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

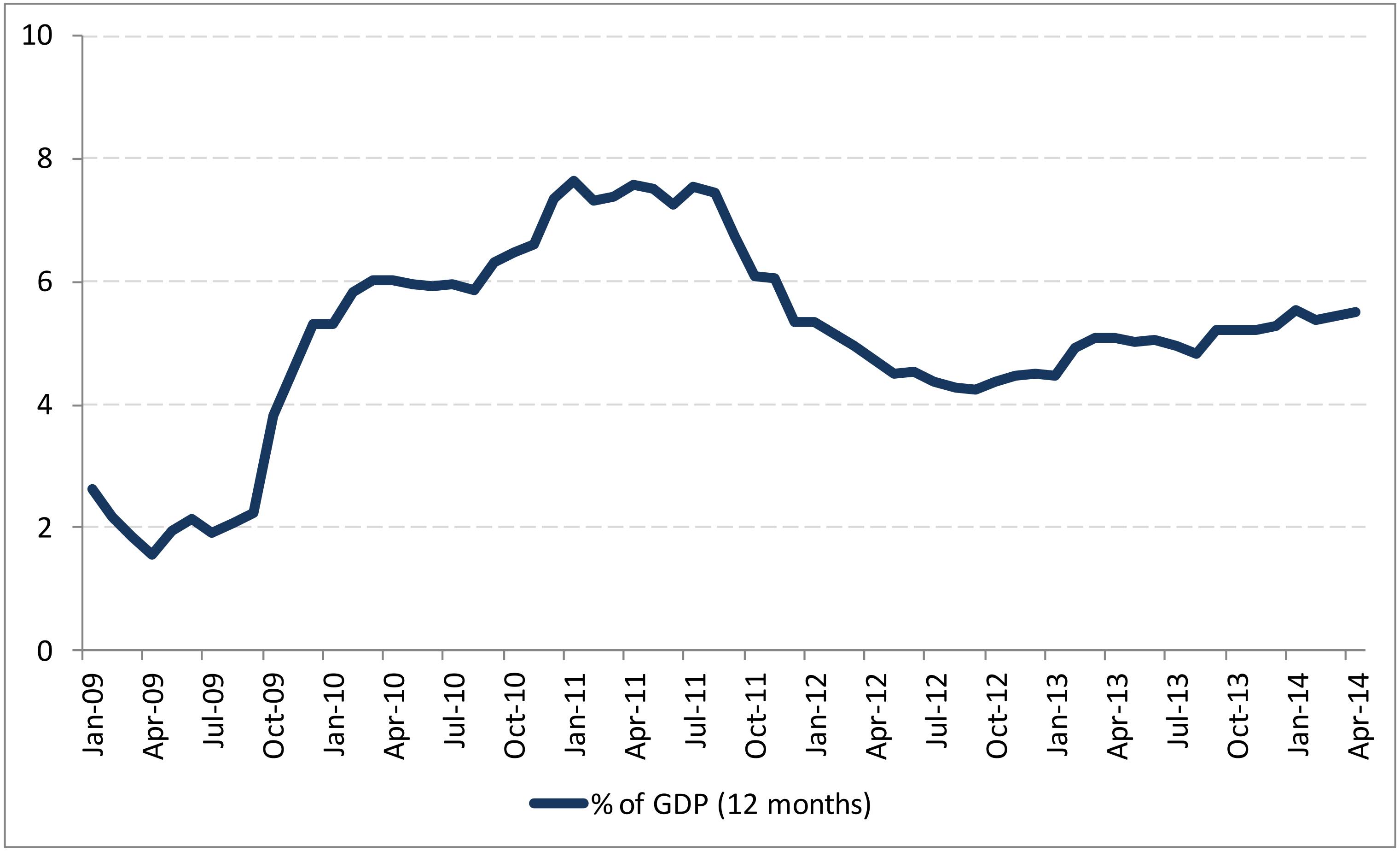
- **Financial investment in the pre-crisis world was based on the idea of a clear market segmentation.**
  - Advanced economies, with very low priced risks
  - EMEs, with assets for more speculative investments

