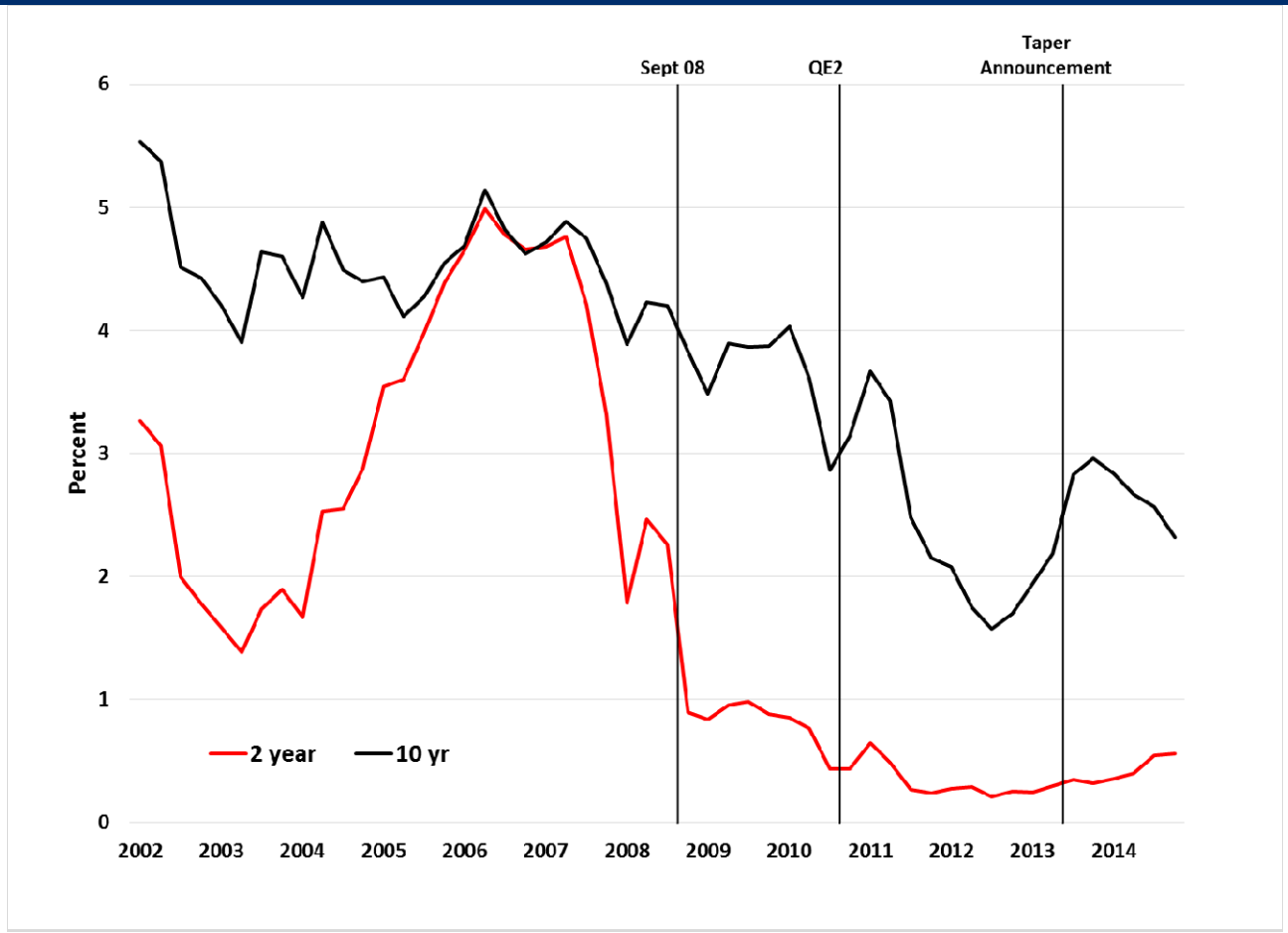
Policy Responses

US monetary policy

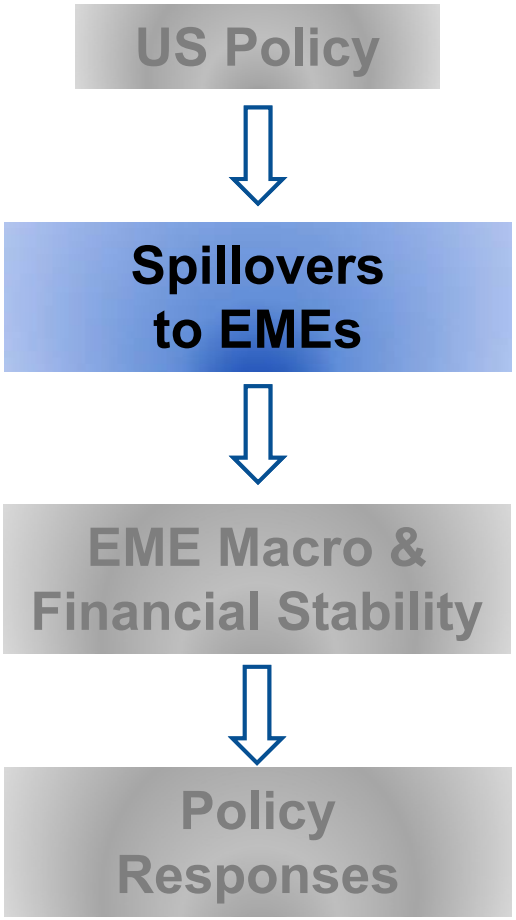
- Short rates
  - Resolves uncertainty about current policy
  - Signal path of future policy rate
- Long rates
  - Signal size & composition of future balance sheet
  - Information about preferences & reaction function
  - Information about inflation & growth – path & risks

US monetary policy: recent experience



Short-term rates: haven't moved much
Long-term rates: big movements in term premia

Linkages


US Policy
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Policy Responses

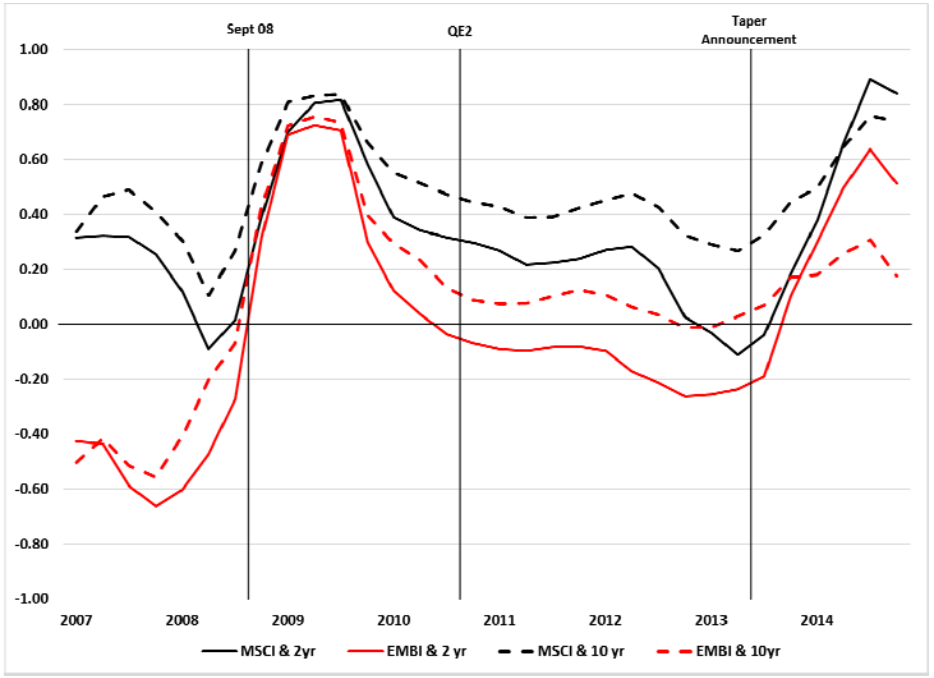
Spillovers of US policy to EMEs

- Quantities
  - Bank lending
  - Equity holdings
  - Bond holdings
- Prices:
  - Equity prices
  - Bond yields
  - Exchange rates

Spillovers of US policy to EMEs

Correlation of **Flows** w/ US rates

Correlation of **Returns** w/ US rates



- Correlations change over time.
- Correlations w/ returns more strongly positive.

Five-year overlapping correlations based on quarterly data.

Spillovers of US policy to EMEs

- Pre-crisis vs post-crisis
  - Stocks and flows are bigger
  - Markets are bigger
  - Correlations of returns & flows with US policy
    - Change over time
    - Returns are more strongly positive
      (Impact more on prices than quantities)

