CROSS-BORDER CONNECTIONS IN CENTRAL BANKING

Adina CRISTE[80], PhD

Abstract

After the global financial crisis outbreak, there are intensified debates on the cross-border spillovers effects induced by unconventional monetary policy of major central banks in developed countries. Based on this observation, the present paper makes a short analysis on the relationship between central banks in post-crisis time, focused on the connection between major central banks (Fed, ECB) and other central banks of local (i.e. national) interest. For an open economy, the central bank's responsibility in promoting the financial stability extends beyond the national borders, becoming a regional or even a global responsibility. At the global level, a great challenge remains the way in which the cooperation between monetary authorities can be strengthened, even in normal times. The major locally-driven effects generated by the global central banks decisions requires further exploration of new areas of cooperation that can limit the accumulation of financial imbalances and vulnerabilities in the economy.

Keywords: unconventional monetary policy, spillover effects, central bank cooperation

JEL classification: E52, E58, F42

Introduction

Central banks have a major role concerning the domestic strategy for sustaining the economic growth and also for mitigating the instability of the financial system. For an open economy, the central bank's responsibility in promoting the financial stability extends beyond the national borders, becoming a regional or even a global responsibility. Statutory, central banks assume objectives of local (national) interest, typically the domestic price stability objective, but the globalization of financial and trade relations points out the need to restore this local objective reconsidering the global economy, especially for those central banks with a major role in the global financial system.

The subject covered in this article belongs to the area of concerns about the effects of the global financial integration process. The financial development and the strengthening of the international economic and financial relations create strong connections between the global economy and the local economies, between the global authorities (whose decisions have global effects) and local ones. The present paper is focused on a short description of the relation between the major central bank from a developed country and the local central bank, from an emerging economy, in order to highlight the relevance of the cross-border connections between central banks, in recent years, after the global financial crisis outbreak. It highlights some issues of a broader research project regarding the global and local relationship in the central banks' policy.

Unconventional measures implemented to a large extent by central banks in advanced countries have spillover effects in emerging economies, and if these effects conflict with the domestic economic policy objectives, including those of the monetary policy, the local authorities (also, central banks) reacts in order to counteract the unsought effects.

Challenges of the International Linkages

In recent years, a number of studies have focused on the cross-border transmission of the monetary policy shocks from the advanced major economies and their impact on the global financial conditions. Rey (2013) evidences the working of a global financial cycle for capital flows, asset prices, and credit growth, driven mainly by the Fed's monetary policy, which change the ”classical” hypothesis of the impossible trinity (the Mundell-Fleming ”trilemma”) into a dilemma, considering that an independent monetary policy is possible provided that there is a direct or indirect control of the capital account. When the cross-border flows and the leverage of global institutions are significant, the monetary policy is globally spread, even under a flexible exchange rate regime. In other words, the increase of the volume for the cross-border financial flows and the

[80] *”Victor Slăvescu” Centre for Financial and Monetary Research, Romanian Academy, Bucharest, Romania, email: a.criste@icfm.ro*

financial leverage of the global institutions within a certain economy facilitate the transmission of the global monetary policy at the local level.

In the context of the global financial crisis and the post-crisis period, the classical monetary trilemma must be reinterpreted, noting that the functioning of the policy levers for ensuring the financial stability at the local (national) level is weakening as the international financial integration is getting deeper (the financial trilemma).

It has been argued that the transmission of the US financial conditions to other economies through the global financial cycles cancels or at least alters the efforts of the local central bank to manage the domestic monetary policy. According to International Monetary Fund (IMF) estimates (IMF, 2017), the global financial conditions are determinant in proportion of 20% to 40% for the domestic financial conditions.

The local central bank's ability to control the long-term domestic interest rates, which are important variables in the money transmission mechanism, is impaired by the global financial cycle.

There is an abundant literature dealing with the domestic transmission of the monetary policy decisions, reviewed by Krishnamurthy and Vissing-Jorgensen (2011)[81]. Nevertheless, the concerns about the international transmission of monetary policy decisions are increasing, mainly after the outbreak of the global financial crisis, as the major central banks in advanced countries have begun to apply a variety of unconventional measures.

