

Contents lists available at [ScienceDirect](https://www.sciencedirect.com)

Emerging Markets Review

journal homepage: www.elsevier.com/locate/emrEmerging market corporate bond yields and monetary policy[☆]

Yannick Timmer

Department of Economics, Trinity College Dublin, Dublin 2, Ireland

ARTICLE INFO

JEL classification:

F38
E43
E52

Keywords:

Global financial cycle
Monetary policy
Emerging markets
Corporate funding conditions

ABSTRACT

I examine spillover of monetary policy on corporate bond yields. Emerging market corporate bond yields are positively associated with the federal funds rate. However, this positive relation is transmitted through the domestic policy rate. If domestic policy rates are held constant, the spillover of US monetary policy on corporate bond yields diminishes. This suggests that domestic policymakers face a tradeoff: if they leave their policy rate unchanged when the Fed hikes, this may have benign consequences for corporate bond yields. However, a higher US policy rate may lead to exchange rate depreciation for emerging market currencies and thus elevated debt burdens for their US dollar debtors. Alternatively, if the Fed hikes and policymakers follow suit, funding conditions for corporates worsen through higher yields.

1. Introduction

Corporate debt in emerging market economies has been in the focus of many policymakers and academics recently (Acharya et al., 2015). Since the financial crisis, there has been a shift from bank lending to corporate bonds (Becker and Ivashina, 2014). Previously, researchers put a focus on the determinants of bank lending interest rates and relatively little attention has been paid to the pass-through of monetary policy on corporate bond yields. This is particularly true for the spillover effects of monetary policy on financing conditions of corporates in other countries. While bank lending interest rates are relatively unrelated to global conditions, there can be a spillover of global conditions on domestic corporate debt financing conditions through the capital markets.

This paper analyzes whether corporate bond yields in emerging market economies are related to US monetary policy and how US monetary policy transmits to corporate bond yields in emerging market economies. Rising financial globalization before the global financial crisis has renewed attention to a global financial cycle that determines economic and financial conditions globally (Bruno and Shin, 2015a; Rey, 2013). The trilemma in international economics emphasizes the impossibility of stable exchange rates, free capital movements and independent monetary policy concurrently (Obstfeld et al., 2005, 2010). Recently, this has been questioned by Rey (2013). She argues that the global financial cycle is the main determinant of global capital flows. Even if the exchange rate of a country is floating, it is exposed to cross-border capital flows that make its monetary policy dependent as cross-border capital flows will determine financial and economic conditions. The conclusion states that it is necessary to have a managed financial account to be insulated from the global financial cycle and to have an independent monetary policy. In addition, Rey argues that both the VIX and the federal funds rate are important determinants of the global financial cycle and global credit flows. She proposes that important central banks should pay attention to how their policy stance affects other economies. In the spirit of Rey, I show that US monetary policy can affect corporate bond yields in emerging market economies. However, it is also important to shed more light on the question if and how policymakers in emerging market economies can insulate themselves from global shocks and how important global shocks are to domestic funding conditions. My results show that emerging market central banks can prevent corporate bond

[☆] I am grateful to Philip Lane for helpful comments. I gratefully acknowledge financial support from the Grattan Foundation.

E-mail address: timmer@tcd.ie.

<https://doi.org/10.1016/j.ememar.2018.04.001>

Received 14 November 2016; Received in revised form 23 October 2017; Accepted 3 April 2018

1566-0141/ © 2018 Elsevier B.V. All rights reserved.

yields from being dependent of US monetary policy if their monetary policy is autonomous.

While research has focused on the effect of the global financial cycle on cross-border capital flows, evidence on the effect of the global financial cycle on corporate financing conditions has been rare. A sudden stop of cross-border capital inflows may lead to an external adjustment process but does not necessarily affect financing conditions in emerging markets when the cross-border flows are offset domestically. In contrast, asset prices can also be determined by the perception of demand and supply as well as self-fulfilling prophecies. These animal spirits can drive prices and therefore move funding conditions even if flows do not change. Accordingly, it is a key factor for financial stability to be aware of the spillover effects of monetary policy elsewhere on corporate bond yields.

As a consequence of the Fed's asset purchase program, investors have rebalanced their portfolios by replacing assets which were bought by the Fed with other assets (Bernanke, 2012). Many researchers focus on the global spill-over of the low global interest rates accompanied with the large-scale asset purchase programs in advanced economies. Burger et al. (2015) find that there has been a portfolio rebalancing towards emerging markets. In particular, the Fed's large-scale asset purchase program and low interest rates in the US have led to capital flight to emerging market economies. This rebalancing was driven by demand for higher-yielding bonds, such as those of corporates in emerging markets. In addition, emerging market corporates tend to issue US dollar debt in a low interest rate environment (McCauley et al., 2015). When the Fed announced that it will curtail its asset purchase program, there was a sudden retrenchment from the emerging market economies. This so-called Taper Tantrum has caused more attention to be paid to the question of how the US monetary policy affects funding conditions of emerging markets. Since then, the fear of hike in the federal funds rate has been prevalent in emerging markets.