- **The crisis challenged the underpinning of this market segmentation.**

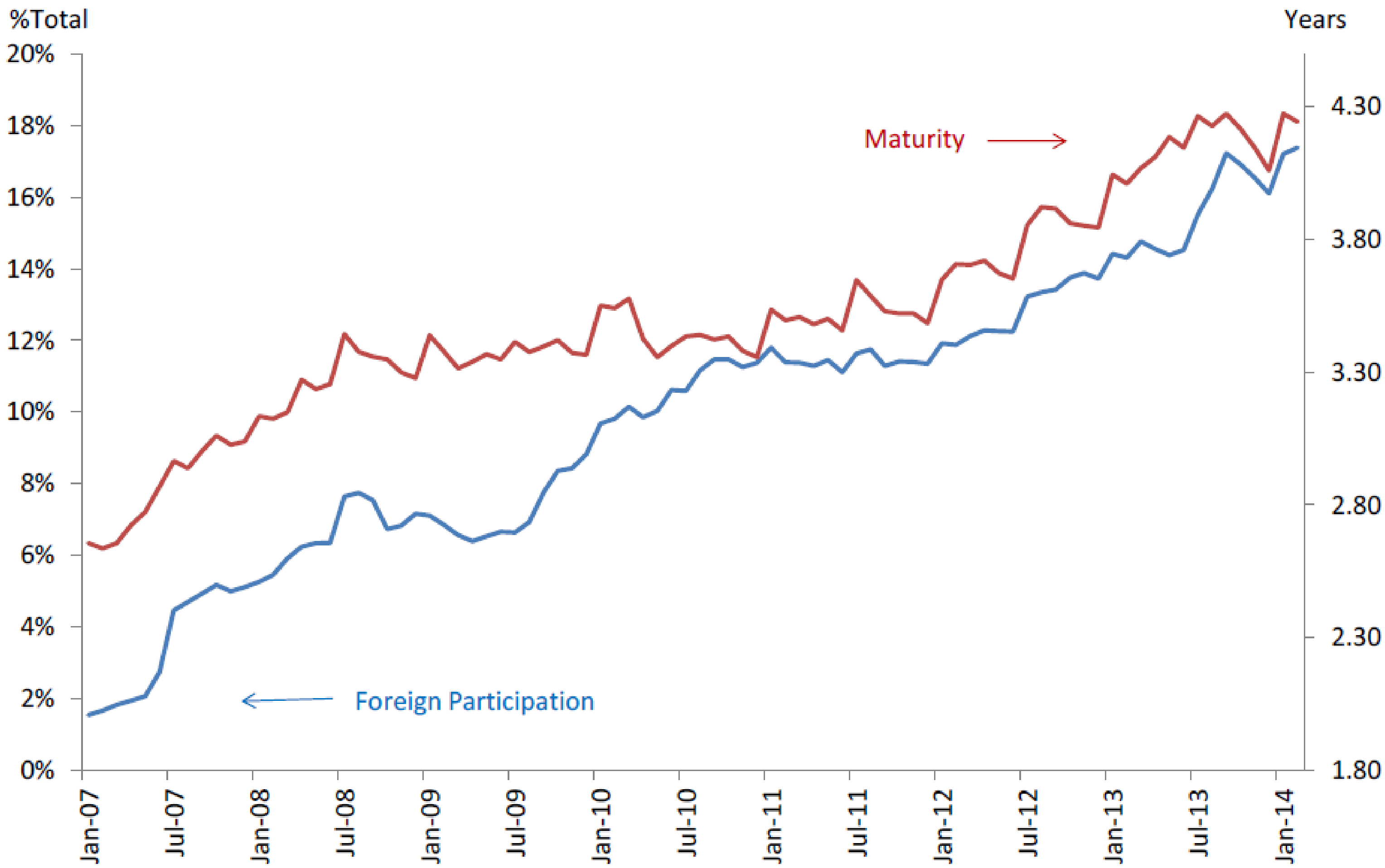
- **Changing risk perceptions caused a rebalancing process in global portfolio.**

