Challenges for emerging market economies

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Introduction

I would like to start by thanking the organizers of this conference, the BIS, for their invitation to participate in this panel. In my presentation I will talk about some of the challenges posed by capital flows to emerging market economies (EMEs), in particular Mexico. I will focus on the driving forces behind these flows and how policymakers cope with them. Needless to say, the views I express here are entirely my own and do not necessarily reflect those of Banco de México.

Since the emergence of the global economic crisis, movements in capital flows have been exacerbated. The current global environment poses two main challenges. The first is the need to rebalance global demand across different economies: those with excess savings should direct policy toward increasing domestic demand; those with insufficient savings should strive to adjust domestic demand to sustainable levels. The second challenge is how to deal with the abundant global liquidity induced by loose monetary policy in many advanced economies, which has resulted in record low interest rates.

Usually, EMEs have benefited from capital inflows because they allow economies with insufficient savings to access foreign resources to finance domestic expenditure to promote growth. However, they have always posed challenges.

Furthermore, new challenges arise from the current global environment, among them the sheer size of the capital flows and their source – the abundance of global liquidity.

Despite the recent turmoil, several analysts claim that if world financial markets calm down in the wake of a positive outcome to European problems, EMEs are likely to receive more capital in the near term. Loose global monetary conditions are likely to persist for a while, and to the extent that EMEs perform better than advanced economies, capital may flow towards them in significant volumes.

Policymakers in EMEs need to address the risks associated with capital-inflow surges. The right policy prescription depends on the nature of the capital flows and the specific conditions in each country. In my view, an important issue is whether capital inflows are mainly driven by improved economic fundamentals or by abundant global liquidity – that is, whether they are motivated basically by carry-trades.

Although in theory it may seem feasible to discriminate between fundamental and carry-trade capital inflows, in practice it is very difficult to disentangle the two. Nevertheless, one should make every effort to differentiate between them, as the distinction has important implications for policy.

When capital inflows are driven by economic fundamentals, the adjustment calls for an appreciation of the equilibrium real exchange rate. The policy response should be geared towards allowing markets to function freely in order to facilitate the transition towards the new equilibrium real exchange rate.

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When they are driven mostly by short-term profit considerations, such as carry-trades, then the policy response should be a mix of monetary, fiscal, and financial policies to prevent misallocation of resources. Avoiding this misallocation quite often entails implementing policies that should, in turn, also prevent credit booms and busts, and the misalignment of asset prices and of the exchange rate.

The surge in capital inflows to EMEs observed during 2010 and in the first part of this year appears not to be mostly driven by fundamentals. Instead, these flows appear to be more related to carry-trade operations, given the wide interest rate spreads between EMEs and advanced economies. Under these circumstances, global external factors play a prominent role. As soon as external conditions change, there is often a rapid change in risk aversion and a sudden reversal of capital flows.

At this juncture, policymakers from several EMEs have attempted to offset the concomitant exchange rate appreciation. Very often, they have ended up intervening in the foreign exchange market, accumulating substantial amounts of international reserves, and incurring huge social costs without achieving their objective.

Countries with inflation rates below the central bank target could respond to portfolio capital inflows by relaxing their monetary policy stances. By doing this, they narrow domestic and foreign interest-rate differentials, thus reducing the appeal of carry-trade operations.

Oftentimes, however, policymakers have limited degrees of freedom when choosing the response. Consider the case of those countries with inflation rates above their central bank's target; relaxing their monetary policy stance is just not an option. A similar limitation appears when it comes to fiscal policy. Whereas the traditional prescription is that, other things being equal, fiscal policy should be tightened in order to induce a depreciation of the real exchange rate, several countries have actually done the opposite in response to the downturn of the business cycle, expanding fiscal policy in order to provide a countercyclical stimulus to their economies.

The Mexican experience with capital inflows

Now I would like to turn to the Mexican experience. In 2010 and in the first months of this year, the country received a significant amount of capital inflows. Last September and October, as a result of renewed turmoil in international financial markets, there was a reversal of capital flows, mostly short-term, and a significant depreciation of the peso.

We have not been able to draw a clear-cut distinction between capital inflows that are related to fundamental reasons and those fueled by carry-trades. However, the analysis of a series of statistical indicators – coupled with market intelligence – suggests that most capital inflows received during the last couple of years have been primarily driven by fundamentals.

