

## When the Fed tightens, emerging market borrowers feel the pinch

By Editorial Staff      Thu, Jan 3, 2019

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*Increases in the federal funds rate of 25 basis points were associated with a 4.2 percentage point larger overall decline in dollar credit for emerging market firms than for developed market firms, according to new research.*

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Roughly 80% of cross-border loans to emerging market economies are estimated to be denominated in U.S. dollars. Dollar-denominated credits make up 60% of Europe's emerging market economies' cross-border lending and over 90% of foreign banks' loans to emerging market economies in Africa, Asia, and the Americas. Foreign bank loans account for about half of all emerging market economies' external liabilities.

In a new research paper, "U.S. Monetary Policy and Emerging Market Credit Cycles" (NBER Working Paper No. 25185), authors Falk Bräuning and Victoria Ivashina find that when the Federal Reserve lowers U.S. interest rates, the volume of cross-border loans by global banks goes up, particularly to emerging market borrowers.

Studying the 1980-2015 period, they find that a four percentage point cut in the Federal Reserve's target interest rate (a typical decrease during an easing cycle) raised loan volumes in emerging markets by 32% relative to the volumes in developed markets. This was true even after accounting for differences in GDP growth, inflation, and forecast future economic performance.

Loan volumes also respond to the yield spread — the difference between the 10-year U.S. Treasury yield and the federal funds rate. As the spread narrows and banks rebalance their lending portfolios toward riskier assets, a one percent decrease in the U.S. spread increases emerging market economy lending volumes by about 16%. This effect was particularly relevant earlier this decade, when the Federal Reserve kept the federal funds rate at zero and eased monetary policy through unconventional measures that directly impacted long-term rates.

Monetary policy easing also is associated with higher loan volumes to riskier firms. In response to a 25 basis point decrease in the U.S. federal funds rate, firms with a one percentage point higher borrowing cost than their country average experienced a one percent higher increase in loans than that afforded to average borrowers.

When U.S. monetary policy tightens, the pendulum swings the other way. Increases in the federal funds rate of 25 basis points were associated with a 4.2 percentage point larger

overall decline in dollar credit for emerging market firms than for developed market firms. Local bank lenders do not offset a contraction in foreign bank credit. Rather, local dollar credit also contracts. A 25 basis point increase in the federal funds rate leads to a 3.5 percentage point drop in local credit.

Changes in eurozone rates affect the volume of euro-denominated cross-border lending of U.S. banks to non-euro borrowers, but they do not affect the volume of dollar-denominated credits. "Foreign monetary policy is relevant only for the loans in the corresponding foreign currency," the researchers concluded.

The researchers used data from the Thompson Reuters DealScan database on global syndicated corporate loan issues. It showed the same result for non-U.S. banks and for banks with portfolios that have little exposure to the United States. The results apply to borrowers in non-tradable industries and those in countries having little trade linkage with the United States, even when controlling for individual borrowers, their home countries, loan amounts, currency, maturity, interest rates, and lenders in the loan syndicate.

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