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

Net capital inflows



Foreign participation and maturity in debt markets



Source: National Treasury

Effects of this increased interdependence

- **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).**

Transmission of unconventional monetary policies

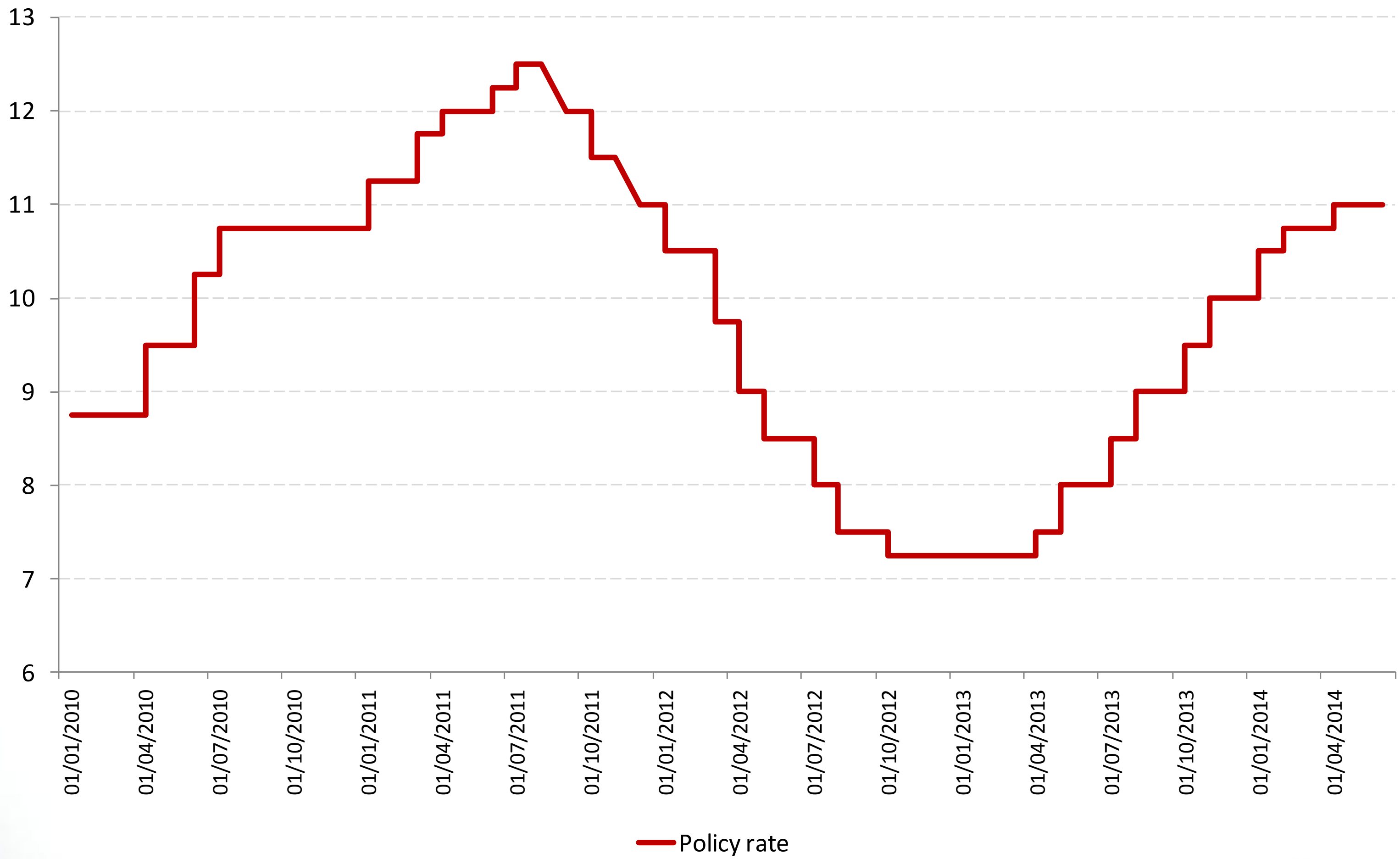
- **Barroso, Pereira and Sales (2013) estimated the effects of US unconventional policies in Brazil:**
  - Had QE policies not been implemented by the Fed, the term spread on treasuries would be 150 bps higher.
  - The additional capital inflows resulting from QE2 are of the order of US$100 billion.
  - 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

Tapering process and effects in EMEs

- **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

Monetary policy actions

➢ **After tapering signaling, BCB acted to mitigate the exchange rate pass-through risk.**



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FX interventions

- Government announced the end of the 6% IOF tax on foreign inflows into fixed income (June 4, 2013)

