Javier Guzmán Calafell: Global divergences - implications for Latin America

Remarks by Mr Javier Guzmán Calafell, Deputy Governor of the Bank of Mexico, at the 2016 Institute of International Finance (IIF) Latin America Economic Forum, organized by the IIF with the sponsorship of Mercantil Servicios Financieros, during the session on "Global divergences – implications for Latin America", Nassau, Bahamas, 9 April 2016.

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The views expressed in this document are strictly personal.

Let me start by thanking the organizers for the kind invitation to participate in this interesting discussion.

While different paths for the main macroeconomic and financial variables across countries and regions are a normal characteristic of the world economy, divergence has become one of the major subjects of concern more recently. The most important feature in this regard is the observed and expected decoupling of monetary conditions and policy cycles in the main advanced economies, with the United States having recently initiated a rate hiking phase, on the one hand, and Japan and the Euro Area still implementing ultra-accommodative monetary policies with the perspective of further easing, on the other.

Monetary policy divergence in the advanced economies is the ordinary result of different economic cycles and the efforts of the corresponding central banks to comply with their mandates. In fact, as would be natural to expect, divergence has been a frequent trait of previous policy cycles in advanced economies. To the extent that these policies are implemented efficiently and as required by current and expected conditions, they should be beneficial for the world economy. Furthermore, unsynchronized economic and monetary policy cycles in advanced economies would in principle tend to make life easier for emerging market economies, since some of the negative spillovers could be at least partially offset.

With this in mind, why is divergence such a source of anxiety this time? In my view, the answer lies in a combination of factors.

First, monetary policies in advanced economies have major spillover effects. In particular, asynchronous monetary policies have important implications for the behavior of exchange and interest rates in these countries and, given their systemic role at the global scale, in the rest of the world. The accompanying volatility in asset prices and capital flows is accentuated by the presence of financial market imperfections. The situation looks even more complicated when the insufficient understanding of global monetary policy spillovers is taken into consideration.

Second, with globalization and in particular the push for less restricted capital movements in many economies, cross-border financial linkages and therefore international spillovers of monetary policy in the advanced economies have increased. For instance, in a recent study the BIS concludes that the sensitivity of emerging market local currency yields to bond yields in the US has accentuated over time, with potential of spillovers from US long-term Treasury bonds larger at the end of 2015 than during the "taper tantrum".[1]

Third, in a situation of global uncertainty resulting from concerns about the strength of the world economy, subdued world trade, low commodity prices, tightening international financial conditions, and problems of a geopolitical nature, among others, the volatility of capital flows and unease about the implications for exchange and interest rates resulting from monetary policy divergence further accentuate the perception of risk.

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[1] Bank for International Settlements, Uneasy Calm Awaiting Lift-Off, BIS Quarterly Review, December 2015.

Fourth, the causes of policy divergence themselves have been a source of apprehension. This includes discomfort about the potential impact of the normalization of monetary policy in the United States on emerging market economies, as well as doubts about the underlying strength of the US economy and therefore the justification to increase interest rates in this country. The situation is worsened by the growing perception that monetary policy is reaching its limits, and results from monetary policy actions that sometimes run counter to expectations, as shown by the recent appreciation of the yen and the euro following a relaxation of the monetary stances by the corresponding central banks.

Fifth, the extent to which divergence may provide some breathing space for emerging market economies may not be wide, given the dominance of the US dollar in international financial markets. It may be useful to note in this respect that according to IMF estimates, the share of total variation in domestic bond yields in the five largest Latin American economies attributable to US shocks is twice the share corresponding to euro area shocks.[2]

Sixth, vulnerabilities in emerging market economies have become increasingly evident. This has been partly the result of external factors, commodity price declines and tighter financial conditions particularly important among them, which have put pressure on both external and fiscal accounts. However, problems of a domestic origin have also played a prominent role in some economies. In this context, economic activity in this group of countries has decelerated for five consecutive years and prospects are bleak.

Is monetary policy divergence likely to persist?

The possible evolution of policy divergence among advanced economies is subject to some question marks. To start with, while improvement in labor market conditions has allowed a reduction of the unemployment rate in the US to levels around long-run estimates, progress in the inflation front is more modest and some measures of inflation expectations have shown a downward adjustment. One must add to this the possible implications for the US economy of global economic and financial developments. As a result, the anticipated pace of monetary policy normalization has moderated and the possibility of an additional relaxation, even though remote, has not been totally discarded. Furthermore, some have argued that the US economy may be crossing through a period of secular stagnation, i.e. a chronic excess of saving over investment that acts as a drag on demand, reducing growth and inflation, and pulling down real interest rates. Under these conditions, the functioning of monetary policy is impaired, with fiscal policy becoming a more efficient tool.[3] Others have also pointed to the potential limits on policy divergence resulting from common external shocks or trends that cause economic conditions to be synchronized across economies, or from the transmission of foreign shocks across borders through exchange rate and other financial channels.[4]

Notwithstanding the above, with the US economy showing a strong labor market, an increase in some measures of inflation, resilience to external shocks, and the perspective of both a gradual strengthening of economic activity and an upturn of inflation, the predominant view, shared in general although with some differences by analysts, markets, and Fed officials, is that interest rates in this country will continue to follow an upward trend in coming years. While secular stagnation cannot be discarded, the counterarguments to this possibility are well known.[5] It is also worth noting that even if the above mentioned limits on divergence as a

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[2] International Monetary Fund, Regional Economic Outlook, Western Hemisphere, October 2015.

