Unconventional Monetary Policy in Emerging Economies: License to QEll

Dear Governor Matolcsy, dear colleagues, and all those who follow this ceremony on-line, as we all got used to these days,

When colleagues from the MNB called to inform me that I have received the Lámfalussy Award, an award for "outstanding professional performance and lifetime achievements on the international scene", I felt both honored and grateful, knowing the importance of the Award, knowing the economist whose name it holds, whom I had an opportunity to know, and who was a really impressive person, and, of course, knowing all the colleagues and friends who have received it before. Thank you very much!

When I thought of the topic of today's speech, as we have also discussed, it seemed appropriate to address the monetary policy in emerging markets in the time of the unconventional monetary policies of the world's largest central banks. First ideas, interestingly, resonated with some thoughts on the "Hitchhikers Guide to the Galaxy", a timeless novel by Douglas Adams.

There are several reasons for this association.

First of all, as you all know, central bankers are a bunch of people who are skeptical about the thoughts of people who take the Universe for granted. So I had to process the information through the solipsistic lens very much akin to the one displayed by the "Ruler of the Universe", a fictional character from the novel.

Secondly, as we know from the ''Hitchhikers Guide to the Galaxy'', 42 is the solution for all our problems, the famous answer to the ultimate question, even though we don't know what the question actually is. That, in turn, somehow reminds me of the monetary policy today. It is being proposed as an answer to almost any problem – from lack of inflation, lack of GDP growth, to rising spreads, lack of access to credit, inequality, pollution and, in my own country recently, even the earthquake consequences. Another interesting parallel –

"don't panic" advice from the cover of the novel – has become a standard piece of advice for contemporary policymakers.

Thirdly, Adams worked with the Monty Pythons before writing the novel. And, regarding monetary policy in a negative interest rate environment – most likely the Monty Python crew would have filmed a sketch about getting paid from the bank window to borrow money. Potentially very funny, but even they might have considered the idea a bit too crazy back in the 1970s.

Today, extremely low real interest rates appear to be a permanent feature of our economies. No one would have thought that just a few years ago. When Japan was first struck by a combination of low inflation and low nominal interest rates about a quarter of a century ago, we considered it to be a temporary phenomenon, or maybe something idiosyncratic to the Japanese economy. Our thoughts on central bank policy rates converging to zero in Western economies about a decade ago were very much along the similar lines.

Nevertheless, signs of falling interest rates have been with us for quite some time. We can observe the implacable trend in our standard statistics over the last couple of decades. Very recent research finds that the trend of falling interest rates covers a much longer period, spanning over at least seven centuries. Falling interest rates seem to predate even the establishment of first central banks (Schmelzing, 2020). Also, over time, the frequency at which negative real rates appeared has increased, and that happened regardless of the dominant monetary regime – fiat money issued by a central bank, or some form of specific monetary standard such as gold or silver.

It is interesting to note that different writers recognized a concept of falling interest rates throughout the history, albeit often in a conflicting manner. For example, Marx turned a declining rate of profit into a cornerstone of his theory, a sort of a doomsday device built into foundations of capitalism. Keynes, on the other hand, saw falling interest rates, but not profit rates, as a means to advance a new, better form of capitalism. It is worth repeating his words from the General Theory:

"I see, therefore, the rentier aspect of capitalism as a transitional phase which will disappear when it has done its work. And with the disappearance of its rentier aspect much else in it besides will suffer a sea-change. It will be, moreover, a great advantage of the order of events which I am advocating, that the euthanasia of the rentier, of the functionless investor, will be nothing sudden, merely a gradual but prolonged continuance of what we have seen recently in Great Britain, and will need no revolution."

Today we don't see low interest rates as a doomsday device. Neither they are a panacea, as Keynes saw them. It is an interesting twist of fate that it is the reduction of investments, as population growth slowed down and the nature of technology changed, that is pushing interest rates down, rather than an increase in savings. Also, we have some evidence that savings rates remained robust due to rising ''rich savings glut'' rather than an increase in general living standards (Atif et al., 2020). On the other hand, a growing portion of the world's excess savings is generated by the Far East economies, with capital flowing "upstream", towards richer economies. In addition, the impact of low interest rates on inequality is far from straightforward. Various channels operating in different ways, and many commentators blaming them for the rise in inequality, particularly inequality in wealth (Bean et al., 2015). Finally, low interest rates interact with the economy in a complicated manner with some evidence of a negative impact on productivity growth, which is often referred to as "a zombification of the economy".

