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Monetary policies of industrial countries, emerging market credit cycles and feedback effects☆

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Abstract

Merging recent empirical findings into an overinvestment framework this paper describes a recursive process of monetary policy interactions between industrialised and emerging market economies that provides an explanation of what may have led to the current global low interest rate environment. Based on the overinvestment framework we show that in the prevailing asymmetric world monetary system, monetary policies of industrialised countries can fuel credit booms in emerging markets. We argue that the absorption of inflationary pressure by emerging markets during boom periods and the fear of feedback effects of crises in emerging markets encourage delayed monetary tightening in industrialised countries.
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1. Introduction

When former Federal Reserve (Fed) chairman Ben Bernanke announced to fade out the Fed's bond buying programs in spring 2013, he caused financial instability in many emerging markets, including economic heavyweights such as India, Turkey, South Africa and Brazil. Because emerging market crises could initiate a wave of contagion across the emerging world, with severe

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feedback effects on financial markets of the US and other large industrialised countries, the Fed had postponed the "tapering" (Plosser, 2013) and current Fed chair Janet Yellen has only raised policy rates one tiny step at the end of 2015.

The situation in the US is no exception. After the 1997/1998 Asian crisis had triggered the Japanese financial crisis, the Bank of Japan delayed its plan to exit from its low interest rate policy and moved towards further monetary expansion. In Japan, interest rates have been close to the zero-bound ever since. The European Central Bank holds on to its low interest rate policy and has started to engage in additional unconventional monetary policy due to the sluggish economic recovery in the southern European crisis countries.

The monetary policies of the large industrialised countries at the centre of the world monetary system (particularly US, Japan and euro area) have been designed to respond to domestic needs such as controlling inflation and reducing output gaps (Taylor, 1993). Prominent central bankers continue to use low levels of domestic consumer price inflation as primary measure of monetary policy success (Bernanke, 2014; Draghi, 2014). Yet in an asymmetric world monetary system, the monetary policies of the large central banks at the centre have a far-reaching impact on the macroeconomic development of the periphery countries, with feedback effects on the industrialised countries themselves.

In the 1930s, Hayek (1937 [1989]) stressed that purely nationally-oriented monetary policies had contributed to the beggar-thy-neighbour policies that were followed by economic disintegration, sluggish growth and political instability. More recently, McKinnon (2013) created the notion of an 'unloved dollar standard', which exports financial instability to the emerging markets. While China has called for a new international monetary system that is less dependent on the US monetary policy (Xiaochuan, 2009), Stokes (2014) suggested that "dollar hegemony" has even increased since the crisis.

The papers aims to model the mutual links between monetary policies of large industrial countries and emerging market economies. Previous papers have analysed the impact of low interest rates in the large industrialised economies on emerging markets, credit booms and global financial imbalances (e.g. Borio & Disyatat, 2011; Cachanosky, 2014), the transmission of such expansionary monetary policies to the emerging markets (e.g. Reinhart, 2013; Rey, 2013) as well as feedback effects of financial turmoil in emerging markets on financial markets in large industrialised countries (e.g. Cuadro-Sáez, Fratzscher, & Thimann, 2009; Kaminsky & Reinhart, 2008). To our best knowledge so far no paper has attempted to merge the findings of these three strands of literature to a recursive process of monetary policy interaction that can provide an explanation of how the world has fallen into the current (potentially persistent) low interest rate environment.

Based on an augmented overinvestment framework, our study shows that during the boom period of the 2000s, central banks in industrialised economies may have postponed monetary tightening, as emerging markets tended to absorb inflationary pressure. Furthermore, we illustrate that the subsequent crises in emerging markets, or the fear thereof,[1] provides grounds for hesitant monetary tightening and further interest rate cuts in the large industrialised countries. Based on our analysis, we derive asymmetric monetary policy patterns and lock-in effects of low interest rate policies in the large industrialised countries that help explain why a decisive exit from the current low interest rate environment has become unlikely.

[1] See Feroli et al. (2014) for an explanation why financial turbulence is likely to recur if the Fed accelerates tapering.

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