Macroeconomic and Monetary Challenges: Some Emerging Market Perspectives

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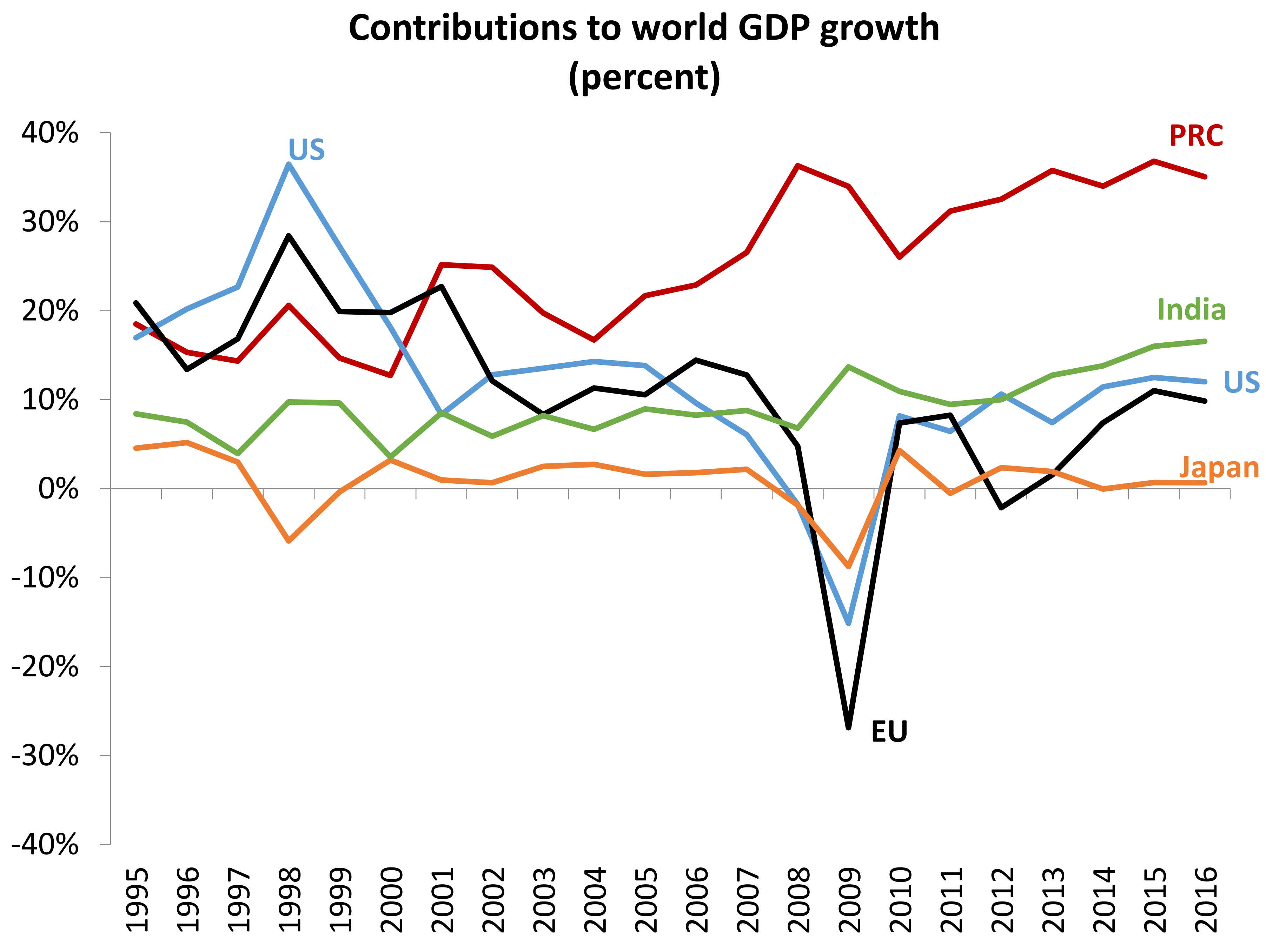
Contributions to world GDP growth
(percent)
40%
30%
20%
10%
0%
-10%
-20%
-30%
-40%
US
PRC
India
US
Japan
EU
1995
1996
1997
1998
1999
2000
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2008
2009
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2011
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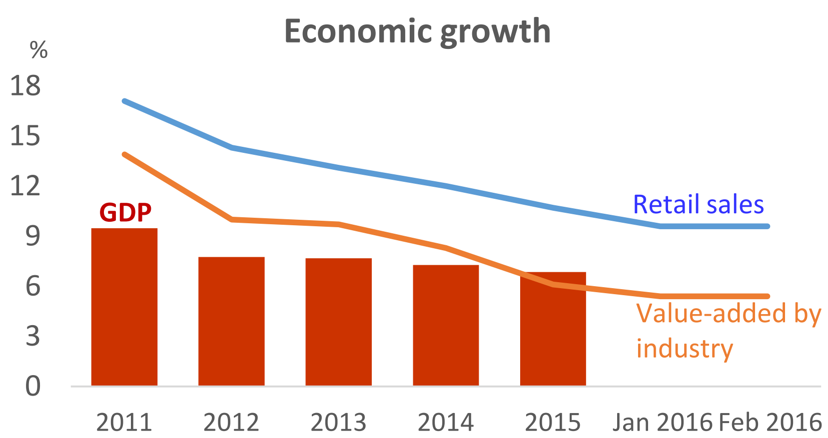
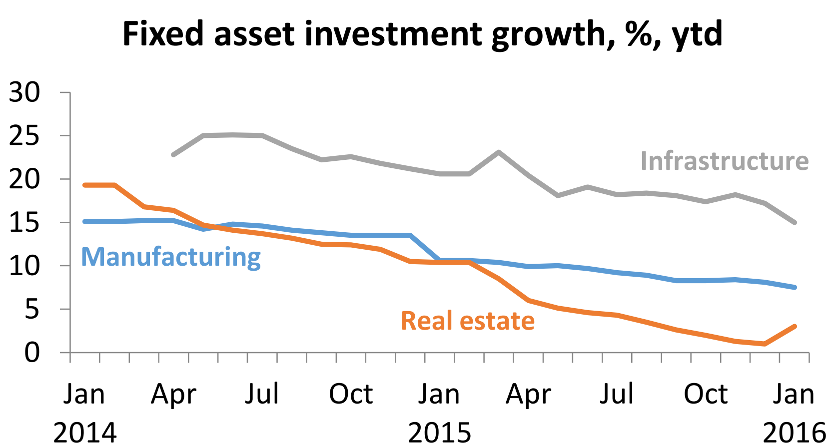
2013
2014
2015
2016