Over the past two years, the country received roughly 69 billion dollars,[2] of which 44% were FDI, while the rest was portfolio investment. Within this category, nearly 28 billion dollars[3] were invested in long-term government bonds, while the rest were invested in either short-term debt or equity instruments.

In this setting, open and developed domestic financial markets have been an important factor behind the capital flowing to the country. For instance, Mexico was included in Citigroup's World Global Bond Index (WGBI) almost one year ago. The current weight of our debt in this

[2] USD 68.6 billion.

[3] USD 27.5 billion.

index stands at 0.6%. Considering that numerous asset managers and institutional investors follow this index, we have reason to believe that they are the ones behind most of the capital inflows the Mexican economy has attracted. Following the inclusion in the WGBI, the holdings of long-term bonds by foreign investors have grown quite rapidly, from 34 to almost 50 billion dollars, and now account for more than 40% of the total. Thus, one may argue that the profile of foreign portfolio investors in Mexico has changed.

However, it is also true that carry-trade opportunities have attracted short-term capital flows. Most of the recent interest in this type of investment was channeled through positions in derivatives on the foreign exchange market. In addition, an appetite for this type of investment was also present in the Cetes market (short-term government paper). During the most recent episode of volatility, we witnessed a sudden reversal of a large part of these flows. Investors reduced their positions in the OTC market: there was an outflow of more than 13 billion dollars. The same is true when one looks at Cetes holdings, which declined by 25%.

In Mexico, as in many other EMEs with capital inflows, policymakers faced various challenges. In our case, these did not appear to be as significant as in other countries. None of the challenges have so far posed a major threat to financial stability. Allow me to underscore a few facts.

First, capital inflows did not lead to a credit boom, nor did they stimulate disproportionate leverage on the part of households or firms. Indeed, different credit indicators have been growing at a pace consistent with the business cycle, while the level of non-performing loans has declined from the peak reached during the financial crisis. Furthermore, there is simply no evidence of an asset-price bubble in any relevant market.

Second, external accounts were and are compatible with a stable, balanced path. While non-oil exports have continued to grow at a healthy pace to this day (16.7% yoy in 2011), imports of consumption goods have barely reached their pre-crisis level. Therefore, there is no evidence of an unsustainable consumption boom. Further, the current account deficit is less than 1%[4] of GDP, and can easily be financed. Overall, it appears that capital inflows during the period when the exchange rate was appreciating did not lead to a serious or persistent misalignment of the real exchange rate.

Third, capital inflows also did not lead to higher inflation in the prices of non-tradable goods. Quite the opposite: inflation in the non-tradable sector is running at 2% and has steadily fallen during the last nine months.

Finally, although most of the main banks in Mexico are subsidiaries of European banks, Mexican institutions have remained well capitalized and closely supervised, which has enabled them to continue expanding credit. Thus, the presence of these global banks has not resulted in a reversal of capital flows or impaired their ability to carry out their business in the local market.

This said, looking ahead, policymakers in Mexico still face a number of risk factors stemming from capital flows. Perhaps among the most important is the possibility that additional inflows could lead to pronounced exchange rate appreciation, and thus to exchange-rate misalignments and distortions to the real sector. On the other hand, there is always the threat of a sudden disorderly reversal of the flows on a major scale, with the potential to destabilize domestic financial markets.

[4] 0.66% of GDP.

Mexican policy response to capital inflows

Before describing the specific policies implemented to address the large capital inflows, a background comment is due on the Mexican macroeconomic policy stance.

The government carried out a fiscal reform in 2009, in order to improve public finances, rather than as an explicit policy to address capital flows. With the benefit of hindsight, and after the crisis in Europe, Mexico did the right thing at that particular juncture. Moreover, fiscal discipline may have also encouraged long-term capital flows and thus helped make the economy less vulnerable.

As mentioned, the appropriate monetary policy response should have been to reduce the policy rate to narrow the differentials between domestic and foreign interest rates, thus reducing incentives for carry-trades. However, at that time, inflation was still above our target. The central bank had to make additional efforts to consolidate price stability and to bring inflation to the target. Thus, there were no degrees of freedom to relax monetary conditions.

In this way, sound macroeconomic policies have implicitly been part of the response to capital flows.

Thus, given the fact that there were almost no degrees of freedom for further explicit actions on the macro front, in general the policy response to the capital flows has rested on two pillars.

