Manuel Sánchez: Emerging markets and the world's unusual monetary conditions

Remarks by Mr Manuel Sánchez, Deputy Governor of the Bank of Mexico, at the GIC Central Banking Series: Madrid, Madrid, 13 May 2015.

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It is a pleasure to be in Spain, a country which has a close history and strong cultural and economic ties with Mexico. I would like to thank BBVA for the invitation to participate in this conference, and to share my thoughts with you on the challenges for emerging economies in the current unique global scenario.

I will begin my presentation by reflecting on the extraordinarily loose monetary stances in most advanced countries. Then, I will describe how these conditions affect emerging economies and their policy options, and I will conclude by touching on Mexico's financial developments. As usual, my remarks are entirely my own and are not necessarily the views of the Bank of Mexico or its Governing Board.

Monetary policies in advanced countries

Since 2008, the central banks of advanced nations have implemented increasingly expansionary monetary policies. This trend has shown at least three important facets: first, authorities have resorted to unconventional tools never tried before; second, the degree of monetary accommodation achieved is unprecedented; and third, the tendency has been widespread, encompassing most major central banks, following the lead of the U.S. Federal Reserve.

In particular, the traditional instruments, benchmark interest rates, have been reduced to minimum levels, to virtually zero in the United States or even to negative values for policy and or deposit rates in continental Europe. The liquidity growth has mainly reflected significant augmentation of central banks' balance sheets, through large-scale asset purchases, commonly referred to as quantitative easing.

The variety of securities bought has been ample, including, in some cases, private credit and stocks. Forward guidance completes the toolkit, in an attempt at influencing market expectations regarding the direction of future policy actions.

In the wake of the global crisis, the main aim of monetary policy was to normalize financial conditions. Central banks implemented extraordinary measures to meet the increased demand for liquidity amid a generalized rejection of assets, highly preferred during the preceding boom, that were suddenly perceived as too risky.

This goal, which was at the core of the central bank role as lender of last resort, was attained well. Financial stabilization benefited not only the countries where measures were undertaken, notably the United States, the epicenter of the crisis, but, in light of the contagion effect, also the world as a whole.

Even after financial markets stabilized, monetary expansion continued to deepen, although through different paths across jurisdictions. While emphasis on objectives differed, each central bank looking to its legal mandate, in general, looser monetary policies have sought to support economic recovery and, at the same time, preserve price stability.

The contribution of monetary accommodation to growth since 2010 has been subject to debate, particularly in the United States. Although evidence tends to confirm a positive effect on economic activity, estimated results have sometimes turned out to be relatively modest.[1]

Regarding price stability, monetary actions in advanced countries have been motivated by recurrent fears of deflation. While such an event cannot be ruled out, concerns about possible implications should not be magnified. Neither theory nor history establish a clear connection between deflation and poor economic activity. The only evident negative episode seems to be the substantial deflation that occurred during the Great Depression. But at that time prevailing monetary conditions were tight, and no precedent exists of significant deflation under highly expansionary monetary conditions.[2]

Regardless of their effectiveness in attaining desired results, extremely loose monetary policies may generate increasing risks and unintended consequences. Low interest rates can result in excessive risk-taking, overleverage and the channeling of credit to projects with low productivity. The discouragement of saving hurts retirees, as well as pension funds and insurance companies, which could face difficulties meeting long-term liabilities.

Asset prices may reach levels inconsistent with underlying fundamentals. Inefficiencies would hinder economic growth, and imbalances could endanger financial stability, something that bears watching especially in light of the recent global crisis. Also, expansionary monetary policies potentially reduce incentives to implement other needed reforms, such as fiscal consolidation and productivity-oriented changes.[3]

In fact, during recent years, monetary measures have kept gaining ground relative to other policies in attempts to support growth. However, expecting too much from monetary policy may be counterproductive. Central banks have become crucial participants in new financial arenas, including credit allocation, at the risk of distorting prices. Additionally, speculation and news about possible central bank decisions have become the most important market movers.

This activist role may have unintentionally weakened the public's confidence in the ongoing recovery. The abnormal situation has resulted in the circumstance that financial participants tend to react positively to weaker-than-expected economic data and vice versa.

The intention on the part of the Fed to begin unwinding its policy in the near future is a welcome development. It will likely reflect stronger U.S. economic performance, which should favor the world economy, especially those countries most closely linked to the United States. Normalization, in turn, is a precondition for containing the accumulation of possible vulnerabilities that could eventually jeopardize global economic improvement.

In any case, the future likely scenario for advanced nations is one of divergent monetary paths. While the United Kingdom will perhaps be next after the United States in unwinding stimulus, the European Central Bank, the Bank of Japan and other major central banks could further loosen monetary stances. The pace in each direction is highly uncertain.

