Agustín Carstens: Emerging markets

Text of The Bagehot Lecture by Mr Agustín Carstens, Governor of the Bank of Mexico, at The Buttonwood Gathering 2013 "Searching for financial stability", The Economist, New York City, 30 October 2013.

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It is a great honor to have been invited to deliver this Bagehot Lecture. Quoting from Neal Irvin's book *The Alchemists*, "Among central bankers (Walter Bagehot) has achieved iconic status for his 1873 book *Lombard Street: A Description of the Money Market*… To this day it remains something of a bible for central bankers dealing with a financial panic."

Given that Bagehot is our "Galileo" in central banking, that this year's Buttonwood Gathering theme is "Searching for Financial Stability" and that I am a central banker, I decided to devote my speech to addressing the challenges that emerging market economies' central banks are facing in today's extraordinary times.

Let me start by stating that central banking has become interesting and fun again. Not more than six years ago, it was simple and boring: in the conventional view it dealt with one main objective, – that is, keeping inflation under control, – and in a few cases with the additional objective of abating unemployment; the central bank was the main institution within the state with the mandate to achieve such objective(s); and it was also empowered with the instrument to achieve this, namely the capacity to set a short term reference interest rate. The flexible inflation targeting regime seemed to work extremely well. Asset price considerations and financial stability tended to play a secondary role.

But this ideal world changed substantially, and indeed abruptly, in 2008 with the financial crisis that erupted just a few blocks away from here.

Advanced economies entered into a major and ongoing crisis. In a context of profound economic, financial and political problems, central banks in advanced economies have played a leading role in the crisis resolution process -a role that some experts claim has "overextended" or "overburdened" central banks. Oftentimes one hears in some regions and countries affected by the crisis that they, the advanced economies' central banks, are "the only game in town".

All these events certainly have had an impact on emerging market economies (EMEs). It is true that during the crisis EMEs have in general performed well, and they have proven to be resilient, based on strong fundamentals. No doubt EMEs have their merits, but at the same time we should not overlook the fact for most of this century they experienced two very positive external shocks, namely very high commodity prices, and abnormally low external interest rates in the context of abundant liquidity. These led to a very rapid rates of economic growth.

But EMEs seem to be facing a turning point this year, as rapid economic growth, induced by high commodity prices and ample liquidity, seem to be coming to an end.

At the same time, and of tremendous importance advanced economies' (AE) central banks, having followed an extremely expansionary monetary policy, are in the process of starting the normalization of their monetary policy stance, which implies a more constrained liquidity and sharply higher interest rates.

So the question is: in this new world, what are the challenges facing EMEs' central banks and what should be their response?

The first challenge for EMEs' central banks is not to drop the ball as they pursue their main mandate of keeping inflation under control. In EMEs it is relatively easier for inflation to spin out of control, even though most countries in this category have autonomous central banks. But these institutions are young, and their credibility is fragile. So the challenge is to resist the pressures to become overburdened with multiple mandates; in particular, EMEs' central banks should not play a very active role in applying countercyclical monetary policies. Countercyclical monetary policies should be applied as one should drink tequila: in moderation.

Second challenge: Financial stability is a precondition for a conventional, simple and effective monetary policy. How does one assure the compliance of that precondition? Since the late 90s, most EMEs have adopted appropriate financial sector supervisory and regulatory regimes, and they have kept up to speed with the adoption of the new international standards. But unconventional monetary policies (UMP) in AE have generated massive, and oftentimes volatile, capital flows in and out of EMEs. An important fraction of these flows has been relatively stable, as it has been induced by medium to long term growth prospects of EMEs relative to AEs. But a not neglible portion of total capital flows, mostly the result of carry-trade type of transactions, is short term and jittery. All these flows have affected the level and volatility of domestic interest rates, credit and exchange rates, both in nominal and real terms, and have made the implementation of monetary policy extremely difficult. In short, UMP in AE have become an important element that can affect financial stability in EMEs.

Some of the flows induced by UMP have been intermediated by local banking systems in EMEs, and some in the bond and equity markets. From a financial stability point of view, the flows of most concern are those intermediated through the banking system and the fixed-income markets.

