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Central Banking in Emerging Markets

International Center for Monetary and Banking Studies (ICMB)

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Monetary policy is challenging in Emerging Markets (EME)

Institutions are still "under construction"

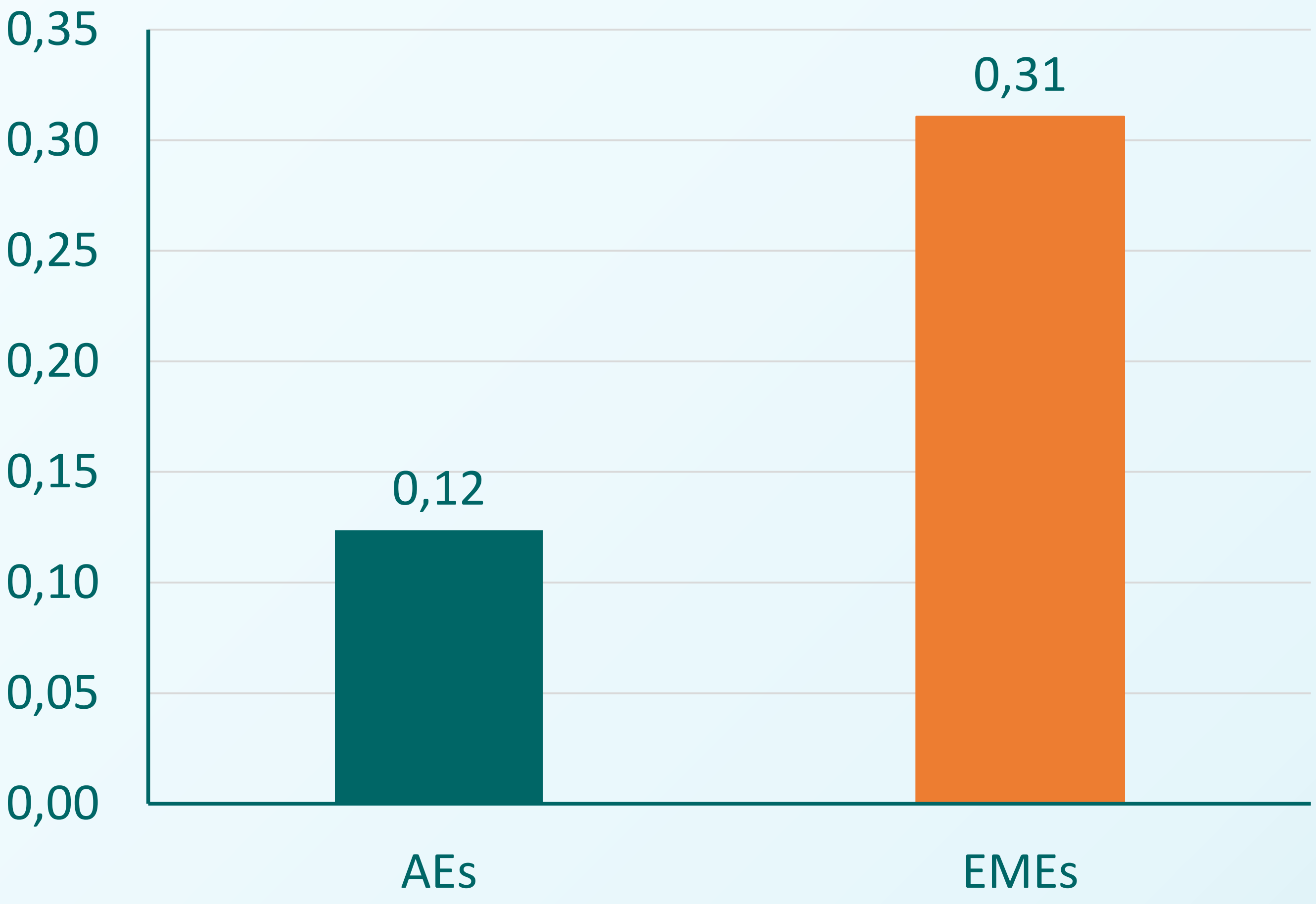
- Fiscal policy is often under scrutiny and stress
- Central bank needs to constantly enhance credibility

Monetary policy is challenging in Emerging Markets (EME)

Higher macroeconomic instability in comparison to AEs

- EMEs are more subject to “sudden stops”
- Balance sheet effects
- Reduced liquidity may produce contagion
- Shocks of greater magnitude

Effects: higher FX volatility



Average exchange rate volatility
2003 Q1 – 2018 Q3

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Data source: International Financial Statistics, IMF (quarterly data).
Obs.: coefficient of variation (standard deviation/average).