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[1] For an estimation of real effects of unconventional monetary policy, see, for example, Engen, E.M., et al. (2015), "The Macroeconomic Effects of the Federal Reserve's Unconventional Monetary Policies," *Board of Governors of the Federal Reserve System Finance and Economic Discussion Series* 2015–005, January; and Wu, J.C. and F.D. Xia (2014), "Measuring the Macroeconomic Impact of Monetary Policy at Zero Lower Bound," *Chicago Booth Research Paper* 13–77, July.

[2] Two analyses on the possible real consequences of deflation are: Atkeson, A. and P.J. Kehoe (2004), "Deflation and Depression: Is There an Empirical Link?" *American Economic Review*, 94 (2); and Ryska, P. (2014), "Deflation and Economic Growth in Long-Term Perspective," *Charles University in Prague, Institute of Economic Studies Working Paper* 18/2014.

[3] For a review of possible risks from prolonged monetary expansion, see Hannoun, H. (2015), "Ultra-Low or Negative Interest Rates: What They Mean for Financial Stability and Growth," *Speech at the BIS Eurofi High-Level Seminar*, April.

Effects on emerging economies

Unconventional monetary policies in developed countries have had significant bearing on emerging markets. Financial stabilization in a U.S. economy overwhelmed by the global turbulence was clearly positive, as it mitigated significant outward contagion. To the extent that a larger collapse was avoided, other countries benefited, a comment that can also be extended to the subsequent U.S. economic rebound.

The search for yield stemming from abundant liquidity since 2010 has translated into substantial capital flows, especially portfolio funds, to emerging economies. Benign financial conditions have helped stock and debt issuers in both local and foreign currencies. In as much as productive opportunities have been exploited, this environment has helped growth.

At the same time, vulnerabilities may have surfaced in some countries. These include the overheating of specific sectors, high indebtedness and excessive exposure to foreign currencies, as well as asset overvaluations that may not be sustainable, especially once easy liquidity conditions are reversed.[4]

These fragilities might have been made worse by the fact that emerging economies have generally loosened their monetary stances in reaction to the expansion in advanced nations. Indeed, policy rates have tended to remain below what is suggested by different versions of the Taylor rule.[5]

In any case, concerns related to the aforementioned risks have shaped defensive measures in emerging markets. Obviously, the actions announced and undertaken by the Fed have played a crucial role.

Before the taper tantrum in May 2013, as portfolio capital moved more steadily and strongly, the main focus of policy makers was probably how to discourage or slow down the entrance of these funds. Strategies in many countries included capital restrictions, official foreign exchange purchases to avoid currency appreciation, and interest rate cuts by central banks. Evidence regarding the net effect of these tools is mixed.[6]

During the last two years, as capital flows have contracted and later resumed with less vigor, a policy shift has apparently occurred towards how to protect financial stability. In some countries, the change has implied the reversal of previous measures, for example, lifting controls, using international reserves to fight currency depreciation, and hiking interest rates. In particular, monetary policy was tightened in economies exhibiting large domestic and external imbalances as well as climbing inflation.

Facing uncertainty in emerging markets

Portfolio capital flows largely exploit carry trades. If a determinant of the trade changes, investor decisions can be expected to change as well. The possible reduction of lax conditions would largely depend on expectations, including those regarding central banks' reactions in emerging markets. In such a scenario, a sudden stop or reversal of capital flows cannot be ruled out.

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4 For an exploration of the effects of unconventional policies on emerging economies, see Chen, Q., et al. (2015), "Financial Crisis, US Unconventional Monetary Policy and Intentional Spillovers," *BIS Working Paper* 494, March; Hoffmann, A. (2014), "Zero Interest Rate Policy and Unintended Consequences in Emerging Markets," *ICER Working Paper* 2/2014, February; and Tillman, P. (2014), "Unconventional Monetary Policy Shocks and the Spillovers to Emerging Markets," *HKIMR Working Paper* 18/2014, August.

5 See, for example, Hofmann, B. and B. Bogdanova (2012), "Taylor Rules and Monetary Policy: A Global 'Great Deviation'?" *BIS Quarterly Review*, September.

6 See, for example, Forbes, K., et al. (2015), "Capital Flow Management Measures: What Are They Good For?" *NBER Working Paper* No. 20860, January; and Alfaro, L., et al. (2014), "The Real Effects of Capital Controls: Financial Constraints, Exporters, and Firm Investment," *NBER Working Paper* 20726, December.