The most important negative side effect of low equilibrium interest rates implies that policy rates may often hit the lower bound, regardless of whether we consider it to be zero, or slightly below zero, thus restricting the ability to pursue the countercyclical monetary policy. Keynes was well aware of that effect as he developed the concept of the liquidity trap. To overcome the problem of the lower bound on policy rates, central banks in major advanced economies have pursued asset purchase policies (APPs) in the context of quantitative easing and forward guidance. Until very recently, such policies have been firmly confined to a small batch of large central banks that issue reserve currencies. However, since the COVID-19 induced crisis, about 20 central banks from emerging markets (EMs) engaged in APPs, a practice they have so far steered clear of (Sever et al., 2020). Indeed, questions on reasons for EM central banks to engage in APPs, their future plans, and sometimes the difference

between the global financial crises and current episode features prominently at almost every conference or investor meeting I have participated in over the past few months.

The main reason for EMs to initiate APPs is obvious with the benefit of hindsight – they were successful. APPs in principle operate through several channels: the bank liquidity channel works through higher bank reserves which expand loan supply, the portfolio rebalancing channel increases asset prices as investors divert their proceeds from asset sales into alternative assets, and finally, the signaling channel reinforces expectations of future accommodative monetary policy. Early evidence confirms that APPs indeed worked in EMs in a more or less similar way to their mechanics in advanced economies (Sever et al., 2020, Hofman and Kamber, 2020). Such policies reduced bond yields and improved financing conditions for the domestic economy. Their impact on equity prices was less pronounced, but it can be argued that the portfolio rebalancing channel is not as important in EMs due to less developed capital markets and other types of non-bank intermediation in the provision of financing to the economy. Also, the main goals of APPs in EMs relate less to pushing up inflation and much more to stabilizing the markets.

One important reason why APPs worked for EMs arises from the benign international environment and compressed risk premiums. While the breakout of the pandemic triggered a reversal of capital flows to EMs in March 2020, this episode was very brief and capital flows quickly resumed. The spillover from massive APPs implemented by the ECB and FED is probably the main reason why EM exchange rates did not react much to the announcement and implementation of APPs. Comprehensive assessments of APPs would also have to take into account the self-selection of central banks. Even as the ranks of central banks implementing APPs swelled, still only a small minority of the world's central banks engaged in such programs, presumably in countries with stronger fundamentals and lesser macroeconomic vulnerabilities. Finally, APPs in EMs were on average quite modest in size, which has kept the risks at bay. The Croatian National Bank implemented one of the largest APPs amongst EMs last year, worth about 5.5 per cent of GDP, which is roughly only half the size of the ECB’s program in the same year. In our case, entering into a currency swap

arrangement with the European Central Bank and the subsequent ERM II accession also helped to stabilize the markets and make APP a success.

The recent evolution of monetary policy regimes in EMs cannot be taken for granted. EMs do not issue reserve currencies and they depend on international borrowing in foreign currencies. Jointly with domestic dollarization or euroization, this makes them heavily reliant on exchange rate movements, subordinating other policy goals to exchange rate stability. They, in general, have less robust overall policy frameworks with lower level of credibility. If fears of fiscal dominance intensify, APPs may not be able to counter increases of risk premiums without jeopardizing other policy goals. Also, deflation is generally not a problem in EMs – elevated inflation more often is. EMs will remain prone to sudden stops and reversals in capital flows, which can trigger a currency and financial crisis. Their hard-earned license to pursue QE type policies may not always be warranted – such a policy will each and every time have to be weighed carefully against vulnerabilities and buffers such as foreign reserves as well as global financial conditions and spillovers from monetary policies of major central banks (Daianu, 2020). APPs in EMs so far do not appear to generate major risks in the domestic economy. Unconventional policies of major central banks, which drive capital flows and credit cycles globally, are likely to remain a more immediate source of risks to financial stability in EMs (Rey, 2013).

Taking everything into account, it is encouraging to see the broadening of the scope of monetary policy instruments in EMs. After all, while the interest rate channel of monetary policy may not be very strong in many EMs, they are used to balance sheet policies. The balance sheet of the Croatian National Bank increased over the past decade more or less in lockstep with the balance sheet of the European Central Bank, just as excess reserves of the banking system increased in parallel. Although the fuel behind those increases have not been purchases of domestic securities, but rather the accumulation of international reserves, the bank liquidity channel has operated in the same way.

In conclusion, let me refer back to Douglas Adams and the Pythons. Despite the popularity and timelessness of his famous novel, Adams managed to reach his peak, in a professional sense, only after he contributed to the Monty Python's Flying Circus in the early 1970s. So, although I received the award for lifetime achievement relatively early, this encourages me

to think that my career might also have a chance of surviving beyond the Lámfalussy Award. I will do my best to continue my work, very much motivated by the recognition I received today.

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