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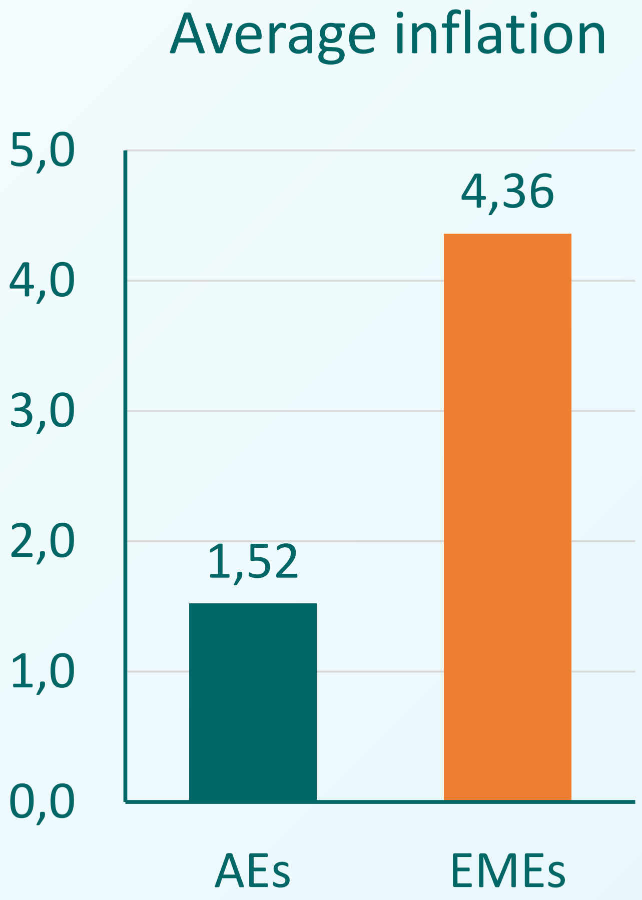
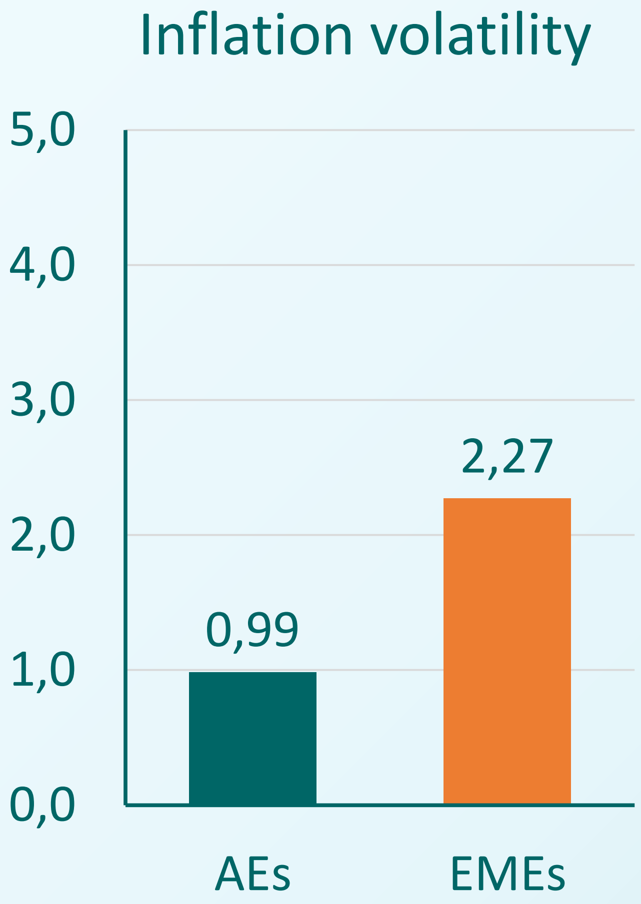
Effects: higher inflation and inflation volatility



