# Manuel Sánchez: Evolving global challenges and policy options for Latin America

Remarks by Manuel Sánchez, Deputy Governor of the Bank of Mexico, at the 2014 IIF (Institute of International Finance) Latin America Economic Forum, Bahia, Brazil, 29 March 2014.

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It is certainly a pleasure to be invited to the stunningly beautiful Brazilian coast to participate in the 2014 IIF Latin America Economic Forum. I would like to thank the Institute of International Finance for the chance to share some thoughts with you on the challenges and opportunities faced by Latin America in the current economic environment.

I will organize my remarks as follows. First, I will comment on the changing global context for emerging markets; second, I will highlight some policy options that our countries may entertain to confront likely external financial headwinds; and finally, I will make a few comments on the Mexican economy.

## Evolving global challenges

Two trends are particularly noticeable in recent world economic developments. The first is decreasing growth since 2010, especially for emerging economies, amid modest post-crisis global improvement. Softening commodity prices and the economic deceleration of China have contributed to this tendency, affecting some Latin American commodity exporters. In particular, grains and metals have seen moderately falling prices, if from high levels.

The second trend is a reversal of fortune in global financial conditions for emerging economies. Whereas in the wake of the Great Recession, these countries drew substantial capital inflows, especially portfolio funds, and saw the prices of their financial assets rise, in 2013, the tables turned. In particular, the expectation and eventual beginning of the tapering of asset purchases by the U.S. Federal Reserve sharpened global risk aversion.

Since May of last year, portfolio capital inflows to emerging economies, previously the darling destination for foreign funds, have contracted and in some countries, even become outflows. At the same time, the prices of many financial assets seen as risky have fallen abruptly. Emerging-market bonds, equities and currencies were affected by the change in market sentiment. Also contributing to lower asset holdings and values has been a weaker relative outlook for growth in emerging economies.

However, not all countries have been treated equally. Investors have differentiated among destinations according to macroeconomic fundamentals and prospects for economic expansion, among other factors. Nations with large financial imbalances, whether internal or external, have been hit hardest, including countries in the Latin American region.

More recently, political tensions and uncertainty on the ability of some governments to resolve external financing and inflation problems have turned up the pressure on various nations to act swiftly. For almost a year, negative spillover effects to other emerging economies have resulted.

Moving forward, the foreseeable real and financial environment for emerging economies will continue to be challenging. Specifically, the world economic upturn will remain muted. One reason is that the recovery is now being led by advanced countries.[1]

[1] See, for example, Consensus Economics (2014), *Consensus Forecasts*, March; and Consensus Economics (2014), *Latin American Consensus Forecasts*, March.

Higher growth for developed nations is good news. But support from them will be moderate. Mature economies by nature only grow so fast. Also, output will probably remain below secular trends given the fact these countries need to continue fiscal consolidation measures in the wake of past expansionary cyclical postures and given increasing long-term government obligations.

Another factor calling for prudent expectations on global recovery is economic change undertaken by China, where the authorities are making efforts to adjust to developments. Rapid credit growth has fed real estate price pressures and affected bank balance sheets; shadow banking operations may pose stability risks; and signs of swift expansion in certain sectors may require restrictive policies. For all these reasons, some commodities are likely to see lower demand from China, which may dampen commodity price growth.

Furthermore, conditions in financial markets will probably continue to be bumpy. A major reason is the uncertainty surrounding the process of reversing the extraordinary monetary stimulus in advanced countries, above all in the United States.

As it reflects better economic prospects, unwinding is a welcome development. But central banks are nonetheless sailing in uncharted waters. Unconventional monetary policies, including asset purchases and forward guidance, are unprecedented; changes in the use of these instruments compound uncertainty related to the eventual decision to raise policy interest rates.

Authorities will no doubt withdraw monetary expansion in the most cautious way possible. However, dissonance between their communication and public perceptions of future actions may give rise to sharp market fluctuations, as occurred in 2013. In any case, even without future turbulence, financing for emerging economies will likely become tighter, chilling enthusiasm somewhat from portfolio investors for their assets.

## Policy implications

In the context of a modest recovery and less favorable financial conditions, what can policy makers in Latin America do to make the best of things for their economies? As always, there is no valid one-size-fits-all response, and desirable measures necessarily depend on each country's circumstances. But two separate situations may help us identify a few policy options.

First, in cases of significant market stress, emergency measures, such as those oriented toward managing the foreign-exchange market and capital flows, might be considered. In particular, the use of international reserves to attenuate market volatility may be helpful, as shown by recent responses in various severely stressed economies, which also tightened monetary policy.

However, evidence on the effectiveness of foreign-exchange market intervention is mixed, and the impact is almost always temporary. In addition, use of this policy should not impede adjustment to any existing large external imbalances. Moreover, the imposition of capital controls has limited short-term success, usually affects only the composition of flows, and may harm prospects for future financing.[2]

In cases of homegrown economic stresses, the limitations of emergency measures are more obvious. For example, some nations have experienced over-leveraging and price bubbles either from capital booms or loose fiscal and financial policies, which may have weakened

[2] Empirical evidence on the effectiveness of policy interventions on foreign exchange markets and capital flows can be found in Broto, C. (2013), "The effectiveness of forex interventions in four Latin American countries," *Emerging Markets Review* 17; and Forbes, et. al. (2013), "Capital Controls and Macroprudential Measures: What Are They Good For?" *DIW Berlin, German Institute for Economic Research, Discussion paper* 1343.

banks' balance sheets. Tackling underlying problems as soon as possible is a necessary condition to regain stability.