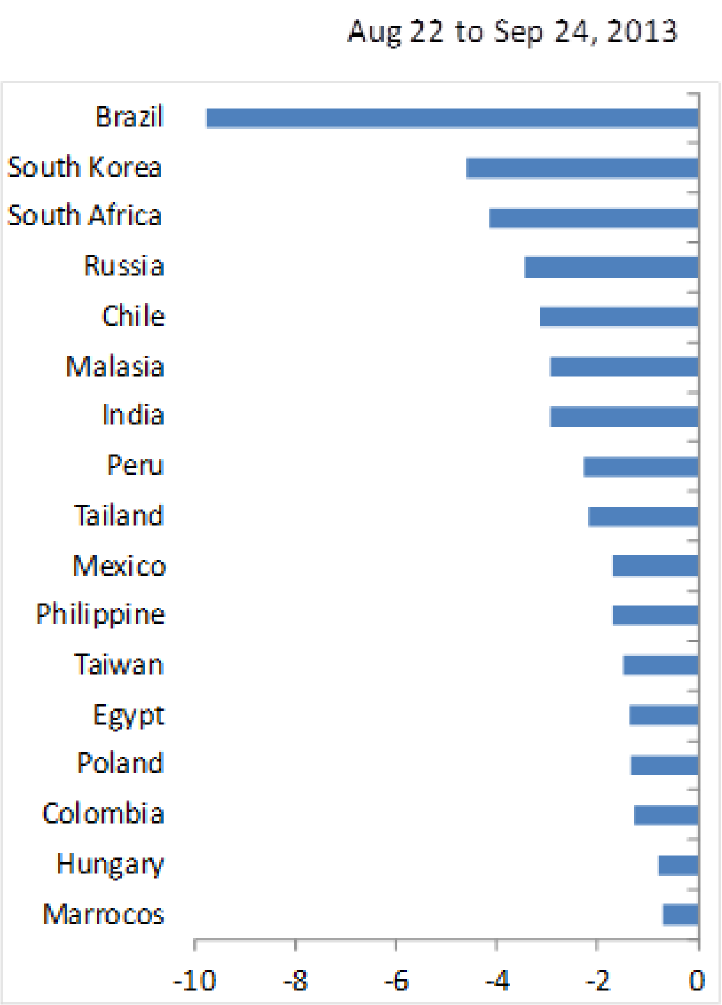
- FX interest rate swaps and FX repo program (launched on 22 August 2013)
  - Goal: provide hedge to economic agents, liquidity to domestic FX market and reduce excessive market volatility.
  - Measures (weekly auctions during 2013):
    - FX interest rate swap auctions: US$2 billion
    - FX Repo: US$1 billion
  - US$100 billion (equivalent) until the end of 2013, considering issues before the program announcement.