The first has been to allow for an orderly exchange rate adjustment. Financial authorities have been fully committed to a floating exchange rate regime and have implemented policies geared towards enhancing the regime's resiliency. The determination to allow market forces to set the exchange rate has been behind every decision related to FX policy.

Moreover, Mexico has refrained from introducing measures to restrict capital mobility, allowing markets to function freely. Exchange rate movements have probably provided the most important element of the financial and economic adjustment to capital inflows.

The second pillar in Mexico's policy response has been to take advantage of the capital inflows in order to reduce economic and financial vulnerabilities.

The central bank has replenished its stock of international reserves by using a rule-based accumulation mechanism. The stock of international reserves is now almost USD 58.1 billion higher than before the collapse of Lehman Brothers in September 2008, a time when the level of reserves was deemed by rating agencies and other analysts to be too low, especially when compared to those of Mexico's peers. The increase in international reserves has been fueled by two sources: oil-related revenues from the state-owned monopoly Pemex and direct purchases from the market through a put-option mechanism. To complement these resources, a Flexible Credit Line with the IMF was negotiated. International reserves currently stand at USD 140.3 billion, or 13.3% of Mexico's GDP.

These actions have reinforced investors' confidence. In particular, in a context of strong fundamentals, Mexico has been able to take advantage of abundant liquidity to promote the development of domestic financial markets, which has brought great benefits. Some of the most important ones are as follows.

Interest rates of government paper have declined more than 200 basis points from their peak with positive spillovers in the private sector. Furthermore, the government has been able to extend the duration of its peso-denominated debt to seven and a half years, making it less vulnerable to refinancing risk. This is a radical difference with respect to the situation 15 years ago, when most government liabilities were short-term.

The presence of foreign investors has reinforced domestic regulators' commitment to continuously improve upon the financial infrastructure. Sophisticated foreign investors have also been prodding domestic institutional investors, such as pension funds, making them more efficient. Thus, domestic institutional and foreign investors have played a key role in fostering demand for long-term debt instruments, and in supporting the development of the markets for derivatives.

Increased investor appetite for Mexican exposure allowed the government to improve its presence in the sovereign dollar-denominated debt markets. Recently, a 100-year bond was issued with a YTM of 5.96%. Moreover, local corporations have also benefited from this environment.

Finally, the flexible exchange rate regime and the improved confidence among market participants have allowed the peso to become an important global currency. According to BIS data, the Mexican peso ranks 13th among the most traded currencies in the world. Its volume has almost doubled in the last decade; the market is liquid and deep, and operates with narrow spreads. Moreover, since entering the CLS platform, the peso operates 24 hours a day.

Despite the benefits of the current policy, it could have drawbacks. First, international reserve accumulation has expanded liquidity considerably in the financial system. Banco de México has been forced to increase its peso-denominated liabilities in order to sterilize this excess liquidity. Fortunately, there is no clear evidence that this policy has so far had a negative impact on the interest rates paid by the central bank. However, there are limits to the extent to which the central bank can sterilize its purchases of foreign currency. There is a quasi-fiscal cost corresponding to the difference between what the central bank earns on international reserves and what it pays on its domestic debt.

Second, excess liquidity has also changed the way monetary policy is implemented. Since 2010, open market operations have been used to drain liquidity on a daily basis, which contrasts with the historic behavior of the central bank as a provider of liquidity to the market.

Finally, there is another source of risk. Foreign investors hold a very large share of fixed-income securities, particularly in the middle segment of the yield curve. Of course, this poses a potential risk should a massive sell-off take place, which brings up the issue of a sudden stop, which would be a threat to financial stability.

To conclude, Mexico's experience with the recent increase in capital flows has had an important effect on both foreign exchange and debt markets. So far, none of these markets have shown signs of potential instability. As a matter of fact, they have weathered the latest episodes of financial turmoil quite well. Specifically, the floating exchange regime has proved itself a successful tool in allowing orderly adjustments. Similar performance was observed in debt markets, since higher global risk aversion has not resulted in massive outflows.

For an economy such as ours, capital flows and globalization are here to stay. Strong fundamentals and a competitive economy are crucial to taking advantage of foreign savings.

A policy oriented towards the development of domestic financial markets has paid off, as a way to enhance the potential benefits of foreign savings and as means to reduce the risk of sudden reversals.

Thank you very much.