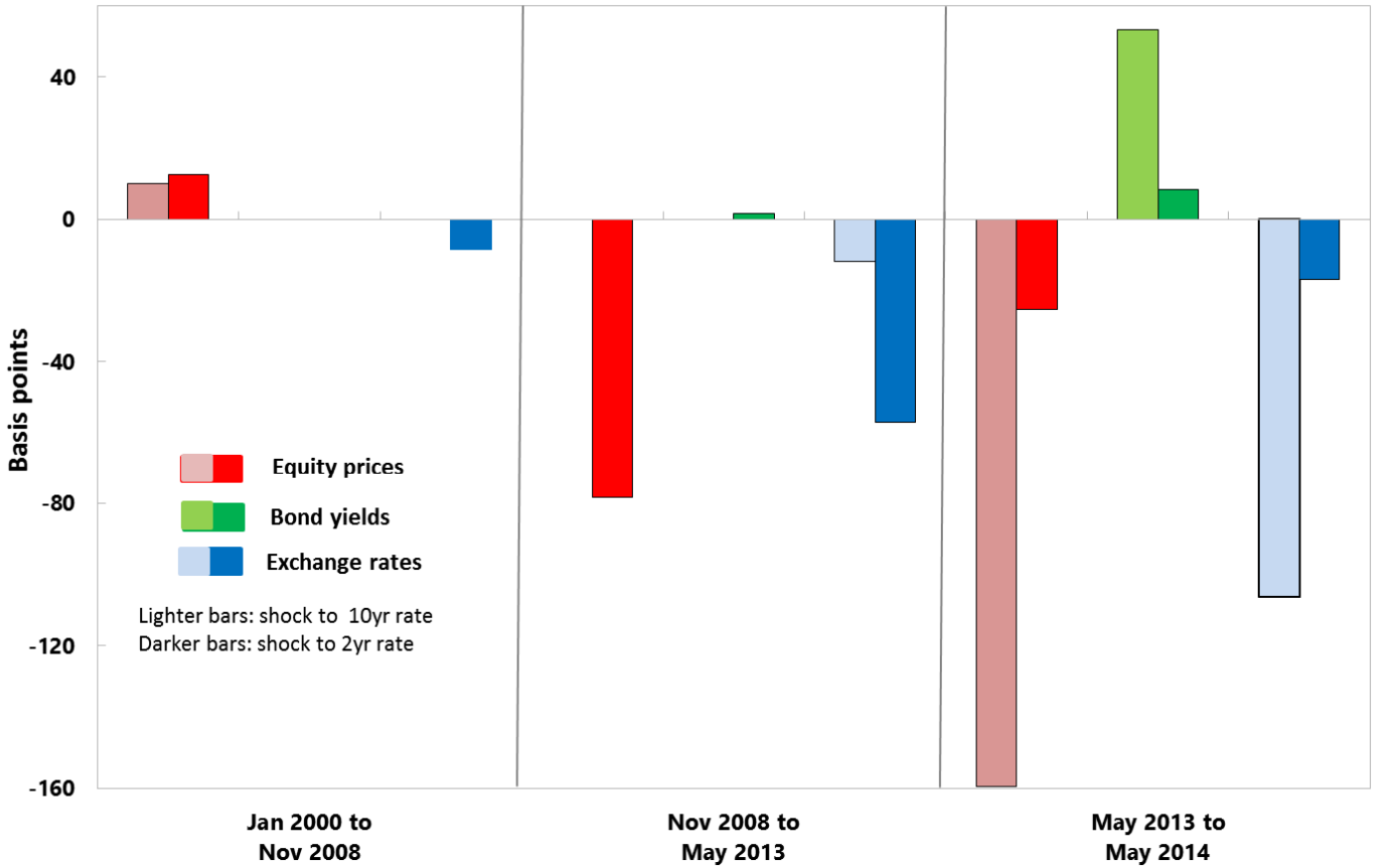
Spillovers of US policy to EMEs
(size of a typical surprise)

One-Standard Deviation Surprise (in basis points)		
	10yr	2yr
Jan 2000 to Nov 2008	5.09	4.18
Nov 2008 to May 2013	11.95	1.63
May 2013 to May 2014	8.86	1.41

- Surprises to the 10 year are larger
- Typical size of a surprise changes over time

Source: Chen, Jaiqian, Tommasso Mancini-Griffoli and Ratna Sahay, 2014. "Spillovers from United States Monetary Policy on Emerging Markets: Different This Time?" IMF Working Paper WP/14/240, December.

Spillovers of US policy to EMEs
(for one-standard deviation surprise)



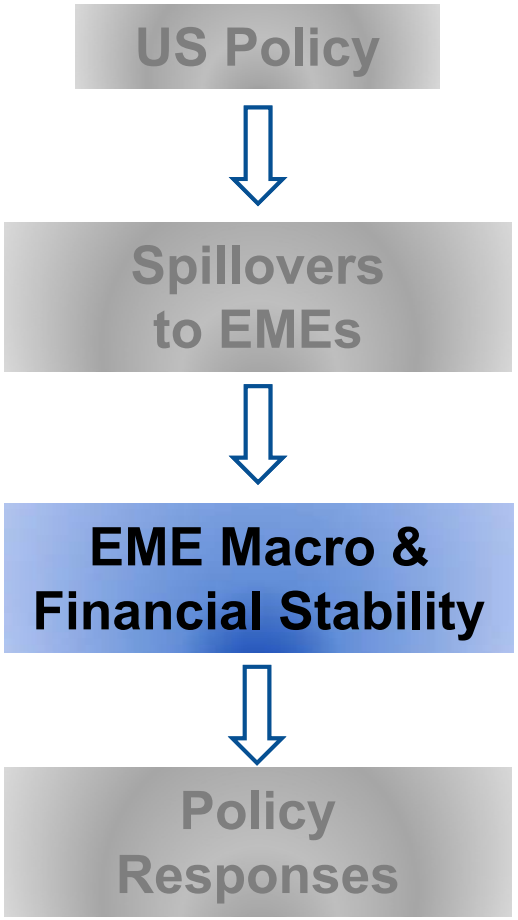
The figure depicts the estimated impact of one standard deviation surprise in the 10-yr US government bond yield (lighter bars on the left) and the 2-yr US government bond yields (darker bars on the right) on equity prices (red), bond yields (green) and US dollar exchange value of the foreign currency (blue) over three phases of US monetary policy.