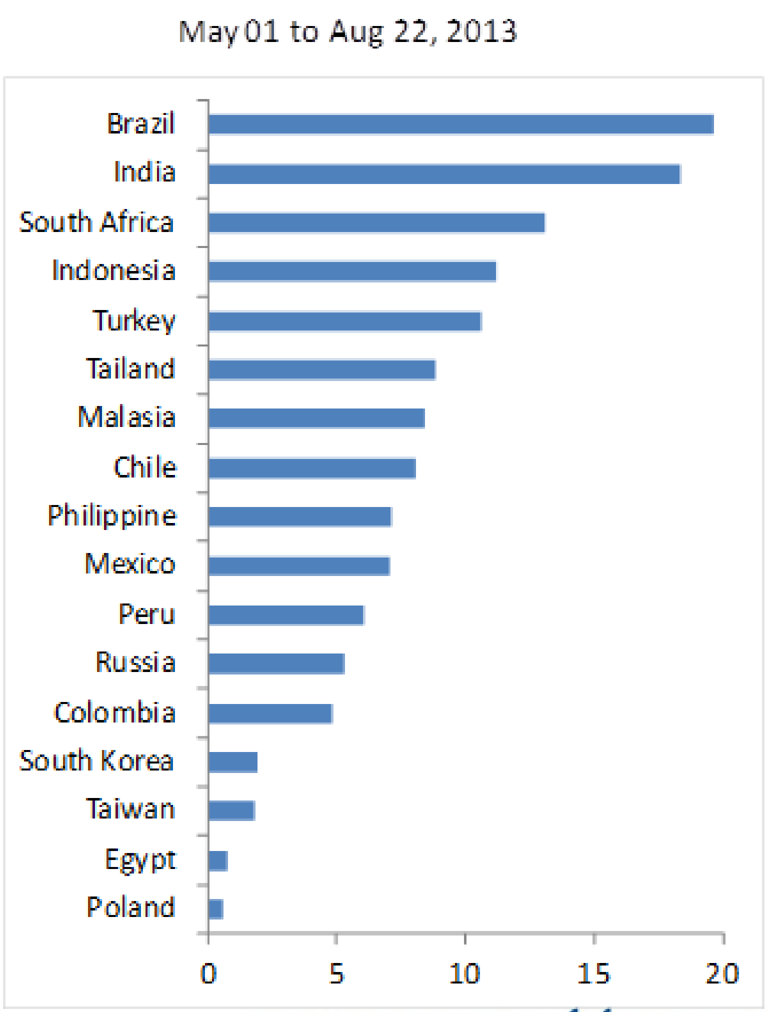
FX interventions: program extension

- **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





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Foreign exchange rate

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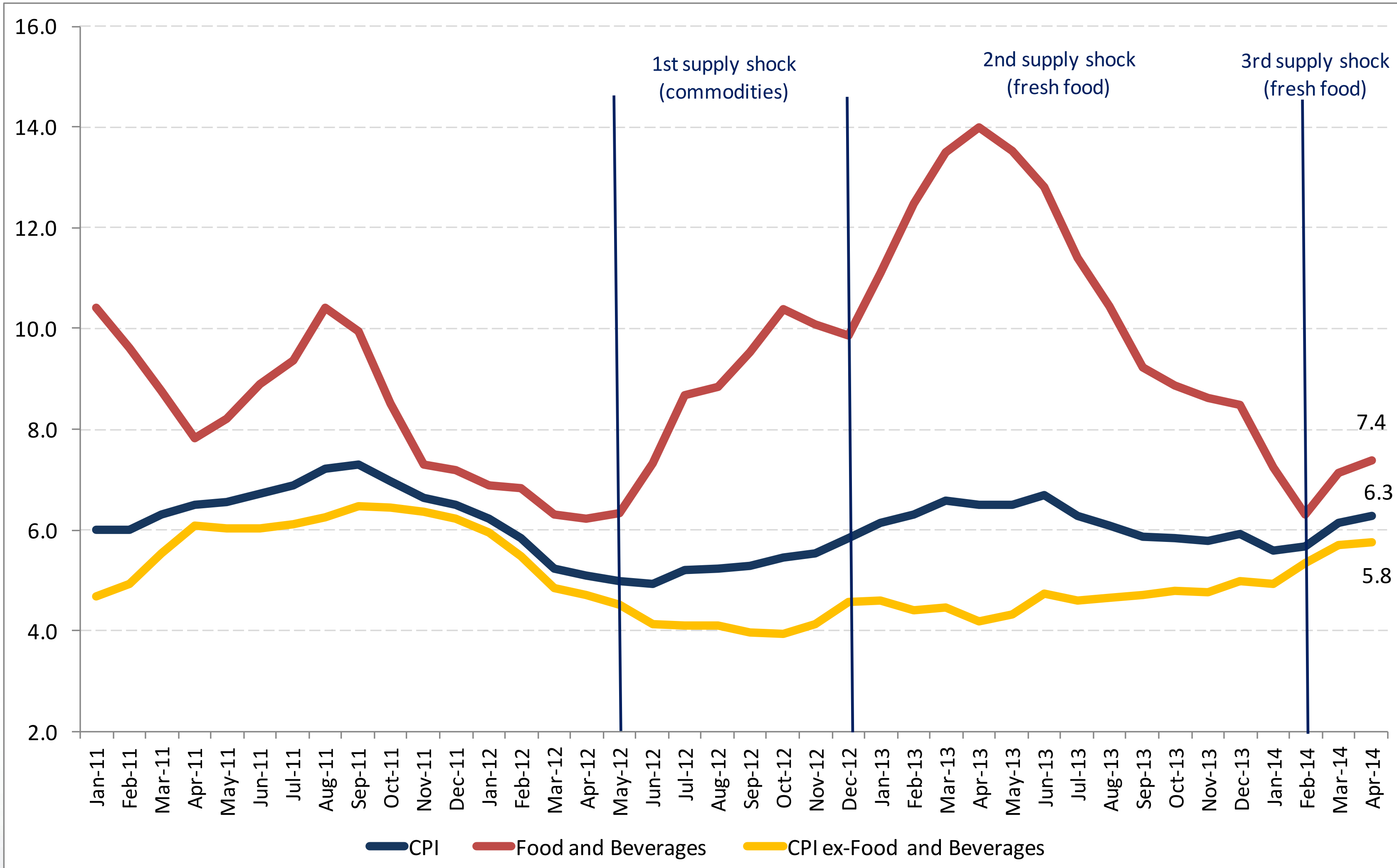
Inflation adversely affected by supply shocks