A closer look at PRC





Growth moderation

- Structural factors
  - Shrinking work force
  - Rising wages/Convergence
  - Attention to environment
- Transitory factors
  - Weak global economy
  - Possibly overvalued RER

Challenges

- Corporate debt
- "Excess capacity"
- Undue but self-fulfilling pessimism

Three challenges that have implications for monetary policies

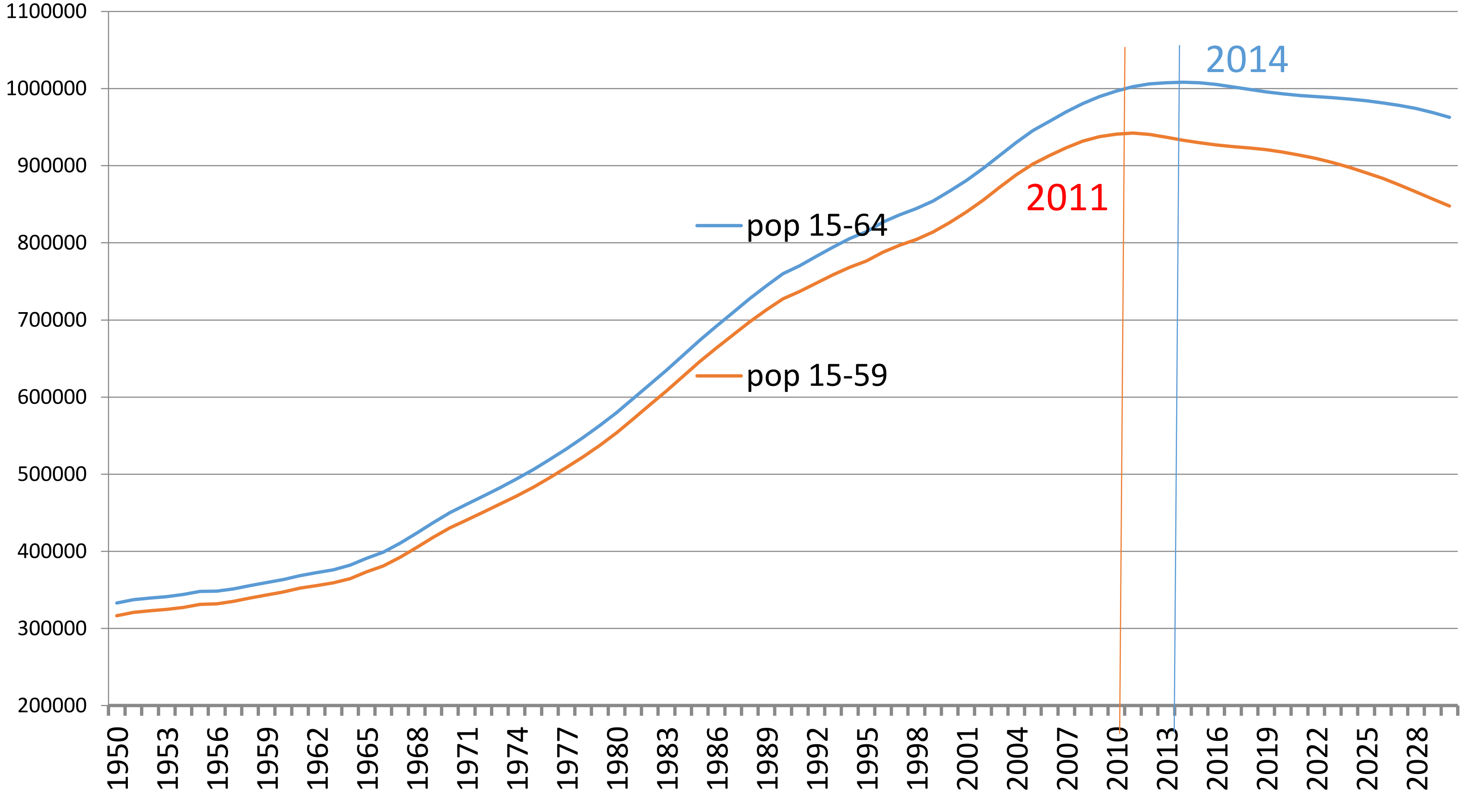
- Aging has become a problem for increasing number of (though not all) emerging market economies;
- Many countries are experiencing PPI deflation even if still with a moderately positive CPI inflation;
