REMARKS BY MR. JAVIER GUZMÁN CALAFELL, DEPUTY GOVERNOR AT THE BANCO DE MÉXICO, ON "EMERGING MARKETS IN AN ERA OF DOLLAR APPRECIATION AND VOLATILE CAPITAL FLOWS", AT THE STATE STREET GLOBAL ADVISORS (SSGA) - OFFICIAL MONETARY AND FINANCIAL INSTITUTIONS FORUM (OMFIF) ROUNDTABLE "POLICY RUPTURE: CHALLENGES AND OPPORTUNITIES FOR PUBLIC INVESTORS". London, April 4, 2017. [1]

I would like to start by thanking the organizers for the invitation to speak at this panel.

Several years after the outbreak of the global financial crisis, the world economy continues to display a weak performance, despite the recovery that has taken place since then. Following the rebound observed in 2010, the growth rate of global GDP has been on a declining trend, averaging 3.5 percent annually during the period 2011-2016, a full percentage point below its pre-crisis trend. It should be noted that the above owes to a large extent to developments in the advanced economies (AEs), whose sharp GDP contraction and slow recovery in the aftermath of the crisis limited the increase in real GDP from 2007 to 2016 to a mere 10 percent.

Even though cyclical factors explain to some extent the aforementioned trends, the markedly low speed with which activity has recovered, as well as the perceived fragility of the process, point in the direction of important structural forces at play. Indeed, global demand for both capital and

[1] The opinions and views expressed in this document are the sole responsibility of the author and do not necessarily represent the institutional position of the Banco de México or of its Board of Governors as a whole.

consumption goods appears to remain subdued due in part to an excess of savings over investment, further compounded by the long-lasting deterioration of balance sheets across sectors and economies as a result of the crisis. On the supply side, factors such as low productivity growth and demographic trends, especially in the AEs, in combination with so-called hysteresis effects from the crisis, are considered to be exerting downward pressure on growth. All in all, this has given rise to concerns about the possibility of secular stagnation and therefore a much less dynamic outlook for the global economy.[2]

The situation is further clouded by parallel and reinforcing trends in international trade flows. Not only is the global trade volume of goods and services estimated to have recorded last year its lowest pace of expansion since the height of the crisis, but its average rate of growth has been cut by over one half between 2000-2007 and 2011-2016. Weakness in the pace of economic activity naturally accounts for a large share of the observed decline in the growth rate of international trade. However, global trade flows have also been undermined by a number of factors directly affecting them. Chief among these is the apparent loss of momentum in the pace of globalization and the trade liberalization process, as evidenced, for instance, by the lessened reduction of tariff and other regulatory barriers, the slowdown in the number and coverage of free trade agreements, and the uptick in protectionist measures. In addition, the patterns of production and trade may be changing, and a tendency to shorten global supply chains might also be playing a part in

[2] See Teulings, C. and R. Baldwin (2014): "Secular Stagnation: Facts, Causes and Cures", a VoxEU.org eBook.

the observed deceleration of the measured cross-border flows of goods and services.[3]

Not surprisingly, these developments and the hardship they have implied for wide segments of society, have fostered the surge of a strong anti-globalization sentiment, particularly in some of the main AEs.

In this context, we seem to be entering a new era, where the problems resulting from the global financial crisis have not been fully dealt with, and new perils are emerging.

I am especially concerned about five sources of risk, in view of the challenges they present to the world economy.

First, the degree of uncertainty surrounding the outlook is significantly greater than what can be deemed normal. Although at the moment this is explained to a large extent by the lack of clarity and details about the future course of policies in a number of areas in the United States, this comes atop doubts generated by exit of the United Kingdom from the European Union, as well as by the still-pending electoral processes elsewhere in Europe, all within the context of strengthening nationalist positions in many other countries.

[3] See Hoekman, B. (2015): "The Global Trade Slowdown: A New Normal?", a VoxEU.org eBook, June; and European Central Bank (2016): "Understanding the Weakness in Global Trade: What is the New Normal?", ECB Occasional Paper No. 178, September.

Second, the possibility of renewed episodes of increased volatility in international financial markets is at present much more likely, given the combination of highly integrated international financial markets, the above described situation of uncertainty, the perspective of tighter global financial conditions derived mainly from the normalization of monetary policy in the United States, the vulnerable situation of several major advanced and emerging market economies, and the potential for geopolitical problems in a number of regions of the world, among other factors.

Third, even though the US dollar has depreciated somewhat during the course of this year, a number of elements point towards a prolonged strengthening of this currency. One of the most important among them is the perspective of higher interest rates in the United States and the likely increasing divergence of monetary policy stances among the main advanced economies, a trend that may be accentuated by the fiscal-monetary policy mix anticipated for the United States in coming years. The implementation of corporate tax reform measures geared towards subsidizing exports and taxing imports, or a trade policy aimed at increasing import tariffs in this country, should they materialize, would also give a boost to the valuation of the dollar.

