

THE IMPACT OF U.S. MONETARY POLICY ON CAPITAL FLOWS TO EMERGING MARKET ECONOMIES**Katia Rocha**

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Fluctuations in global financial markets have historically significantly influenced financial and macroeconomic conditions in emerging markets economies (EMEs). Under buoyant global financial conditions, emerging markets have enjoyed stronger economic growth supported by abundant foreign capital inflows. Conversely, when global financial conditions tightened – most notably during the global financial crisis – economic activity in emerging markets was severely affected.

Foreign portfolio flows are an important source of funding for EMEs. Nonresident portfolio investment can help expand and diversify the investor base for emerging market assets, lower the cost of funding, and contribute to stronger economic growth. However, reliance on foreign financing can also entail risks. Heightened uncertainty in the global economy can lead to a significant tightening of global financial conditions and increased portfolio flow volatility. Moreover, the strong and persistent portfolio inflows seen in earlier periods can create vulnerabilities by encouraging excessive domestic credit creation and an overvaluation of local currency and other financial assets.

At the end of February 2020, news of the global spread of covid-19 hit financial markets with devastating force. One month later, global risk aversion had reached an intensity not observed since the peak of the global financial crisis, while capital flows began to cascade out of EMEs.

Since the announcement of several successful covid-19 vaccine trials in late 2020, the global economic outlook has improved. Given a more backloaded access to vaccinations and less policy space to provide

lifelines and support economic activity, many EMEs are projected to have a more protracted recovery than major advanced economies.

During economic recovery, many emerging markets might struggle to provide sizable fiscal policy support for a prolonged period, given their more constrained policy space – and even more so following last year's sharp increase in public debt. Constrained fiscal policy, in turn, would heighten the role of monetary policy. This prompts the question of how much autonomy policy-makers in emerging markets would have in keeping monetary policy rates low at a time when improved economic conditions may lead central banks in advanced economies to begin increasing interest rates. On this point, a commonly held view is that, even with a flexible exchange rate, emerging markets have little monetary policy autonomy against a powerful global financial cycle that is strongly influenced by monetary policy in advanced economies.

Going forward, the pressing question for emerging-market policy-makers is how capital flows will respond to the Fed's withdrawal of monetary stimulus and eventual increase in interest rates. To shed some light on this issue, this paper examines the potential impact of US monetary policy normalization on portfolio capital flows to EMEs explicitly taking into account the unconventional US monetary policy.

Our paper builds on two main strands of the literature. First, it builds on the extant literature on the determinants of capital flows to EMEs that focuses on the role of both country-specific or "pull" factors and global or "push" factors. Our aim, however, is not to revisit the debate on the determinants of

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capital flows in general, but to focus on the impact of US monetary policy on portfolio flows to EMEs.

Second, it builds also on a second recent area of research that focuses on the spillovers to EMEs from advanced economies' monetary policies, with a particular focus on unconventional policy.

Our paper contributes to these two strands of the literature on the role of US monetary policy in driving capital flows by using the fed funds shadow rate as a measure of monetary policy stance instead of the fed fund rate itself, as most of this literature. In response to the Great Recession and the covid-19 crisis, the Federal Reserve, like many other central banks, cut its policy interest rate close to zero. When this happens, the lower bound constraint on nominal interest rates makes it difficult to determine the stance of monetary policy given prevailing economic conditions from the observed policy rate alone. In an influential paper, Wu and Xia (2016) use a term structure model to construct a 'shadow' policy rate intended to quantify the interest-rate-equivalent stance of policy at the zero lower bound (ZLB). The basic idea is that we might use the shadow rate series as a way of summarizing what the Fed has been doing with its unconventional policy measures such as large-scale asset purchases and forward guidance. If the Wu-Xia framework is correct, these unconventional policies can all be summarized in terms of what effect they had on the shadow short rate.

We build an econometric model of the drivers of capital flows to EMEs and using sample data from January 2010 to December 2019 we find that the coefficient of the US monetary policy stance has the expected negative sign and is highly statistically significant for both Brazil and EMEs. The coefficient for EMEs being four times as big as that for Brazil, suggests that Brazil maybe less vulnerable than EMEs to changes in US monetary policy.

REFERENCE

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