Spillovers of US policy to EMEs

- Pre-crisis vs post-crisis
  - Stocks and flows are bigger
  - Markets are bigger
  - Correlations of returns & flows with US policy
    - Change over time
    - Returns are more strongly positive
      (Impact more on prices than quantities)

- Conventional vs unconventional
  - Unconventional has larger impact per unit surprise
  - Long rate surprises bigger & more important

Linkages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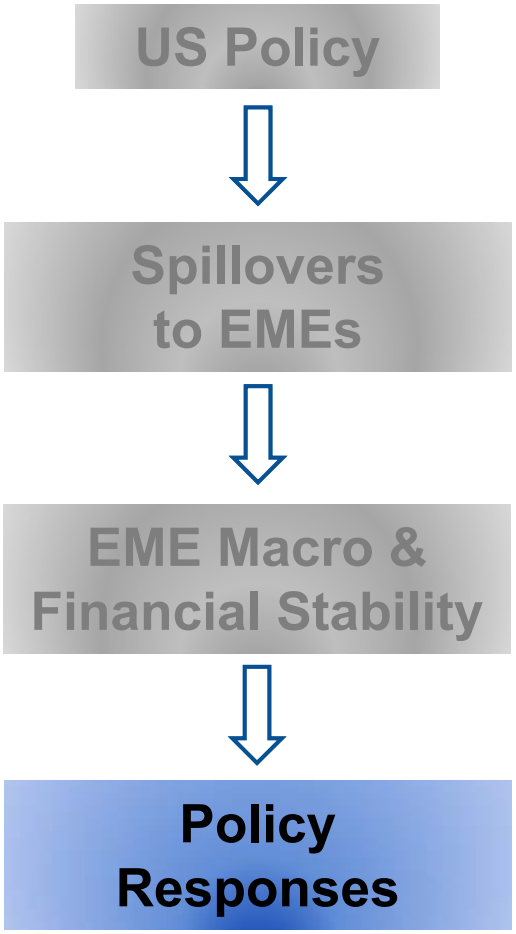
EME Macro & Financial Stability
Policy Responses

EME financial stability policy: reducing vulnerabilities

- Factors that tend to **dampen** the impact of shocks:
  - Higher Growth
  - Lower Inflation
  - Bigger current account (smaller deficit/bigger surplus)
  - Smaller share of local debt held by foreign investors

Linkages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Policy implications: EMEs

- Prudential preparation
  - Ensure sufficient buffers
  - Have stringent stress tests
  - Manage off-balance sheet risks through CCPs
- Discretionary reaction
  - Domestic interest rates: risk to aggregate demand
  - FX intervention: requires reserves
  - Capital flow management: impact temporary
  - IMF FCL: unlikely to be big enough
  - Swap lines with the Fed: global dollar safety net

Policy implications: US

- Internal
  - Domestic mandate
  - Account for spillbacks
- Communication
  - Spillovers larger $\Rightarrow$ clarity more important
  - Further reduce uncertainty where possible
- External

US policy: external

- Central role of US dollar
  - 80% of trade finance
  - 87% of currency transactions
  - 42% of transactions on SWIFT
- Off-shore short-term US$ liabilities: $10 to $15 trillion
- US banking system total assets $11 trillion

- There are two dollar-based financial systems!

US policy: external

- Benefits accruing to the US
  - Funding advantage: ½% of GDP per year
  - Current account: deficit 2% of GDP per year
- Costs borne by others
  - 0.2% of global GDP per percentage point difference between US Treasury rate and global return
- Global financial stability requires US dollar safety net

Swap lines from the Fed!

Conclusions

- Capital market are much more open
- Flows to EMEs have grown significantly
- Spillovers have grown
- Federal Reserve policy changes have global effects

Conclusions

- EME policies to mitigate risks:
  - Sound macro fundamentals
  - Rigorous prudential policies (including tough stress tests)
  - Credible policy framework
- Fed policies to mitigate spillovers:
  - Clear communication
  - Global dollar safety net


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