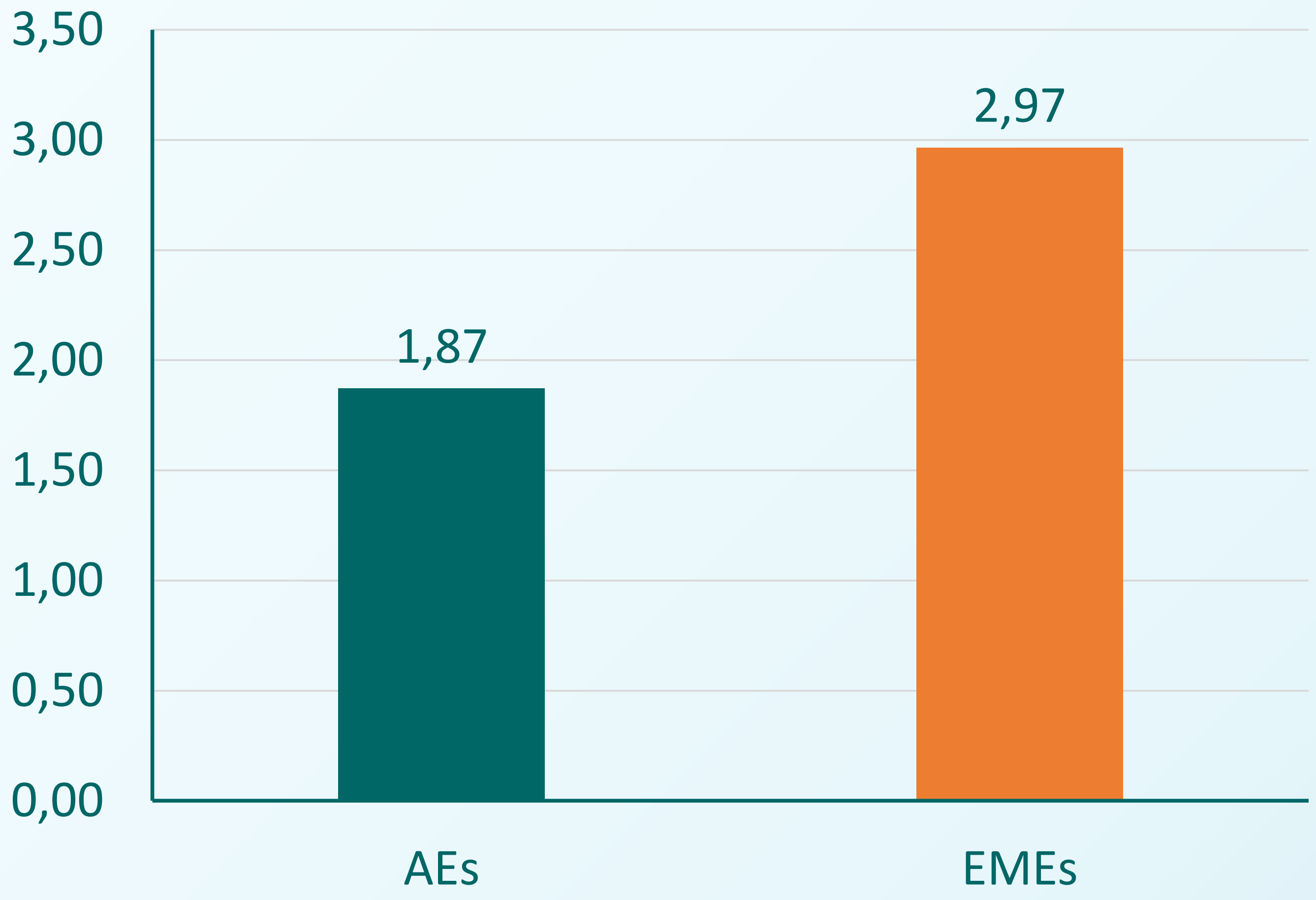


Average inflation (% a.a.) and inflation volatility (average of standard deviation) 2003 Q1 – 2018 Q3

Data source: International Financial Statistics, IMF (quarterly data).

Obs.:: CPI, percentage change, corresponding period previous year, percent.

Effects: higher output volatility



Output growth volatility
(average of standard deviation)
2003 Q1 – 2018 Q3

Data source: International Financial Statistics, IMF (quarterly data).
Note: Real GDP seasonally adjusted , percentage change, corresponding period previous year, percent.

Current risks for monetary policy in EMEs

- Risk aversion in global financial markets
    - Fear of global deceleration
- Uncertainties related to trade disputes
- Normalization of interest rates in some advanced economies