In the ***first case***, excess liquidity has led in some instances to asset price bubbles, mostly in the real estate market, representing potential future vulnerabilities for the banking system. In bond markets, the spillover effects of UMP have manifested themselves in very rich prices, excessive spread compression in some cases, overdone risk taking by some investors as they search for yield in "new frontiers" or in "covenant lite" and high yield EME corporate bonds. The unwinding of these investments could be a source of significant turbulence, as we saw recently in last May and June when the Fed's "tapering talk" started.

All these inflows have also generated important nominal and real exchange rate appreciations that are not in line with fundamentals, and they have had real effects in EMEs, slowing down exports and economic growth. This is a way to shift part of the adjustment from AE to EMEs.

As you can imagine, this scenario has represented a real dilemma for EMEs' central banks. On the one hand, given our past history of external capital deprivation, we tend to be conditioned to attract as much capital as possible. On the other hand, very large capital inflows in short periods of time can generate major damage to the economy, given its limited absorption capacity. Responses have varied among EMEs. Some, such as Mexico, have allowed market adjustments (in interest and exchange rates) to play a stabilizing role, while others have intervened heavily in the markets, and in not a few cases attempted macroprudential policies.

I would venture to say that the field of macroprudential policies is a promising one. Nonetheless there are several reasons why it is not yet fully developed.

The field is relatively new, and there are still some issues to be worked out, for example: the definition and content of macroprudential policies is not clear; there is no consensus on which authorities should direct and implement them; they have been used or "abused" to pursue inadequate objectives such as competitive currency manipulations or the adoption of protectionist measures.

My suggestion for macroprudential policy is that the international community should develop "best practices". Whenever possible, central banks should be entrusted with their management, drawing a clear line with monetary policy actions, and they should assure that, at a minimum, macroprudential policies are transparent; targeted to a specific market failure or externality; and preferably be transitory.

In sum, in the case of rapid capital inflows, EMEs' central banks should: pursue as a primary objective a low and stable rate of inflation, allowing market adjustments in interest and exchange rates, unless such adjustments could lead to an unacceptable equilibrium and threaten future financial stability; and ***second***,

If such non-equilibrium adjustments are a possibility, use transparent, well targeted and transitory macroprudential measures.

Now the third, and not unrelated, challenge. The recent problems facing EMEs' central banks since May and June have not been related to capital inflows, but outflows. These have generated market responses that in some cases were more violent than those in the wake of the Lehman Brothers collapse, in terms of exchange rate volatility and increases in long term interest rate.

A key point here is that by and large, markets have differentiated among EMEs – those with better fundamentals and fewer vulnerabilities have fared better.

The main lessons for EMEs:

– Today it is a ***must*** to have a strong external position, characterized by a low current account deficit, substantial international reserves, long duration in the public debt, and if possible contingent international financing, as in the cases of Mexico, Colombia and Poland with the IMF flexible credit line (FCL). Additionally, it is important to have a flexible exchange rate regime, in combination with a flexible and credible inflation targeting framework.

– Finally, there is also a premium for conservative fiscal policies and sustainable public debt levels and projections.

Even with these elements in place, as UMP in AE are unwinded, capital outflows will follow, domestic interest rates will increase, and financial conditions could become very turbulent. From the EMEs point of view the only adequate response, is one that is comprehensive and consistent, involving fiscal, financial and monetary policies. Central banks cannot deal with this kind of situation alone (say, by raising interest rates and/or selling foreign exchange in the market). To overburden central banks with the defense of financial stability by themselves in such a scenario could be self-defeating. A key element is to get the appropriate policy mix: a tighter fiscal policy, to reduce the financing needs of the government and to control the current account deficit, could be combined with a moderately tighter monetary policy, so as to contain capital outflows and protect economic growth.

Let me conclude with the following thought: the IMF estimated recently that 2/3 of spread compression in EMEs is explained by external factors. These external factors are reverting. If EMEs want to preserve such spread compression, they should:

– ***First***, reinforce their macroeconomic fundamentals, keeping the central bank focused on keeping inflation on track and playing a leading role in the design and implementation of macroprudential policies; assuring the sustainability of its debt, and upgrading the regulatory and supervisory regime in the financial sector, and ***second***,

– Proceed with structural reforms to enhance competitiveness and growth and at the same reduce the correlation with the world's business cycle.

Thank you very much.