The rise in global risk aversion and the significant financial volatility triggered by the taper tantrum may be an indication of how markets could react to a surprising move by the Fed. Currently, a lot of speculation has centered on the date of the first hike, but this and other details on U.S. monetary unwinding cannot be known in advance, simply because, as the Fed itself has stated, the whole process is data dependent.

It seems reasonable to assume that the Federal Reserve will continue to use forward guidance as cautiously as possible, especially in light of its experience with the taper tantrum. In that sense, if monetary changes are anticipated and gradual, international volatility resulting from such actions may be contained. Presumably, markets would price in those changes in advance, without much over- or undershooting of asset prices and, perhaps, of portfolio adjustment.

Indeed, the Fed has revealed its preference for incremental moves, stating that the policy rate may stay at levels lower than those consistent with full achievement of its mandate for some time even after those goals have been attained. This expectation, along with the assumption that other advanced nations may further deepen their monetary expansion, could keep world liquidity conditions relatively ample for some time.

However, gradualism cannot be assured. In the event of a surprise tightening of the U.S. labor market, for instance, the monetary authority may be forced to change gears more significantly than initially planned.

Also, other countries may end up taking monetary postures less loose than currently envisioned. For example, extreme unconventional monetary policies have resulted in negative interest rates for a wide array of maturities in a number of European countries. If they prevail too long, we do not know what impact these rates may have on financial stability or economic efficiency. That territory has never been explored, and its possible consequences can hardly be estimated.

In such an uncertain scenario, an effective way for emerging economies to shield themselves against external shocks is by strengthening their macroeconomic fundamentals. At the same time, authorities must remain vigilant to detect factors that may endanger financial stability and react in a timely manner.

Financial developments in Mexico

Like other emerging economies, during the last few years, Mexico has been the destination of considerable portfolio capital flows. Substantial external resources have been channeled to the domestic markets, and financing in foreign currencies has been successfully tapped by the government and corporates.

Mexico's capital account openness has facilitated these inflows. The most noticeable impact has been observed in nonresidents' holdings of peso-denominated government bonds, which rose since 2010 to reach approximately 37 percent of the total outstanding.[7]

It is worth noting that Mexico's banks are not large recipients of capital flows. They enjoy an ample, low-cost domestic funding base in pesos. Also, prudential bank regulation, established in the 1980s and 1990s as a result of macroeconomic crises, imposes stringent foreign currency restrictions in terms of limitations for opening deposit accounts, caps on net liabilities and open positions, as well as a minimum liquidity ratio.

Obviously, Mexico has not been immune to changes in global risk aversion. The clearest recent impact has been felt in asset prices, especially through movements in the exchange rate. In particular, the currency's weakening and volatile trend since the middle of last year

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[7] Outstanding refers to federal government debt securities.

has mostly mirrored the generalized appreciation of the U.S. dollar, in addition to the fall in oil prices. In contrast, medium- and long-term interest rates have increased moderately since the taper tantrum, resulting in steepening of the yield curve, slightly more than that of the United States.

Furthermore, since 2013, nonresident holdings of peso-denominated government securities have remained roughly stable as a proportion of the total outstanding. Throughout these months, composition has changed, with long-term bonds gaining a higher share at the expense of zero coupon short-term securities, which may reflect a cleaning-up of highly speculative positions.

Mexico's relative resilience to external shocks seems to be based on a solid economic foundation, including prudent fiscal management, monetary policy focused on controlling inflation, and a sound regulatory and supervisory framework for financial institutions. Additionally, a broad reform agenda may be contributing to a positive perception of the economy.

Nevertheless, recent financial developments are no guarantee of future tranquility. The challenges ahead are faced by other emerging markets as well. Mexico can further differentiate itself through commitment to an announced multiyear reduction of public debt, the convergence of inflation to the permanent target, and a profound implementation of ongoing structural reforms. These measures should foster financial stability and long-term economic growth.

Concluding remarks

The likely divergent monetary paths of advanced nations pose challenges for emerging economies. The proximity of the liftoff of rate hikes in the United States is encouraging, as it will reflect a strong economic performance that should favor the world recovery. The intended gradualism by the Fed, and the possible continuation of monetary expansion by the European Central Bank and the Bank of Japan, may suggest that the global economy will still see abundant liquidity, with relatively benign financial conditions for emerging markets.

However, uncertainty surrounding the pace of U.S. normalization and of monetary actions in other countries may give rise to episodes of international financial volatility. In particular, market sentiment towards emerging economies could change. The best strategy for countries to shield themselves against external shocks is to strengthen economic fundamentals, while at the same time authorities remain on alert for factors that would put financial stability at risk.

Finally, Mexico can potentially remain attractive to investors by assuring public debt sustainability, consolidating convergence of inflation to the target, and implementing ongoing structural reforms in a deep-seated, effective manner.