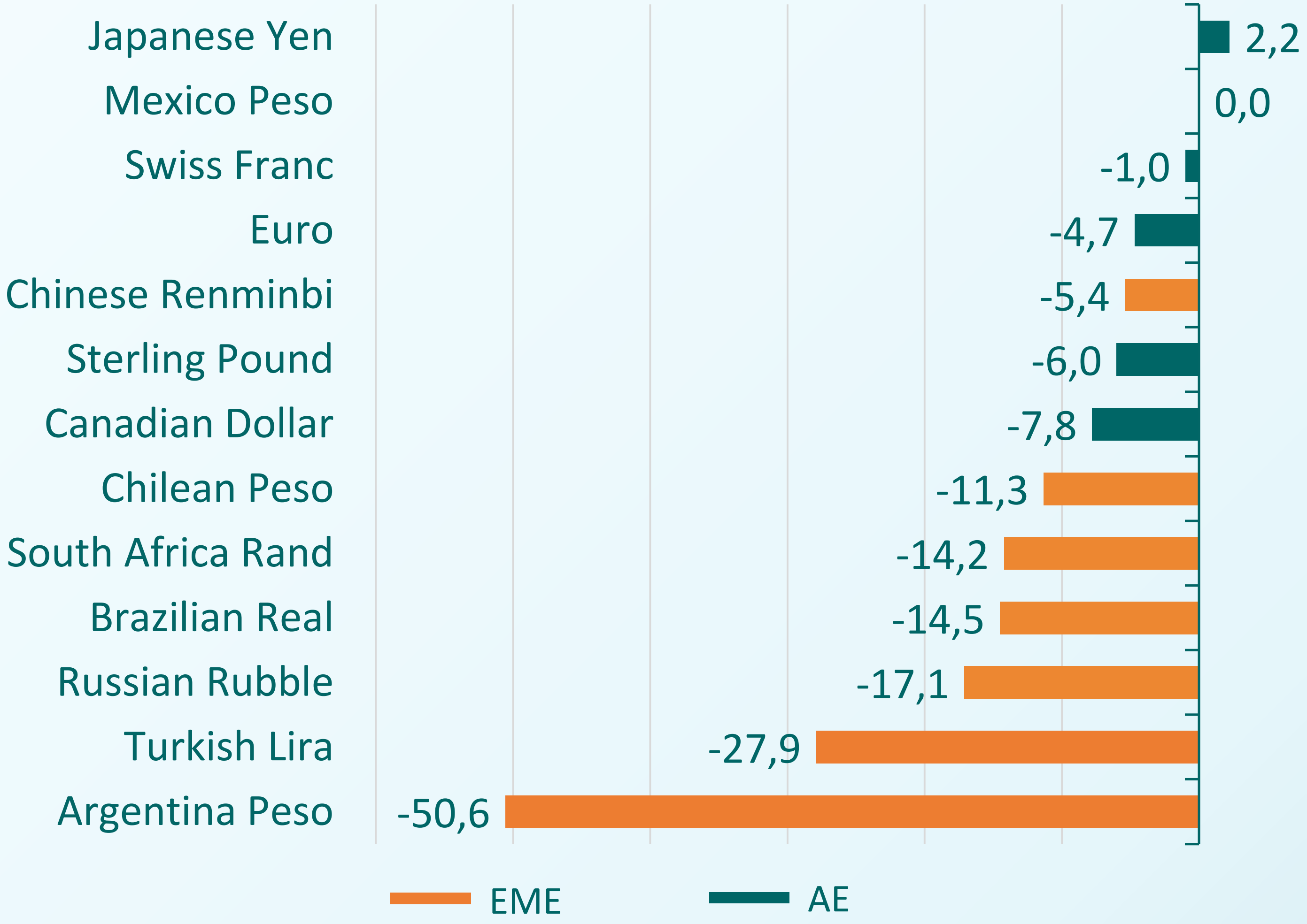
Global shocks, local effects

The recent shocks have affected each country according to its particular characteristics and fundamentals.

Important factors for market reactions:

- External conditions (current account position, stock of international reserves, sensitivity to trade tensions, level of foreign corporate debt)
- *De facto* autonomy of the central bank
- Existence of fiscal and monetary room for countercyclical policies (low level of inflation, anchored inflation expectations)

Changes in FX rates



2018

FX change against USD (%)

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Data source: Bloomberg

Obs: Percentual change in the amount of U.S. dollars needed to buy one unit of foreign currency.

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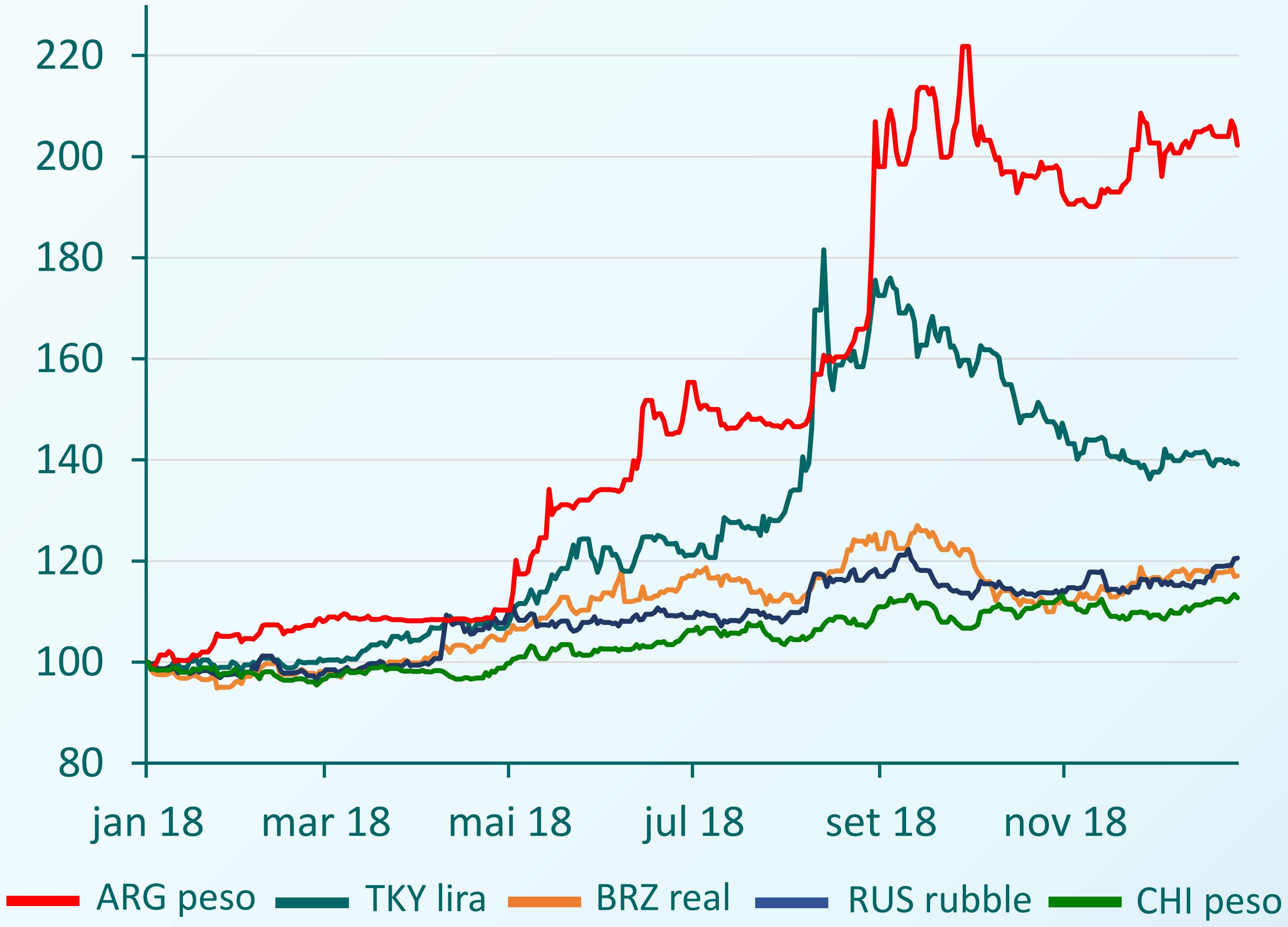
FX volatility increased