The quantitative easing measures applied by central banks in advanced countries have financial effects on the liquidity, risk aversion and relative price of capital (equity, bonds, real estate). By changing the liquidity level, the quantitative easing policy can influence both the level of the bank reserves, and thus the bank lending, and the net wealth of banks and firms. These two sub-components of the lending channel are expanding internationally, given the growing importance of the cross-border lending for both banking and non-banking sector[82].

The higher external openness of the local financial systems and the increasing of the cross-border financial flows influence the domestic credit conditions, both by the access of banks to the money and interbank markets, and by the issue of international bonds and securities (Lane and McQuade, 2014).

Caruana (2013) underlines that the quantitative easing measures applied by global central banks have influenced emerging countries by: lowering policy interest rates, reducing domestic bonds yields, influencing the global asset allocation by increasing fluctuations of both the exchange rates for local currencies and the foreign exchange reserves. Besides, these measures have increased the currency mismatch through the accumulation of local currency assets and foreign currency liabilities, and also they have influenced the domestic capital markets of emerging economies through the cross-border capital flows.

Considering the general remarks on the functioning of the transmission channels for foreign monetary policy, the central bank connections address the variables that link the global monetary policy to the local one: the exchange rate, the short-term interest rates, the long-term interest rates and the cross-border capital flows, with their components: the international bank lending flows and the portfolio flows. The global-local connection concerning the central bank policy is seen in terms of the relationships between emerging and advanced economies, following the reaction of the four variables to the global monetary policy, i.e. the Fed monetary policy, for the emerging economies linked to the US dollar, and the European Central Bank (ECB), for the emerging economies linked to the euro.

[81] *For the domestic economy, the monetary policy signals are transmitted through three relevant channels: the exchange rate channel, the expectations channel, and the interest rate channel.*

[82] *In the globalization era, in emerging economies, there is a tendency for the non-financial corporations to significantly increase their external borrowing and debt issuance on the external market, increasing the role of the non-bank funding.*

Highlights on Cross-Border Connections in Monetary Policy[83]

In open economies, the exchange rate is an important channel for transmission of the external monetary conditions, and its role depends on the extent to which the exchange rate regime is flexible. This flexibility allows a reduction in the external interest rate to determine the appreciation of the domestic currency.

In the post-crisis period, mainly during May - September 2013 and the early of 2014, the capital outflows in emerging economies led to strong exchange rate depreciation, as a result of the Fed's announcement of monetary policy normalization.

The persistent fluctuations in the cross-border financial flows and the increased risks to the financial stability have led to a greater focus of central banks on the exchange rate, as a commonly used tool, for those central banks with a flexible exchange rate regime.

Monetary policy decision-makers carefully monitor developments in the exchange rate on the assumption that this would be an important channel for transmitting the unconventional monetary policy measures from abroad. When the financial channels (the risk channel, the portfolio channel and the wealth effect channel) and capital flows are important, controlling the exchange rate movements cannot prevent the transmission of the unconventional monetary policy of the global central bank into emerging economies dependent on it. Such a remark is also shown by Falagiarda et al. (2015) for the case of the relationship between the unconventional monetary policy of the ECB and that of non-euro area countries (Czech Republic, Hungary, Poland and Romania). Central banks do not intervene in the exchange rate market for any exchange rate change to maintain a certain exchange rate level, as the costs and risks involved are not insignificant. Central bank foreign exchange interventions aim at lowering the exchange rate volatility, rather than targeting a certain exchange rate level, with a more focusing on the exchange rate fluctuations.

The central banks of emerging economies can react directly to changes in monetary policy rates by altering their own interest rates, with a leader's follow-up behaviour. Taylor (2013) argues that emerging economies can follow such an imitation policy to avoid the unfavourable effects on the exchange rate that would result in an increase in the gap between the domestic interest rates and the external interest rate., as the exchange rate appreciation hinders the long-term competitiveness, and a possible exchange rate overvaluation would encourage the foreign currency lending, whose value is relatively lower.

