International Transmission of Monetary Policy into EMEs: The Case of Brazil

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The views presented here are those of the author and do not necessarily reflect the position of the Central Bank of Brazil.
Increased interdependence

- Financial investment in the pre-crisis world was based on the idea of a clear market segmentation.
  - Advanced economies, with very low priced risks
  - EMEs, with assets for more speculative investments

- The crisis challenged the underpinning of this market segmentation.

- Changing risk perceptions caused a rebalancing process in global portfolio.

- This rebalancing increased EM links with the global economy and spillover effects have become more evident.
Net capital inflows

% of GDP (12 months)
Foreign participation and maturity in debt markets

Source: National Treasury
The greater foreign participation increased the sensitivity of the long end of the yield curve to global factors (see Gourio, Siemer and Verdelhan (2011)).

- Possibility of risk-on and risk-off episodes

- There is substantial evidence of effects of the US monetary policy on foreign exchange markets and capital flows to EMs.

- The effects on economic activity appear to be small (Akinci, 2013).
Barroso, Pereira and Sales (2013) estimated the effects of US unconventional policies in Brazil:

- Had QE policies not been implemented by the Fed, the term spread on treasuries would be 150 bps higher.
- The additional capital inflows resulting from QE2 are of the order of US$100 billion.
- Additional 0.9% of GDP of non-earmarked credit to households.
- Fall of 5 p.p. in interest rates in reference loans.
- Increase of 12% of GDP in stock market value.
- Near to 13% of nominal exchange rate appreciation
The beginning of the discussions initiated in May 2013 led to:

- Re-pricing of risks
- Sell-off of emerging market assets
- Depreciations in exchange rates
- Increasing bond yields and credit defaults swaps
- Falling stock market prices
After tapering signaling, BCB acted to mitigate the exchange rate pass-through risk.
Government announced the end of the 6% IOF tax on foreign inflows into fixed income (June 4, 2013)

FX interest rate swaps and FX repo program (launched on 22 August 2013)

- Goal: provide hedge to economic agents, liquidity to domestic FX market and reduce excessive market volatility.

- Measures (weekly auctions during 2013):
  - FX interest rate swap auctions: US$2 billion
  - FX Repo: US$1 billion

- US$100 billion (equivalent) until the end of 2013, considering issues before the program announcement.
The program was first extended until June 2014, with modifications (in December 2013)

- Measures (weekly auctions):
  - FX interest rate swap auctions: reduced to US$1 billion
  - FX Repo: offered as needed

The program was now extended for a still undefined term.

The current position of the BCB in currency swap contracts is around US$87 billion.
Efforts to reduce risks were successful

Exchange rate change

Aug 22 to Sep 24, 2013

May 01 to Aug 22, 2013
Foreign exchange rate

Program announcement
August 22, 2013

May 2013
Inflation adversely affected by supply shocks

- 1st supply shock (commodities)
- 2nd supply shock (fresh food)
- 3rd supply shock (fresh food)
Labor market

Real wage

Unemployment

- Real wage (YoY%)
- Unemployment Seas Adj.
Concluding Remarks

The Brazilian experience has shown that:

- The increasing foreign participation in domestic treasury markets increased the sensitivity of the long end of the yield curve to global factors.

- Unconventional monetary policy in advanced economies impacts asset prices and economic activity, with capital inflows being an important transmission channel.

- Tapering talk increased asset price and exchange rate volatility and intervention with swap instruments – backed by international reserves – has been effective to cope with hedging demand.

- Capital flow regulation and liquidity buffers are effective in reducing financial instability associated with global factors.
References:

