A Review and Outlook on the Impact of the Federal Reserve's Monetary Policy on the Depreciation of Emerging Market Currencies

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ABSTRACT

This article focuses on the study of the impact of the Federal Reserve's monetary policy on the depreciation of currencies in emerging markets. By reviewing relevant literature, it systematically elaborates on the transmission channels, influencing factors, strategies adopted by emerging markets in response, and future research directions. The research shows that the Federal Reserve's monetary policy affects the exchange rates of currencies in emerging markets through channels such as capital flows, exchange rate expectations, economic fundamentals, and policy space constraints, and the degree of impact varies among different emerging markets.

Emerging markets can cope with the pressure of currency depreciation by optimizing economic structure and strengthening policy coordination. Future research can pay more attention to the changes of global financial structure, the differences within emerging markets and policy innovation.

Keywords: Federal Reserve monetary policy; Emerging markets; Currency depreciation; Transmission path; Response strategies.

1. INTRODUCTION

In the context of the deep integration of global economy and finance, the Federal Reserve, as one of the most influential central banks globally, has a wide and profound spillover effect from its monetary policy adjustments [1]. Emerging market countries, due to significant differences in economic scale, the development level of financial markets, and international currency status compared to developed countries, are more likely to be impacted by the changes in the Federal Reserve's monetary policy [2].

Among them, currency depreciation has become one of the outstanding problems faced by emerging markets during the adjustment of the Federal Reserve's monetary policy.

The impact of currency depreciation on emerging markets is manifold. From the perspective of import and export trade, currency depreciation may theoretically enhance the competitiveness of export commodities. However, most of the export commodities in emerging markets are primary products or low value-added industrial products, and the price elasticity of international market demand is low, and it may also face the substitution pressure of other cost-advantage countries, which makes it difficult for the growth of export volume to offset the decrease in income brought about by currency depreciation [3]. In terms of balance of payments, currency depreciation may lead to capital flight, which will break the balance between current account and capital account and further aggravate the imbalance of balance of payments [4].

Moreover, currency depreciation may trigger inflation, make domestic things more expensive, reduce our actual ability to buy things, and also affect social stability and economic development [5]. At the same time, capital flight will reduce domestic investment and slow down economic growth, which will bring great challenges to the economic stability and sustainable development of emerging markets [6].

Therefore, it is of both theoretical and practical significance to study the impact of the Federal Reserve's monetary policy on currency depreciation in emerging markets. Theoretically, this can help us to understand more deeply how the spillover effect of global monetary policy is transmitted, and also enrich and develop international financial theory. The traditional international financial theory mainly focuses on the influence of a country's monetary policy on its own economy, but less on the spillover effect of monetary policy. With the in-depth development of global economic integration, the economic ties between countries are getting closer and closer. The adjustment of a country's monetary policy will not only affect its own economy, but also affect the economies of other countries through trade and capital flow [7]. Studying the influence of Federal Reserve's monetary policy on currency depreciation in emerging markets can provide new perspectives and ideas for the innovation and development of international financial theory.

On the practical level, studying the impact of the Federal Reserve's monetary policy on currency depreciation in emerging markets can provide reference for emerging market countries to formulate coping strategies. Emerging market countries can understand the direction and intensity of the Fed's monetary policy adjustment, make preparations in advance, and adopt effective policies to ease the pressure of currency depreciation and maintain economic stability [8]. For example, emerging market countries can improve their economic structure, strengthen policy coordination and strengthen the management of foreign exchange reserves, so as to enhance their ability to resist external shocks and reduce the impact of the Fed's monetary policy adjustment on their own national currency exchange rates.

2. THE TRANSMISSION PATH OF THE FED'S MONETARY POLICY ON THE DEPRECIATION OF EMERGING MARKET CURRENCIES

2.1 capital flow channels

The pursuit of profit by capital is the basic feature of the international financial market. When the Fed adjusts its monetary policy, it will change the interest rate difference between different economies, which will lead to changes in the direction of cross-border capital flows. When the Fed initiates an interest rate hike cycle, the yields of US Treasury bonds and US dollar deposit rates rise simultaneously, and the gap between the yields of local currency assets in emerging markets gradually narrows or even reverses. This causes international investors, especially speculative capital seeking short-term high returns, to withdraw from emerging markets and convert their funds into US dollars to return to the United States to obtain higher returns and lower risks. For example, during the Fed's interest rate hike cycle from 2015 to 2018, the net inflow of investment in emerging markets decreased sharply from an annual average of 250 billion US dollars to less than 80 billion US dollars. The outflow of funds from the stock market was particularly significant, which was highly consistent with the 10% - 20% depreciation of emerging market currencies during the same period. Capital outflow led to an increase in the supply of local currencies in the emerging market foreign exchange market, an increase in the demand for the US dollar, and subsequently, the depreciation of the local currency.

2.2 Exchange Rate Expectation Channel

In modern foreign exchange markets, expectations often have a greater influence on short-term exchange rate trends than immediate fundamental factors. The Fed's interest rate hike cycle is usually accompanied by the strengthening of the "strong dollar" narrative. Market participants will form a consistent expectation based on the Fed's policy statements, economic data, etc., that "the dollar will continue to appreciate." This expectation spreads rapidly through media reports, trading strategies, etc., leading to convergent market behavior and triggering "race to the exit" behavior, causing exchange rate overshooting and a depreciation magnitude that may far exceed what can be explained by fundamental factors. In addition to the strengthening of the "strong dollar" expectation, the market's perception of the "fragility" of emerging market currencies due to the Fed's interest rate hike will also be strengthened. When global liquidity tightens, the market will pay more attention to indicators such as the "double deficits" (fiscal deficits, current account deficits), high foreign debt, and insufficient foreign exchange reserves, believing that emerging markets have a weaker ability to resist capital outflows, and thus increasing short-selling efforts, triggering currency depreciation.

2.3 Economic Fundamental Channel

The impact of the Fed's interest rate hike on emerging markets does not stop at the financial market level but will penetrate the real economy through trade, debt, inflation, etc., ultimately exacerbating the pressure of currency depreciation. The appreciation of the US dollar directly affects the export competitiveness of emerging markets. On the one hand, the export goods of emerging markets are mostly denominated in US dollars. When the US dollar appreciates while the local currency depreciates, although theoretically the depreciation of the local currency should enhance the price competitiveness of export goods, in reality, most emerging market export goods belong to primary products or low-value-added industrial products, and the price elasticity of international market demand is low, and they may face the substitution pressure from other cost-competitive countries, making it difficult for export volume to offset the income reduction caused by the appreciation of the US dollar. On the other hand, the appreciation of the dollar will increase the import cost of emerging markets. Most emerging markets rely on imported energy, food and high-end industrial products, all of which are denominated in dollars. The appreciation of the US dollar will directly cause these imported goods to be more expensive in local currency, which will lead to imported inflation. When inflation gets worse, the purchasing power of local currency will decline, which makes the pressure of currency depreciation even greater.

2.4 Policy space constraint channel

When central banks in emerging markets face the adjustment of the Federal Reserve's monetary policy, they often encounter the problem of limited policy space. In order to cope with capital outflow and currency depreciation, central banks in emerging markets may be forced to raise interest rates, but this will further suppress domestic economic growth. If the foreign exchange reserves are not enough, the ability of the central bank to intervene in the foreign exchange market will also be limited. For example, during the Fed's interest rate hike cycle, some emerging market countries could not stabilize the exchange rate by selling a large amount of dollars and buying local currency because of their limited foreign exchange reserves, but only devalued their currencies. Moreover, the monetary policy of emerging market countries may be subject to both international capital flows and exchange rate stability. It is difficult for them to adjust their monetary policy independently according to the domestic economic situation, which further weakens their ability to cope with external shocks.