2018

Exchange rates indexes (01/01/2018=100)

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Data source: Bloomberg

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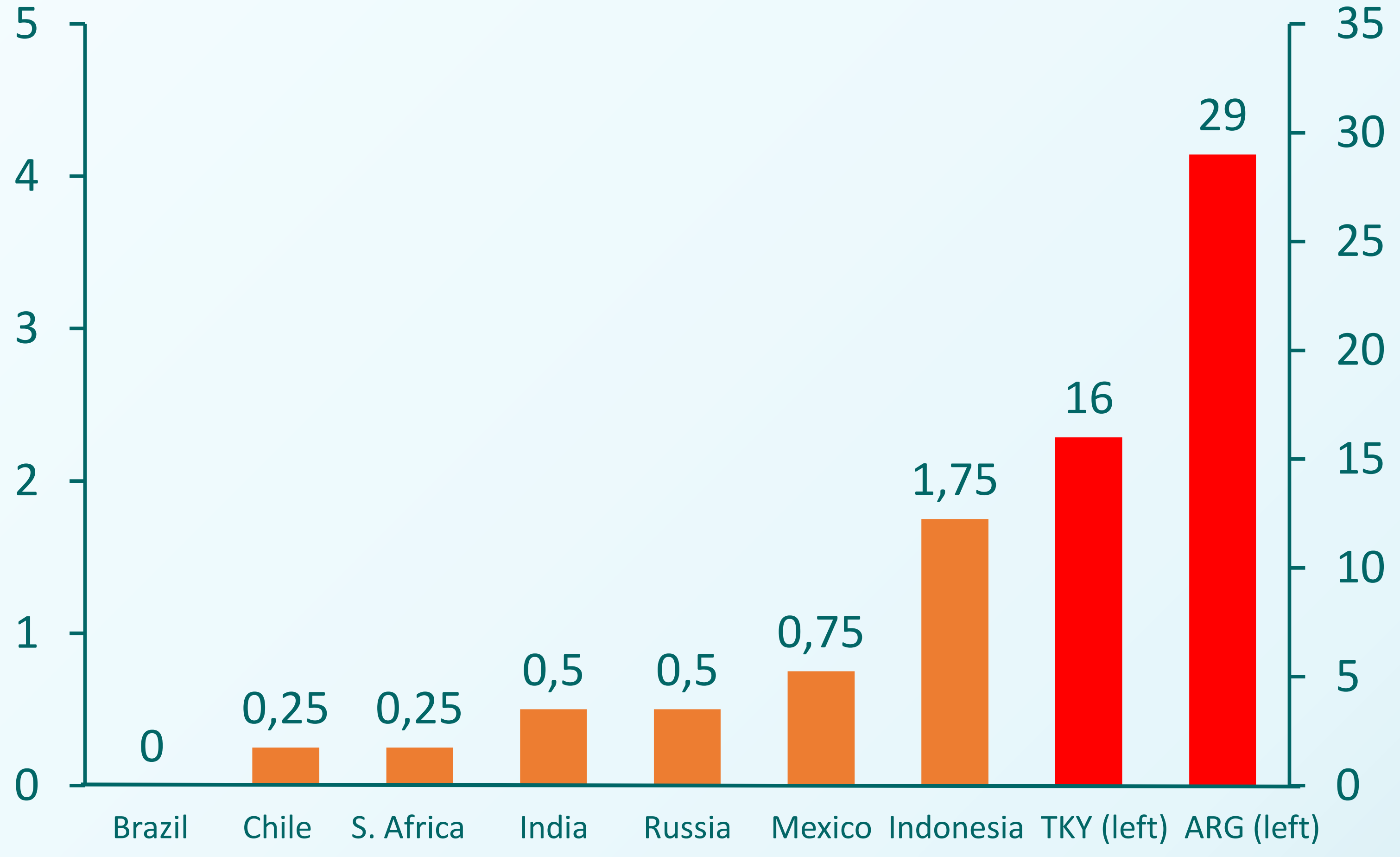
Policy rates increased

Changes since May/18 (p.p.)