Available tools include fiscal and monetary tightening, micro and macro prudential policies and exchange rate adjustment. In the short term, some tradeoffs may be involved. For example, more restrictive monetary policy to counteract capital outflows may weaken a cyclical upturn and result in disorderly deleveraging, but keeping monetary policy loose could trigger inflation and exacerbate balance-of-payment problems.

Second, even if no significant imbalance is evident, preventive policies are always called for to prepare for potential financial strain. Possible fragilities to watch for and correct preemptively include rapidly rising external debt and foreign currency mismatches, as well as domestic asset price bubbles. All in all, the best strategy is to strengthen macroeconomic foundations, fortify the financial system through better regulation and oversight, and promote reforms that enhance economic efficiency and hence potential growth.

### The Mexican economy

During recent years, Mexico has been an important recipient of foreign portfolio funds among emerging economies. The country has also fared relatively well in the current less favorable external financial environment. In particular, since May 2013, the Mexican peso has depreciated less than many other emerging-market currencies. This is noteworthy as in this period Mexico has not resorted to any type of foreign exchange intervention, a policy that has become more pervasive in several other countries. The freely floating exchange rate regime in Mexico is clearly in force.[3]

Since last May, the yield curve has steepened in tandem with that of the United States. Shifts in the yield curve have mainly reflected higher term premiums, stemming from anticipated unwinding of the expansionary monetary stance in the United States. Possible effects from domestic expected inflation, currency risk and future policy interest rate hikes do not seem to have played an important role. Also, country risk indicators, such as the Mexican government's credit default swaps, rose less than those of many other emerging economies.[4]

Moreover, capital flows have continued to increase, albeit at a slower pace, particularly those oriented toward fixed-income assets. Foreign holdings of peso-denominated government bonds have reached new highs, although portfolio duration has dropped slightly. This contrasts with the reductions of holdings observed in emerging markets as a whole.

Mexico's ability to weather recent market turmoil may reflect several factors, including the flexible exchange rate regime that has long served as a buffer to external shocks, transmitting global financial signals to the domestic economy efficiently.

Also, no clear imbalances built up during the capital boom years. Current account and fiscal deficits have remained moderate relative to GDP. Furthermore, the ratio of private-sector credit to output, if anything, stayed too low if international comparisons are taken into account. The growth in this ratio during the last few years has been one of the lowest among emerging economies, which poses challenges for making credit more available in Mexico.

Longstanding prudential regulation and more adequate business models have made the banking system solid, with healthy levels of capital, provisions and asset quality. Bank rules designed to forestall foreign currency mismatches cover deposits, net liabilities, net open positions and liquidity ratios.

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3 Pursuant to regulation issued by the Bank of Mexico in accordance with its law, the Federal Treasury and Pemex must carry out all of their foreign currency transactions with the central bank. Proceeds from Pemex transactions have largely been the source of international reserves accumulated by the Bank of Mexico.

4 See Banco de México (2014), *Informe Trimestral, Octubre – Diciembre 2013*, February, pp. 50–53.

Mexico needs to stay the course, buttressing its economy through effective monetary policy to keep inflation subdued, as it has been in the last decade. A list of sound economic fundamentals does not imply that the economy is free of risks. Stability cannot be taken for granted, and authorities will have to continue monitoring conditions for signs of any weaknesses in order to prevent any potential market disarray.

Finally, the Mexican economy is undergoing a period of low cyclical growth that began in the middle of 2012. Some factors should be of a temporary nature, such as a slowing of Mexican exports due to the previous deceleration of the U.S. economy, lower government spending tied to the beginning of a new federal administration and the restructuring of the housing developers market in the wake of the failure of the three largest firms in the sector.

Thus, improvement in these factors should lead to an upturn. In particular, close linkages with the U.S. economy could make future growth more solid than that derived from the dependence of exports on commodity prices.[5]

Other more lasting problems center on the stagnation of total factor productivity, which contributes largely to Mexico's disappointing long-term economic performance. Current momentum on structural reforms, which seek to generate greater efficiency, is highly promising. The agenda is ample, covering many sectors of the economy. Although the full effects of the reforms may take years to materialize, their direction and the confidence that comes with positive expectations have likely already helped to attract continued capital inflows, and should fuel a sustained recovery.[6]

## Concluding remarks

The present environment is a challenging one for all emerging economies, including those of Latin America, but challenges, of course, always carry with them potential opportunities. The expected global economic rebound is good news, especially for those countries poised to benefit from strong ties with the world's biggest consumers.

Future market conditions may be rocky, posing risks in particular to nations with financing vulnerabilities. The best ring-fencing strategy is to correct imbalances as efficiently as possible. In any case, a preemptive approach to strengthen macroeconomic and financial foundations is imperative. Furthermore, structural reforms to foster productivity may show the way to more sustainable long-term economic growth.

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5 Commodities make up less than 20 percent of Mexico's total exports, while the average share in other Latin American countries surpasses 60 percent. Source: own calculations with data from Banco de México and the World Trade Organization Statistical Database.

6 For a summary of some salient structural reforms see Sanchez, M. (2013), "Mexico's prospects for economic growth," presented at the *United States-Mexico Chamber of Commerce, N.Y.*, October.