In the emerging economies linked to US dollar, the tendency of following the leader (i.e. the Fed) is less pronounced than in the emerging economies linked to euro. In the early stage of the monetary easing measures implemented by the Fed, when the Federal Reserve rate reached the minimum level, there was a clear proclivity of the local central banks towards cutting the policy interest rates, reflecting the behaviour of following the leader. However, after the completion of the first quantitative easing program, the synchronization is no longer maintained, with interest rates becoming quite divergent across countries. This shows that the monetary policy rate continues to be a major instrument by which the central bank responds to the domestic challenges. After the "taper tantrum" shock[84], the divergence of the policy rates is even more obvious. Instead, for the emerging economies linked to the euro, the synchronization of interest rate developments is more pronounced.

Central banks in the emerging countries lose the ability to influence the long-term domestic interest rates, due to the global financial cycle. Moreover, the long-term interest rate in the US influences the benchmark on long-term global bond yield as well as investor risk appetite (Turner, 2014), so that the price of bonds issued by emerging economies on local and international markets depends on the dynamics of the external financial markets.

In addition to the trend of expanding the domestic bond markets in emerging countries, there are also an increasing number of foreign investors in the local currency bonds markets. In this way, the yields on the "local bonds" become more closely linked to the yields of securities in the major financial

---

[83] *The data referred to in this section is provided by the research project "Raportul global-local în politica băncilor centrale" ("The Global-Local Relationship in the Central Banks' Policy"), Criste A. (coord.),"Victor Slăvescu" Centre for Financial and Monetary Research, 2017.*

[84] *This term refers to the effects produced by the Fed's announcement (May 2013) on the normalization of the Fed monetary policy by slowly reducing the pace of its monthly purchases of financial assets.*

centres. Through these strong connections, especially after 2008, the monetary policy of global central banks tends to have a growing influence on the long-term yields evolution for the emerging economies.

A forward-looking challenge for central banks in emerging economies concerns the asset prices valuation and their influence on the long-term yields, as traditional domestic benchmarking tools and the local market valuations have lost their anchoring role. Basically, asset prices have become increasingly dependent on expectations of future monetary policy developments in the US, and thus, the apparently insignificant changes in monetary policy, can cause large fluctuations in the financial market.

One of the main influence factors on the interest rates developments in the financial markets is the forward guidance policy. By this instrument, the central bank conveys signals about the monetary policy outlook and guides expectations for the future short-term interest rates. However, this instrument is not available to central banks from the emerging economies, as it implies conditions that are specific to a highly credible central bank. This credibility is assured not only by a greater experience in communication with the public and markets, through a variety of instruments, but also by a well-endowment with advanced technical instruments and methods for forecasting and a greater specialization in the quantitative forecasting of macroeconomic and financial variables. The practical experience shows that central banks from advanced economies, especially the major ones, apply this forward guidance policy, starting from the prerequisite that the public commitment of a global central bank to continue maintaining low interest rates in the future, will reduce the long-term interest rates, generating further changes across countries on the gap between bond yields across the range of maturities.

It can be argued that by means of monetary easing measures, the global central banks aims at controlling the long-term interest rate developments Besides, the forward guidance is an additional tool that guides the market so that to reach the "intermediate target". Even if local central banks do not have the capacity to influence the long-term interest rates (given the dominant external factor), they can adjust their monetary policy according to the signals transmitted by the global central banks in this regard.

The quantitative easing measures applied by central banks in developed countries have increased the global liquidity. Under these circumstances, the cross-border capital flows tend to be large and swift, with a quick reversibility, and therefore they are important challenges for the financial and macroeconomic management in emerging economies.

According to statistical data from Bank of International Settlements (BIS debt securities statistics), after 2008, the gross capital flows from and to the emerging economies have more fluctuating developments. Also, emerging economies are experiencing a massive expansion of debt securities issued by companies on international markets, especially after 2010. Recent changes in the dimension and structure of capital flows could be factors that amplify the vulnerabilities of emerging economies. Debt-based financing could be pro-cyclical, when there are a few large asset management companies that adopt similar strategies for investments in assets of emerging economies, thus contributing to asset price dynamics. Also, by holding such securities denominated in local currency (of emerging economies), the investors are exposed to the foreign exchange risk, and in times of stress in the economy, the sudden depreciation of the exchange rate amplifies the tensions in the financial markets by increasing the sales of such vulnerable securities.

Addressing the challenges posed by cross-border capital movements, the central banks from emerging economies have a limited capacity of reaction, depending on how they refer to the policy of the financial stability.