Data source: Bloomberg

How should EMEs react?

- EMEs governments should focus on continuing to advance structural reforms aimed at improving the fundamentals and increasing the resilience of their economies
  - Important initiatives: tax and fiscal reforms, opening for trade, financial reforms, and initiatives aimed at increasing productivity and efficiency gains
- Buffers should help smoothing the adjustment path: especially international reserves, current account, low inflation and anchored inflation expectations.

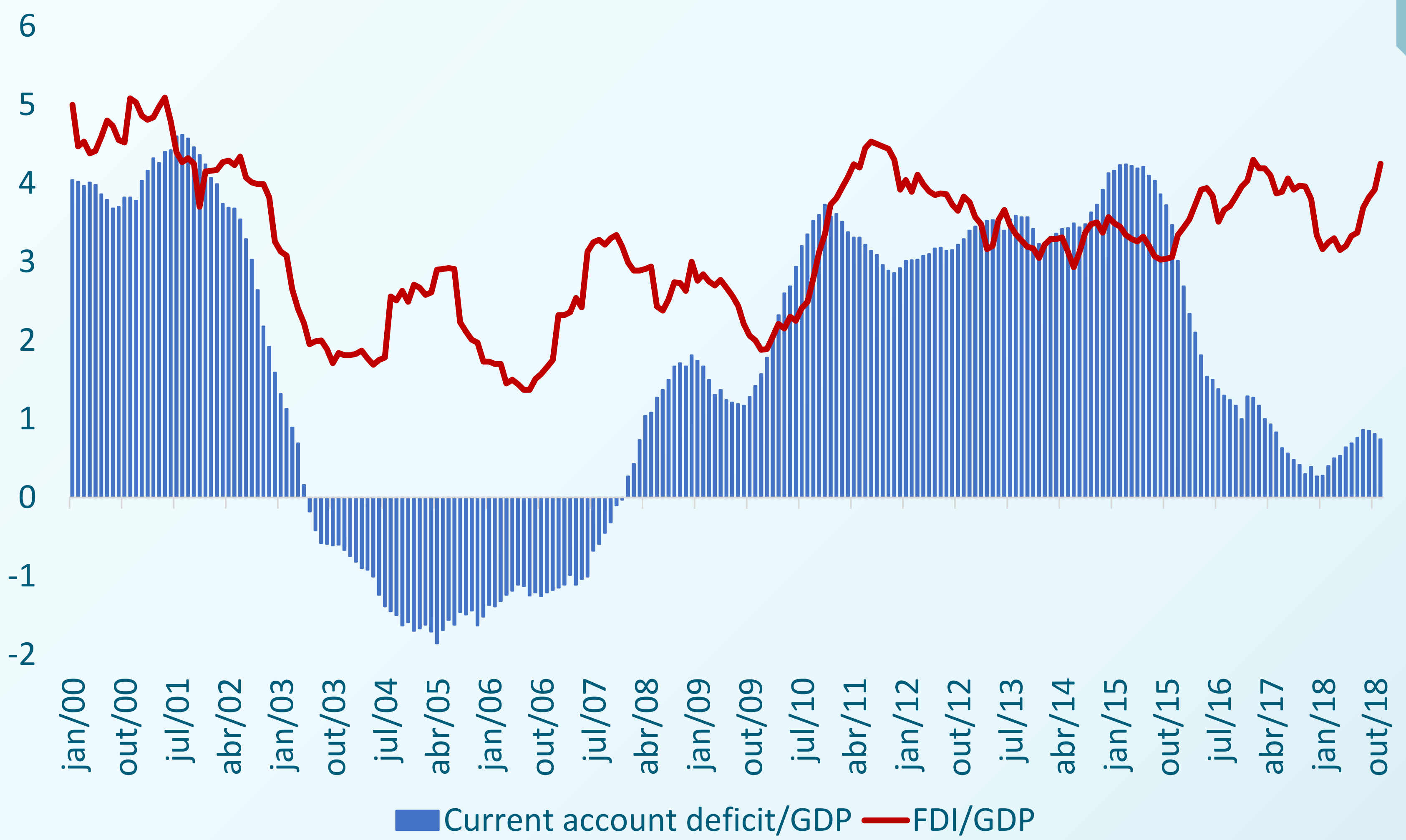
Reaction to shocks: Keep the framework

- Brazil:
  - Focus on the inflation-targeting framework.
  - In case of shocks that lead to changes in relative prices, monetary policy focuses on their second-round effects.
  - Monetary policy should not react to stabilize exchange rate *per se.*