[3] See Summers, Larry, The Age of Secular Stagnation, Foreign Affairs, February 2016.

[4] See Brainard, Lael, What Happened to the Great Divergence?, US Monetary Policy Forum, New York, February 2016.

[5] See Bernanke, Ben, Why are Interest Rates so Low?, part 2: Secular Stagnation, Brookings Institution, 31 March 2015.

result of external factors became operative, the continuation and even increase in this trend would not be necessarily precluded. With far more serious economic difficulties in the euro area and Japan than in the US, it is difficult to imagine a closer synchronicity of their monetary policies in the foreseeable future. In view of the above, I concur that policy divergence among advanced economies is likely to remain a central feature of the world economy still for a significant period. In any case, from an emerging market country perspective, it is far better to assume this will be the case and prepare accordingly.

What should be the proper response to this scenario?

I think this has at least two dimensions.

The first one is of course the reaction at the country level. Policy divergence in the advanced economies will continue to give rise to challenges for both macroeconomic and financial stability in emerging market economies. Taking into account the integration of financial markets worldwide, and the characteristics of the world economy mentioned above, this may affect even those countries with sound economic fundamentals. The key then, is how to ensure that any adverse impact from divergence is not long-lasting or, in other words, how to differentiate from weak economies.

While the proper framework must consider the particular characteristics of each country, the general recommendations are well known. Emerging market economies should implement cautious fiscal and monetary policies, focused on the assuagement of any macroeconomic vulnerabilities. Exchange rate flexibility should play a major role in the absorption of external shocks, although interventions in the foreign exchange market may be needed to face problems of a temporary nature and to ensure an orderly market functioning. Proper macro and microprudential policies will be key for financial stability. In particular, given the systemic importance of some key players for domestic financial systems, a careful and thorough monitoring of specific banks, firms, and market sectors is called for. The above should be supplemented by measures of structural reform, aimed at increasing productivity and the potential for growth.

Reality, however, is more complicated than theory. While policy recommendations seem straightforward, their implementation is far more troublesome. Recent experience in a number of emerging (and in fact also advanced) economies clearly show that proper macroeconomic diagnoses cannot be taken for granted. Furthermore, policymakers frequently face political restrictions to set in motion the required measures. The need to ensure a proper coordination of different policy tools will often result in additional implementation challenges. One should also consider that the adequate timing of policy action is not always clear-cut. For instance, in the face of macroeconomic risks, monetary policy may need to respond even under the presence of a low inflation rate and stable inflation expectations. Determining the specific moment for action is not easy in circumstances like these.

The causes of divergence and the magnitude of the challenges it originates, suggest that a response based solely on domestic policy efforts may be both insufficient and unfair. This leads me to the second dimension of the strategy, namely, the need for efforts at the international level. The crucial element here is what can be done regarding the most relevant form of divergence, i.e. monetary policies in advanced economies. As the experience during the initial stages of the global financial crisis shows, coordination may play a key role in some circumstances. However, it is also true that this may face significant obstacles. Different economic cycles, at the heart of the current policy divergence in advanced economies, is a case in point, and there are also hurdles of a political and institutional nature.

However, it is also clear that the scope for more and better cooperation in this field is wide. Indeed, it is imperative that advanced economies take proper consideration of the international repercussions of their monetary policy actions. Moreover, there is widespread agreement that our understanding of monetary policy spillovers is modest, but it is far from clear that sufficient efforts are underway to change the status quo. I am also of the view that some proposals that have been put forward recently to agree on mutually acceptable rules for responsible monetary policy behavior deserve to be analyzed and discussed more thoroughly. Finally, recent experience with the “taper tantrum”, on the negative side, and with the first increase in the federal funds rate in the US after seven years virtually at zero, on the positive one, underlines the crucial role of proper communication efforts to avoid surprises and unpleasant market reactions.

Allow me to make a final reflection. Paradoxically, a major source of divergence for emerging market economies in general and for Latin America in particular, derives from some convergence in the rates of growth of the two main economies in the world. While as I noted above the US economy is expected in general to proceed with a gradual recovery in coming years, the deceleration of the Chinese economy is projected to continue, due to its ongoing rebalancing from investment to consumption, and from industry to services. Naturally, this has different implications for emerging economies, with those with closer economic links to China and with exports more concentrated on primary commodities facing the most acute challenges. On the other hand, it is also true that a successful transition in China to lower but more sustainable rates of economic expansion should at the end be a net positive for the world economy.