- Changes in the monetary policies of major rich economies could induce less-than-desirable policy changes in emerging economies

1. With declining work force, could the monetary policy be too tight?

- Declining work force -> declining natural rate of interest -> optimal monetary policy should be a bit looser than otherwise the case
- A Taylor-rule that does not take into account demographic changes could be too tight

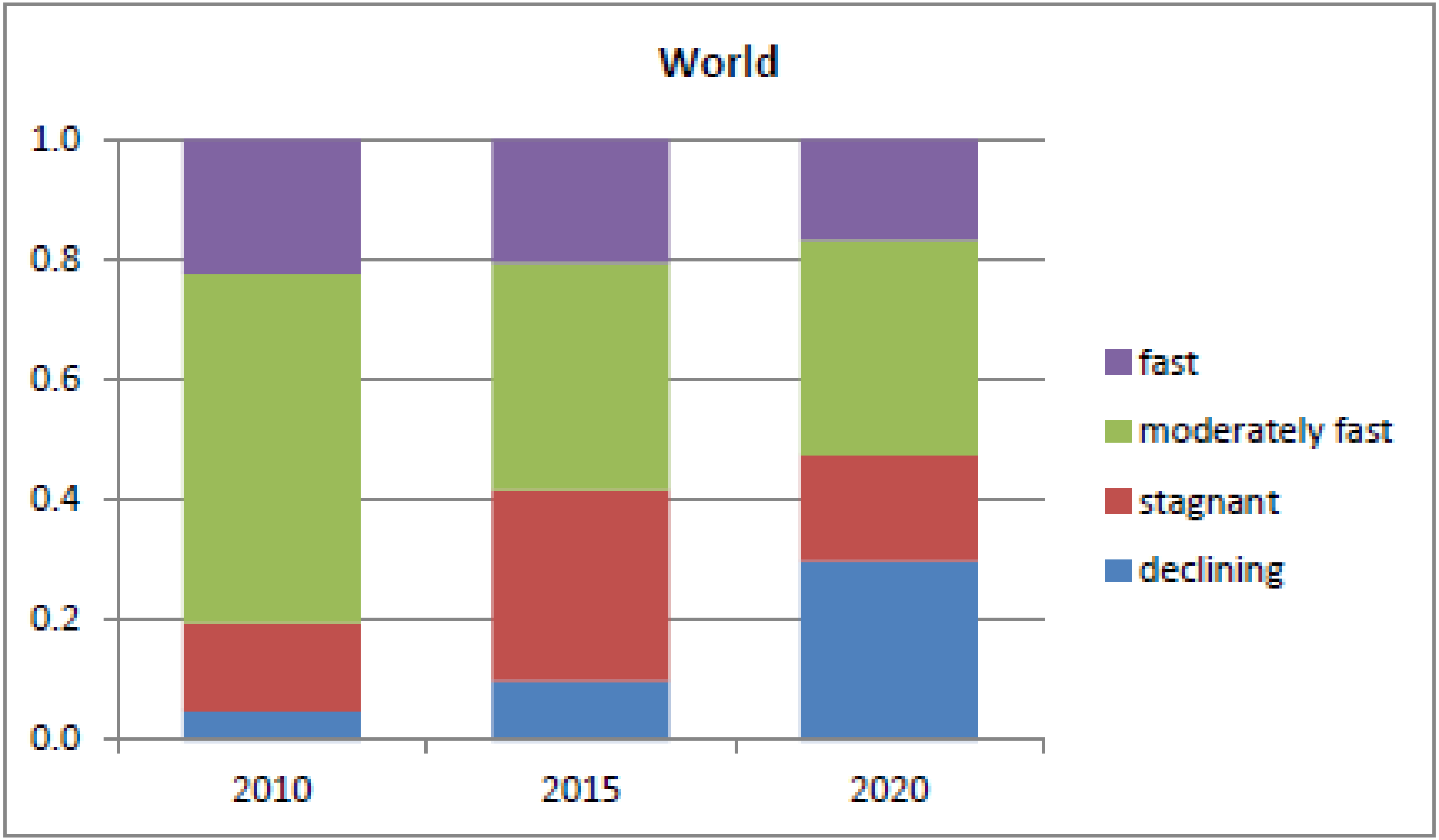
- “Declining Trends in the Real Interest Rate and Inflation: Role of Aging” by Shigeru Fujita and Ippei Fujiwara