Brazil: buffers

- Brazil has buffers to resist shocks:
  - A robust balance of payments position
  - A floating exchange rate regime
  - Adequate levels of reserves
  - Low current levels of inflation and well-anchored inflation expectations

Brazil: buffers



Current account and net foreign investment flow

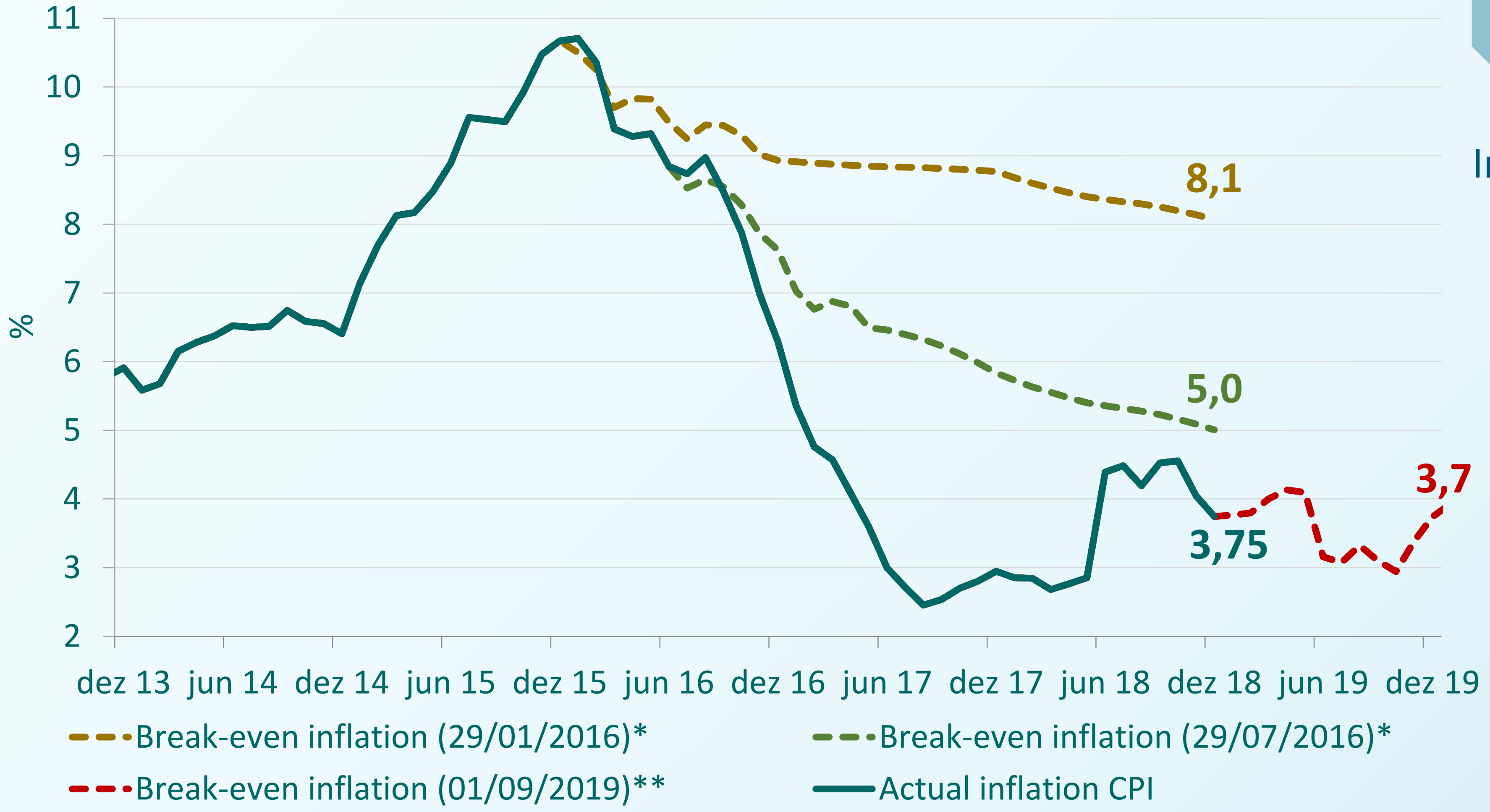
Source: BCB / IBGE

Brazil

- Made some progress in the reform agenda: spending ceiling, labor reform, education reform and Agenda BC+
- Brazil needs to continue on the path of adjustments and reforms, especially the pension system reform, in order to ensure confidence on fiscal sustainability and engender higher growth.

Anchoring inflation expectations

Inflation expectations in twelve months close to the target



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Source: BCB / IBGE
*Implied inflation expectations in inflation indexed bonds (NTN-B).
**Implied inflation expectations in CPI futures (DAP).

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Policy rate in a downward trend

Declining trend in the long run
(% a.a.)

Source: BC
Obs. : From 04/01/1996 to 03/04/1999 – Effective Selic (policy rate)
De 03/05/1999 até 12/18/2018 – Target for the policy rate

Real interest rates declining

Ex-ante real interest rates
(% p.a.)