3. FACTORS AFFECTING THE DEPRECIATION EFFECT OF EMERGING MARKET CURRENCIES DUE TO THE FED'S MONETARY POLICY

3.1 Economic Structure of Emerging Markets

The economic structure factors of emerging market countries, such as industrial structure, trade structure, and debt structure, will affect the sensitivity of their currencies to the Fed's monetary policy. Countries with a single industrial structure, such as those overly dependent on the export of a certain type of resource, are more susceptible to the fluctuations in international market prices and changes in external demand. When the Fed adjusts its monetary policy, the pressure for currency depreciation may be greater. The exchange rate fluctuations of resource-based currencies are relatively smaller because the income from resource exports can provide some support for the currency. Moreover, the trade structure of emerging market countries also affects the currency depreciation effect. If a country's main trading partners are the United States and the trade settlement is mainly in US dollars, then the impact of the Fed's monetary policy adjustment on its currency exchange rate may be more direct and significant.

3.2 Elasticity of Emerging Market Exchange Rate Systems

The degree of elasticity of the exchange rate system determines the adjustment ability of emerging market currencies to external shocks. Countries with a fixed exchange rate system, when facing the adjustment of the Fed's monetary policy, need to consume a large amount of foreign exchange reserves for intervention. Once the foreign exchange reserves are insufficient, they may face a currency crisis. Countries with a floating exchange rate system can adjust the currency exchange rate freely according to market supply and demand, which can better absorb external shocks, but it may also lead to significant exchange rate fluctuations and increase economic uncertainty. Some emerging market countries implement a managed floating exchange rate system, and the adjustment range and frequency of their exchange rates will be subject to the intervention and regulation of the central bank. This exchange rate system can, to a certain extent, balance the need for exchange rate stability and the independence of monetary policy, but it also requires the central bank to have higher policy regulation capabilities and sufficient foreign exchange reserves.

3.3 International Financial Market Environment

The overall environment of the international financial market also affects the transmission of the Fed's monetary policy to the depreciation effect of emerging market currencies. In a stable global financial market with a high risk appetite, even if the Fed raises interest rates, international capital may not withdraw in large quantities from emerging markets, and the pressure for currency depreciation is relatively smaller. In a situation where the global financial market is turbulent and risk appetite is down, investors will be more inclined to transfer funds to safe assets, such as US dollar assets, which leads to an intensification of capital outflows from emerging markets and an increase in the pressure for currency depreciation. In addition, the adjustments of the monetary policies of other developed economies will interact with the Fed's monetary policy, jointly affecting the exchange rate of emerging market currencies. For example, when the European Central Bank and the Bank of Japan implement loose monetary policies, they may alleviate the capital outflow pressure faced by emerging markets and reduce the degree of currency depreciation.

4. STRATEGIES FOR EMERGING MARKETS TO DEAL WITH CURRENCY DEPRECIATION CAUSED BY THE FED'S MONETARY POLICY

4.1 Optimizing Economic Structure

Emerging market countries should accelerate industrial structure adjustment and upgrading, reduce dependence on a single industry and external markets, and enhance economic diversification and risk-resistance capabilities. By developing high-end manufacturing, service industries, etc., high value-added industries, improve the quality and competitiveness of products and services, increase export income, and improve trade balance. At the same time, strengthen domestic infrastructure construction, improve production efficiency, reduce production costs, and enhance the internal growth momentum of the economy. Additionally, emerging market countries should optimize debt structure, reduce the proportion of external debt, especially short-term external debt, extend debt maturities, and reduce exchange rate risks and debt repayment pressure.

4.2 Strengthening Policy Coordination

Emerging market countries should enhance the coordination and cooperation of monetary policy, fiscal policy, and exchange rate policy to form a policy synergy to cope with external shocks. In terms of monetary policy, based on domestic economic conditions and external environment changes, flexibly adjust interest rate levels and monetary policy tools, maintain the independence and effectiveness of monetary policy. In terms of fiscal policy, reasonably arrange fiscal expenditures, optimize the fiscal expenditure structure, increase investment in education, science and technology, healthcare, etc., improve public service levels, and promote sustainable economic development. In terms of exchange rate policy, according to the flexibility of the exchange rate system, reasonably guide market expectations, avoid excessive exchange rate fluctuations. At the same time, strengthen policy coordination and cooperation with other emerging market countries to jointly deal with the spillover effects of the Fed's monetary policy.