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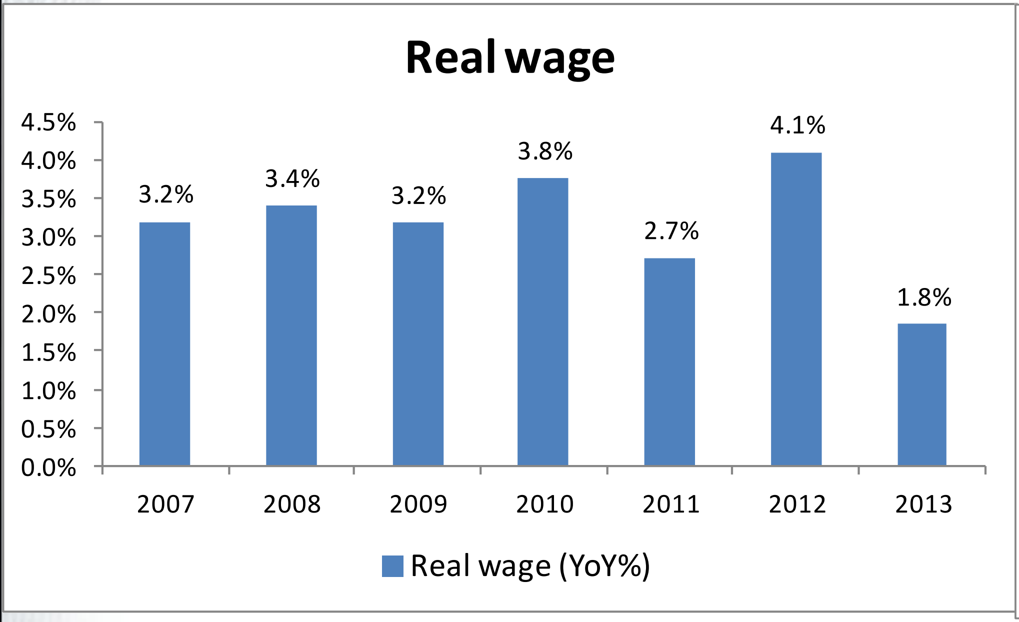
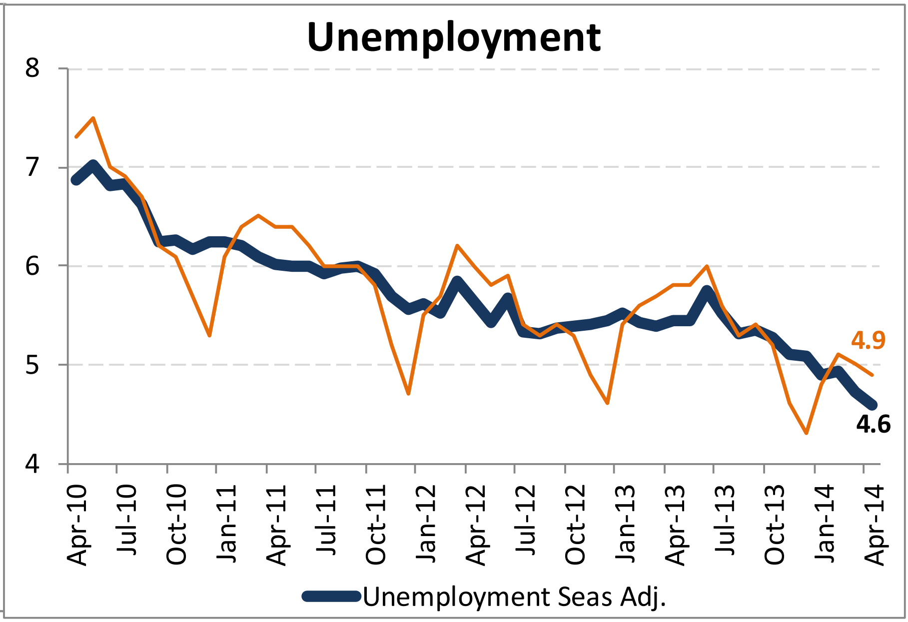
Labor market





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:

- Akinci, O. (2013), “Global Financial Conditions, Country Spreads and Macroeconomic Fluctuations in Emerging Countries”, Federal Reserve Board.

- Barroso, J. B., L. A. Pereira and A. S. Sales (2013), “Quantitative Easing and Related Capital Flows into Brazil”, Central Bank of Brazil Working Paper.

- Gourio, F., M. Siemer and A. Verdelhan (2011), “International Risk Cycles” Journal of International Economics.