Source: Bloomberg
The ex-ante real interest rate is derived from the Brazil CPI IPCA Median Smooth and the BRL SWAP PRE-DI 1 Year rate

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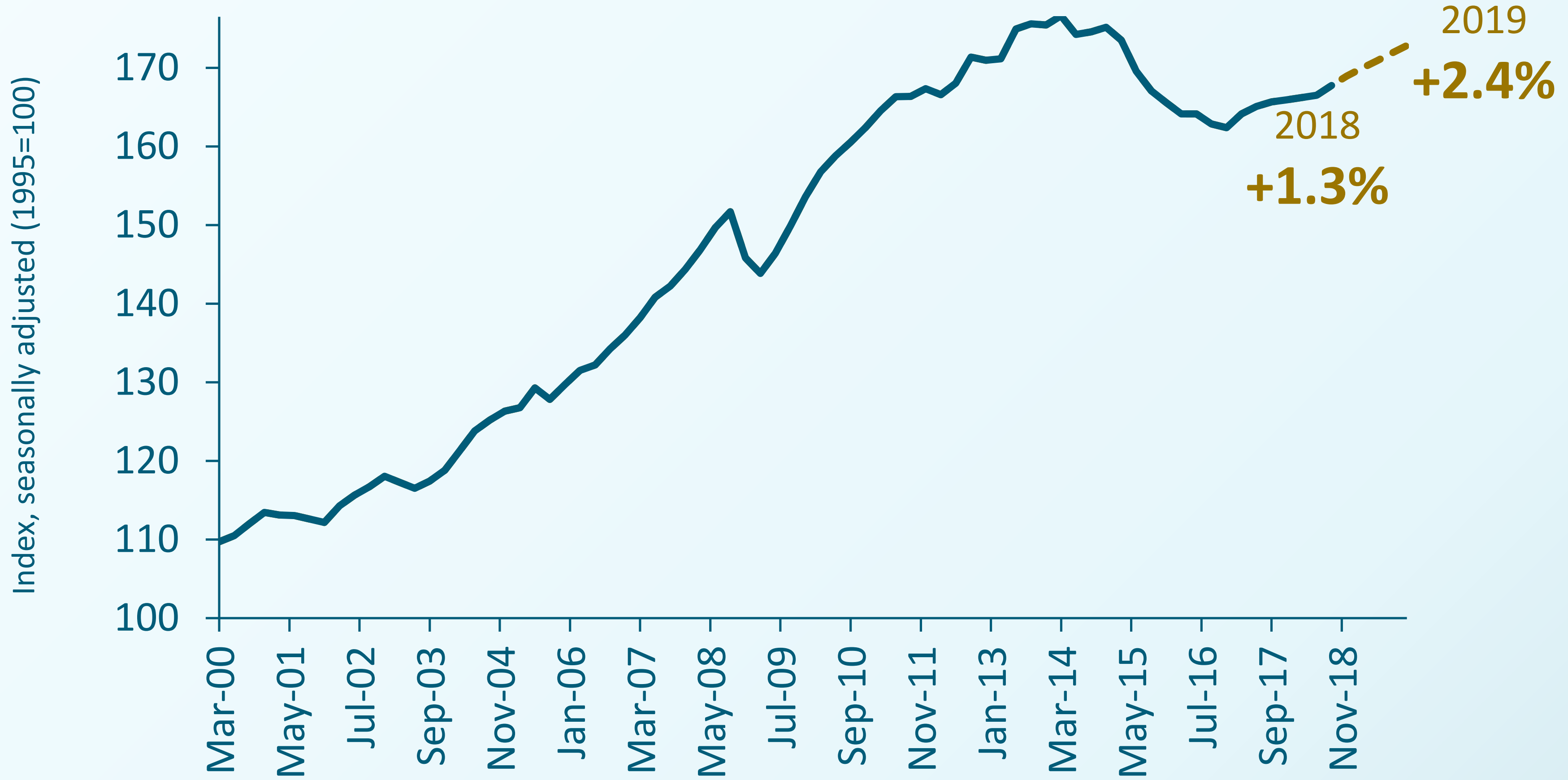
Economic recovery

GDP



Source: IBGE and BCB
- Index number, seasonally adjusted (1995=100)
- Projections for 2018 and 2019, December 2018 Inflation Report

Conclusions

- Monetary policy in EMEs faces increased challenges
    - Institutions “under construction” tend to amplify shocks, increasing volatilities in FX market, inflation and output growth;
- Important to stick to the IT framework, even in the event of stress. React if inflation targets are at risk.
- In the case of Brazil, the new direction of economic policy and the firm conduct of monetary policy led to some positive results:
    - Inflation around the target and anchored expectations;
    - Interest rates at historically low levels;
    - Gradual process of recovery of the economy.
- EMEs governments should focus on continuing to advance structural reforms aimed at improving the fundamentals and increasing the resilience of their economies.
- Buffers should help smoothing the adjustment path.

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THANK YOU!