Monetary policy may remain independent of the external factors influence, if there is a control over the capital movements. The difficulties in coordinating the monetary policies at the global level call into question the need for a capital flows management, a measure that, alongside macroprudential measures, extends the range of instruments used by local central banks. However, based on the practical experience, the macroprudential tools have not always been effective over time.

Final Remarks

The working of the four (indirect) connections between the two categories of central banks was better highlighted in postcrisis time, after the "taper tantrum" shock. In this context, it is remarked an increasing importance of connections through both the exchange rate channel and the capital flows, especially for those emerging economies that have a flexible exchange rate regime. During the analysed period, many central banks intervened in the foreign exchange market primarily in order to reduce the volatility, and not to maintain a certain exchange rate level. Although, in case of higher financial openness the exchange rate flexibility cannot provide a full protection against the external shocks, this quality is useful for many economies in that it provides to monetary policy additional room for manoeuvre. Obstfeld et al. (2017) shows that emerging economies with fixed exchange rate regime are more exposed to the global financial conditions that may increase the financial vulnerabilities (either sharp increases in domestic lending and real estate prices, or rising the bank leverage).

The link through the capital flows has been strengthened in the post-crisis period, as a result of their consequences upon the financial and macroeconomic stability, stemming from the sudden changes in both the size and the orientation (reversals) in capital movements. The recent experience of many economies has shown that prudential national policies cannot be fully effective when the capital markets are open to the cross-border transactions, even when the exchange rate regime is flexible. Thus, such a condition points to the need for formulatng the international collaborative reform at a global level. Within this framework, the relationship between central banks should be based on the cooperation and coordination, in terms of monetary policy and exchange rate policy, at least. Policy makers in those countries that generate large capital flows should consider how their own policies (including monetary policy) can influence the overall economic and financial stability, and cross-border coordination should mitigate the risks in this direction.

The major locally-driven effects, particularly at the emerging economies level, generated by the global central banks decisions requires further exploration of new areas of cooperation that can limit the accumulation of financial imbalances and vulnerabilities in the economy. However, there is some uncertainty about the possibility of maintaining such intense cooperation in normal times. Under normal conditions provided by the financial and economic stability, each central bank will act primarily on the interest of its own country (in case of ECB, for the euro area member countries), with global interest being second.

At the global level, a great challenge remains the way in which the cooperation between monetary authorities can be strengthened, even in normal times, when it can be apply "counter-cyclical" measures in order to be prepared for countering the future global financial crisis episodes. Within this framework, it is important to enter international agreements supported by additional measures at the national level.

Bibliography

Caruana, J. (2013). Ebbing global liquidity and monetary policy interactions, speech delivered at the Central Bank of Chile Fifth Summit Meeting of Central Banks on Inflation Targeting: “Global liquidity, capital flows and policy coordination”, Santiago, Chile, 15 November.

Falagiarda, M., McQuade, P., Tirpák, M. (2015). Spillovers from the ECB’s nonstandard monetary policies on non-euro area EU countries: evidence from an event-study analysis, ECB Working Paper Series, No 1869, November.

Krishnamurthy, A., Vissing-Jorgensen, A. (2011). The effects of quantitative easing on interest rates: channels and implications for policy, Brookings Papers on Economic Activity, 2, pp 215-287.

Lane, P.R., McQuade, P. (2014). Domestic credit growth and international capital flows, Scandinavian Journal of Economics, Vol 116, No 1, January, pp 218-252.

Obstfeld, M., Ostry, J.D., Qureshi, M.S. (2017). A Tie That Binds: Revisiting the Trilemma in Emerging Market Economies, IMF Working Paper, WP/17/130, June.

Rey, H. (2013). Dilemma not trilemma: the global financial cycle and monetary policy independence, in: Federal Reserve Bank of Kansas City Jackson Hole Economic Symposium Proceedings, pp 285-333.

Taylor, J. (2013). International monetary policy coordination: past, present and future, BIS Working Papers, no 437, decembrie.

Turner, P. (2014). The global long-term interest rate, financial risks and policy options in EMEs, BIS Working Papers, no 441, februarie.

* * *,(2017). Global Financial Stability Report October 2017: Is Growth at Risk? International Monetary Fund.