4.3 Enhancing Foreign Exchange Reserve Management

Sufficient foreign exchange reserves are an important guarantee for emerging market countries to deal with capital outflows and currency depreciation. Emerging market countries should increase the scale of foreign exchange reserves through reasonable means, such as encouraging exports and attracting foreign investment. At the same time, optimize the structure of foreign exchange reserves, reduce reliance on US dollar assets, increase the proportion of other currencies and assets such as gold, RMB, and euros, and diversify exchange rate risks. In addition, strengthen the liquidity management of foreign exchange reserves to ensure that in the face of capital outflow pressure, foreign exchange support can be provided in a timely manner to stabilize the exchange rate.

4.4 Promoting Financial Reform and Opening Up

Emerging market countries should further promote financial reform, improve the financial market system, and enhance the competitiveness and risk management capabilities of financial institutions. Strengthen financial supervision, prevent financial risks and ensure the stable operation of financial markets. At the same time, promote financial opening in an orderly manner, gradually relax capital account restrictions, and improve the freedom and convenience of capital flow. However, when promoting financial opening up, we should grasp the rhythm and intensity of opening up to avoid increasing financial risks. In addition, emerging market countries should strengthen cooperation with international financial institutions, actively participate in the formulation of international financial rules, and enhance their voice and influence in the international financial field.

5. RESEARCH PROSPECTS

5.1 Focus on the Impact of Global Financial Pattern Changes on the Transmission Effect

As the global economic pattern continues to evolve, emerging market countries are gradually enhancing their positions in the global economy, and the international financial system is also moving towards multipolarity. In the future, the international status of the US dollar may decline relatively, while the status of other currencies such as the euro and the renminbi may rise. Such changes will affect the transmission path and intensity of the Fed's monetary policy on the depreciation effect of emerging market currencies. Therefore, future research needs to focus on the trend of global financial pattern changes, analyze their impact on the spillover effect of the Fed's monetary policy, and provide reference for emerging market countries to formulate response strategies.

5.2 Deeply Study the Impact of Internal Differences in Emerging Markets on the Currency Depreciation Effect

Different emerging market countries have differences in economic structure, exchange rate system, and policy environment, which will lead to different sensitivities and response capabilities to the Fed's monetary policy. Future research can further analyze the factors of internal differences in emerging markets, such as national size, development stage, political stability, etc., and explore how these factors affect the currency depreciation effect, providing theoretical support for emerging market countries to formulate personalized response strategies based on their own characteristics.

5.3 Explore Policy Innovation and Cooperation Mechanisms in Emerging Markets

Facing the spillover effect of the Fed's monetary policy, emerging market countries need to continuously innovate policy tools and cooperation mechanisms to enhance their ability to cope with external shocks. Future research can explore the innovative measures in monetary policy, fiscal policy, and exchange rate policy of emerging market countries, as well as how to strengthen regional financial cooperation and international policy coordination to jointly address the challenges brought by the Fed's monetary policy. For example, research can be conducted on the effectiveness and feasibility of establishing currency swap mechanisms, regional financial stability funds, and other cooperation mechanisms among emerging market countries.

6. CONCLUSION

In conclusion, the monetary policy of the Federal Reserve has a significant effect on the depreciation of emerging market currencies. The transmission channels include capital flows, exchange rate expectations, economic fundamentals, and policy space constraints. The factors affecting currency depreciation include the economic structure of emerging markets, the flexibility of exchange rate system and the environment of international financial markets. Emerging market countries can cope with the pressure of currency depreciation by optimizing economic structure, strengthening policy coordination, improving the management level of foreign exchange reserves, and promoting financial reform and opening up. Future research should pay attention to the changes of global financial structure, differences within emerging markets and policy innovation cooperation, so as to provide theoretical support and practical guidance for emerging market countries to better deal with the spillover effect of Fed's monetary policy. Under the background of global economic and financial integration, emerging market countries need to continuously strengthen their own capacity building, improve their ability to resist external shocks, and achieve economic stability and sustainable development.

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