Tighter US monetary policy might affect bond yields in the US, leading to a rebalancing back to US assets of the portfolios of investors that target a specific return. The portfolio rebalancing mechanism may have consequences for the prices and yields of emerging market economy assets. Tighter funding conditions can materialize once maturing assets need to be rolled over at higher yields.

There has been much emphasis on the trilemma of international economics as well as, more recently, on the global cycle and how it affects capital flows. To the best of my knowledge, there is no study that investigates the spillover of the monetary policy of the US on corporate funding conditions in emerging market economies including implications in terms of how policymakers can possibly prevent spill-over effects. I aim to fill this gap in the literature.

My empirical approach consists of three steps. First, I regress the country specific corporate bond yield on the domestic policy rate. Second, I substitute the domestic policy rate with the federal funds rate. Third, I regress the corporate bond yield on the domestic policy rate and the federal funds rate. My main specification also includes control variables and country fixed effects. The rationale behind this approach is the following: a regression of the corporate bond yield on the domestic policy rate, omitting the federal funds rate, shows the response of the corporate bond yield to the domestic policy rate unconditional on the US monetary policy stance. If the domestic policy rate of emerging market economies is following the federal funds rate as highlighted in Han and Wei (2014), I should not control for the domestic policy rate and only regress the corporate bond yield on the federal funds rate. If I omit the domestic policy rate, I allow the policy rate to float. Regressing the corporate bond yield on the federal funds rate clarifies how corporate bond yields react to the federal funds rate unconditional on the domestic policy rate. However, if the federal funds rate is changed and domestic policy rates follow suit, I can control for the policy rate in order to see how the federal funds rate affects the corporate bond yield, holding the domestic policy rate stable.

My results show that a higher federal funds rate in the US is associated with higher corporate bond yields in emerging market economies. However, this is not the case if policy rates in the domestic country stay unchanged. Therefore, the domestic monetary policy rate dominates the effect of the federal funds rate. A federal funds rate hike leads to an increase in the corporate bond yields of emerging market economies only if I allow the policy rate to follow the Fed. As soon as I control for the domestic policy rate, the effect diminishes and can be even negative. A higher federal funds rate is then associated with lower corporate bond yields.

This indicates the following tradeoff for emerging market economy policymakers: if the Fed changes its policy rate and emerging market policy rates follow suit, corporate bond yields increase and corporates in emerging markets face tighter funding conditions. This can jeopardize the economies of emerging markets and also affect the global economy through the global investor base in emerging market debt. Since corporates in emerging markets levered up massively since 2010, rollover risk can be significant once their debt securities mature. If domestic policymakers follow the Fed and increase their policy rates as well, this may lead to the above-described tighter funding conditions. In addition to the borrower side, the buy side in advanced economies may be affected when the yields of emerging market corporate debt securities rise and prices fall.

The alternative for emerging market policymakers is to leave their policy rate unchanged if the Fed hikes the policy target rate, which decreases the policy rate differential between the emerging market economies and the US. A change in the policy rate differential between two countries puts downward pressure on the currency with the relatively lower interest rates, and countries with floating exchange rates suffer a depreciation of their currency (Eichenbaum and Evans, 1995). While a depreciation of the domestic currency can boost exports and the economy in general, it has some dangerous implications for borrowers that face a currency mismatch in their balance sheets. Corporates in emerging market economies have increased their issuance of dollar debt massively since 2010 (McCauley et al., 2015). However, it is likely that the currency exposure is not fully hedged (Bleakley and Cowan, 2008; Bruno and Shin, 2015c; Schreger and Du, 2014). Hence, the currency mismatch increases the value of their net debt liabilities when the US dollar appreciates. Although most emerging markets have accumulated foreign exchange reserves in recent years, it will be a challenge to provide the corporate sector with US dollar reserves unless by lending to corporates that suffer a US dollar shortage directly.¹

¹ Aizenman et al. (2015, 2010) explain why economies may have built up exchange rate reserves recently and that countries with fewer reserves suffered higher currency depreciations during the Taper Tantrum.

Download English Version:

<https://daneshyari.com/en/article/8942338>

Download Persian Version:

<https://daneshyari.com/article/8942338>

[Daneshyari.com](https://daneshyari.com)