Chinese working age population peaked in 2011



More and more people live in countries with a declining or stagnant population

Distribution of population living in each type of country

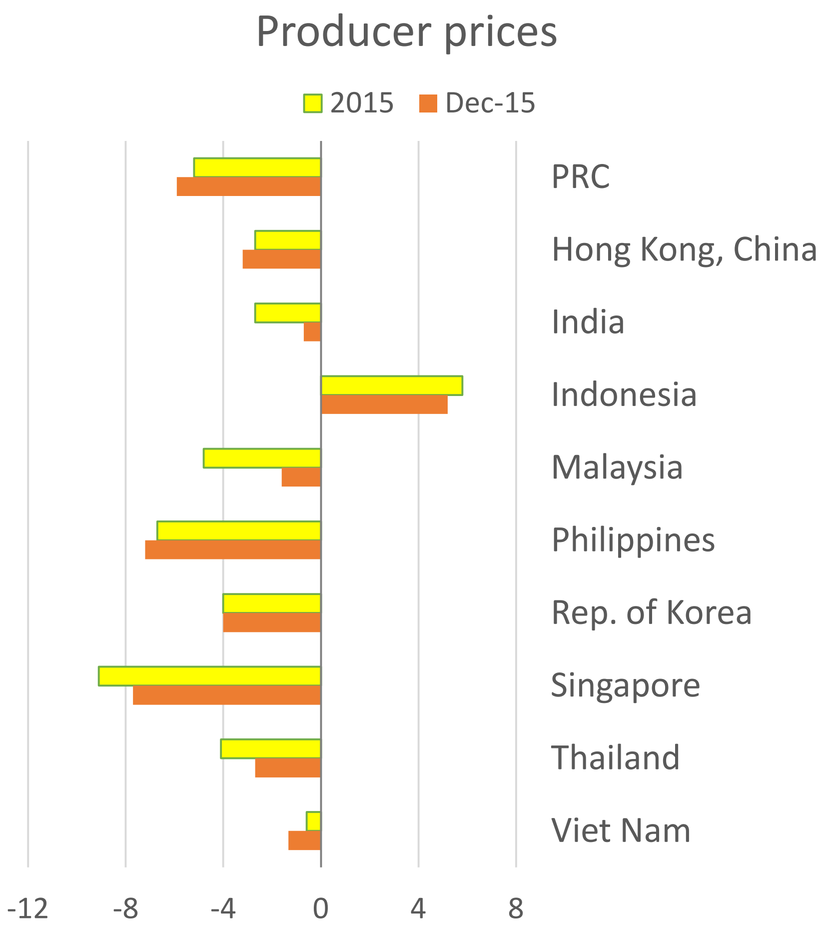


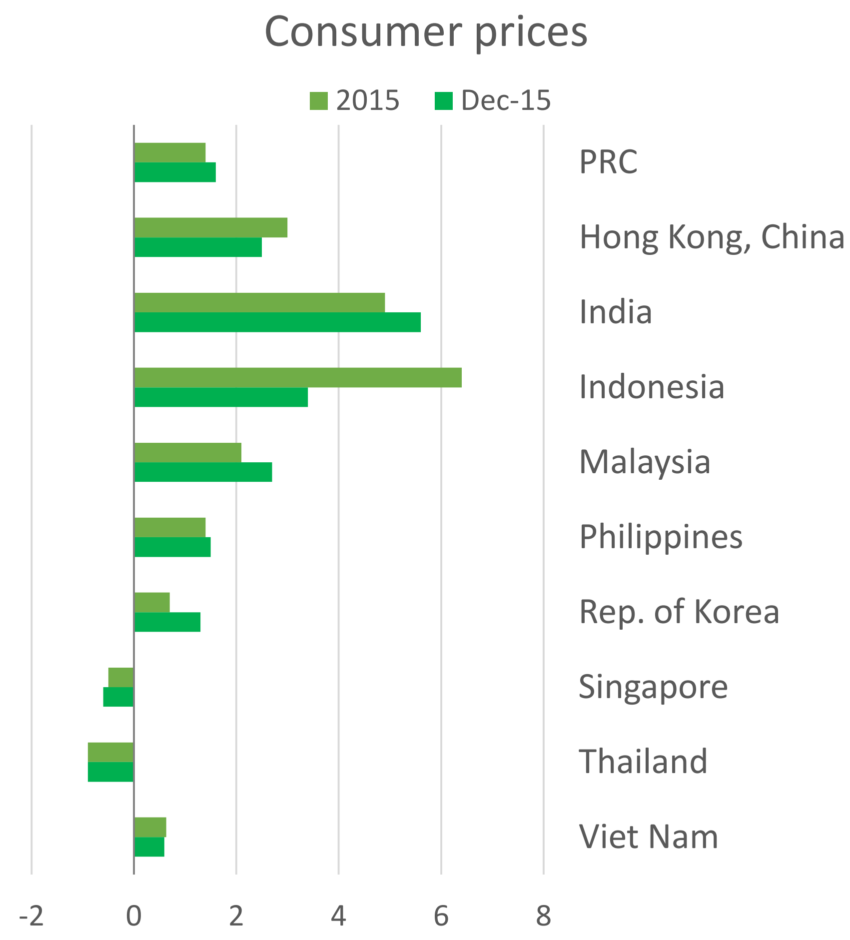
2. With PPI deflation, could the monetary policy be too tight?

- When both intermediate and final goods sectors have sticky prices, optimal monetary policy should assign weights to both PPI and CPI inflation
    - Kevin Huang and Zheng Liu, "Inflation targeting: which inflation to target?" Journal of Monetary Economics, 2005

- Implication: by ignoring CPI deflation, "standard" Taylor rule may adopt too tight a monetary policy

Many economies experiencing PPI deflation





3. Could emerging market economies suffer from an “innocent bystanders problem” when the monetary policies of the rich world change?

- Monetary policies of the rich world respond to own domestic needs
  - Brexit, asset price bubbles, financial crisis

- Involuntary imports of the policies by merging market economies?
  - Does a flexible exchange rate regime convey monetary policy autonomy? (Obstfeld, 2015)
  - Trilemma vs. Dilemma? (Calvo and Reinhard, QJE 2002; Tong and Wei, RFS 2011; Rey, Jackson Hole, 2015)
  - 2.5 Lemma? (Han and Wei, 2016)

- Han and Wei, 2016, "International transmission of monetary policy shocks"
- Control for domestic need (Taylor rule augmented by exchange rate volatility) and global financial shocks
- Estimate sensitivity of domestic monetary policy to US monetary policy
  - Flexible exchange rate regime per se does not confer monetary policy autonomy
    - Asymmetry (especially reluctant not to lower rate)
  - Some capital controls (cross-border prudential policies) appear necessary
  - Some evidence that a combination of a flexible rate and capital controls offer the most autonomy ("2.5-lemma")

Summary: Emerging markets face challenges in monetary policies

- Declining work force ("aging")
- Widespread PPI deflation
- Involuntary imports of monetary policies via capital flows or interest rate arbitrary