Fourth, the rise of nationalist sentiment across a broad range of economies could result in in an increase of protectionism worldwide, in a context in which new trade restrictions returned in 2016 to the trend levels observed since 2009[4] and a shift towards more opaque measures of protection is taking place.

[4] World Trade Organization (2016): "Report on G20 Trade Measures", 10 November.

According to some recent studies, even an increase in tariffs by WTO members within accepted rules would have a significant impact on world trade and welfare.[5] Naturally, the consequences of an environment of retaliatory trade restrictions would be far more severe.

Lastly, the increasing barriers to the flow of labor between economies embodied in recent anti-immigration policy proposals, would represent a missed opportunity to mitigate some of the challenges faced by the global economy. In particular, the aging and low growth of the labor force in some of the main economies would continue to be a major drag on both realized and potential global growth. Recent research by the IMF finds that a 1 percentage point increase of the migrant share in the adult population of AEs, can lead up to a 2 percent increase in the level of their GDP per capita in the long run.[6]

What are the policy options for EMEs under such a scenario?

Although specific circumstances will vary from one country to another, some principles of a general nature can be underscored.

A first one is to fight external uncertainty with policies aimed at enhancing domestic assurance. The priority here of course is to preserve macroeconomic and financial stability. Under a situation of volatile capital flows, this implies an emphasis on prudence and preemptive action on both the fiscal and

[5] See World Bank (2017): "Global Economic Prospects", January; and Bouet, A., and D. Laborde (2010): "Assessing the Potential Cost of a Failed Doha Round", World Trade Review Vol. 9 (02): 319-351.
[6] Jaumotte, F., K. Koloskova and S. Saxena (2016): "Impact of Migration on Income Levels in Advanced Economies", International Monetary Fund Spillover Note No. 8, December.

monetary policy sides. Flexible exchange rates can provide margins of maneuver to cope with capital movements. However, exchange rate flexibility may be accompanied by costs, and therefore intervention in the foreign exchange market may be needed to gain some additional space. In this process, the implementation of a balanced policy mix, which avoids excessive reliance on one single instrument, is of the essence. Financial stability is a complex objective that will frequently require the coordinated implementation of a number of tools, including fiscal, monetary, microprudential and, in particular, macroprudential policies.

A second one is that in the face of a difficult external environment, reduced margins to implement other macroeconomic policies to stimulate domestic economic activity, and low productivity growth in a broad range of countries, efforts towards structural reform in EMEs take on particular relevance. As the empirical evidence demonstrates, structural reform can lead to improved productivity performance and broad-based macroeconomic benefits.[7] This strengthens the domestic sources of growth, thus making the economy less vulnerable to external developments, while increasing the potential to compete in international markets and the attractiveness of the economy to foreign investment flows. In addition, aggregate demand may be effectively stimulated by structural reform measures, not only directly, but also through, for instance, the higher efficiency with which other countercyclical policy measures operate owing to reform-enhanced transmission mechanisms.

[7] See Christiansen, L., M. Schindler and T. Tressel (2013): "Growth and Structural Reforms: A New Assessment", Journal of International Economics 89(2): 347-356; and Prati, A., M. Onorato and C. Papageorgiou (2013): "Which Reforms Work and under What Institutional Environment? Evidence from a New Data Set on Structural Reforms", The Review of Economics and Statistics 95(3): 946-968.

However, it is important to emphasize that the design and implementation of structural reforms face a number of challenges. First, as the international experience evidences, efforts in this direction are often undertaken within the context of episodes of severe economic distress, with the risk of higher implementation costs, of a less carefully planned set of reform measures, and of turning what should be regarded as a strategic action into a desperate search for immediate relief. A second complication arises from the multiplicity of idiosyncratic factors that must be taken into account to maximize the potential of reform success on a case-by-case basis, such as the stage of development and institutional setup of the subject economy; the careful identification of a sensible order of priorities, sequencing and intensity of reforms; and the nonlinearities, interactions and complementarities that may exist among them. Third, the adequate implementation of structural reform faces important difficulties of its own. Among these, the required political support may prove elusive and costly to achieve, while the possibility of implementation mistakes affecting the beneficial impact of the reform effort cannot be disregarded. Lastly, in addition to being feasible, structural reform must also be sustainable in the long-term, which in turn requires a strong and broad sense of ownership by the societies implementing them, aided too by a balanced mix of short- and long-term benefits.

Trade policy represents another key component of the policy toolkit nowadays. In my opinion, a crucial issue here is to keep in mind that openness to trade flows has unquestionable advantages. In addition to the benefits arising from greater competition and the reallocation of resources across sectors on efficiency, technological development and innovation, the wider variety and better quality of raw and intermediate inputs available to domestic producers at a lower cost also constitutes an important channel through which significant productivity and output gains can be obtained. Motivated by these and other beneficial effects, important strides towards trade liberalization have been made at a global scale. However, the pace of progress in this direction seems to have declined, and there remains an ample margin for further trade liberalization. According to recent estimations by the OECD,[8] a broad-based convergence of trade policy towards a stance such as the one currently observed in some of the most open economies would yield, over the long term, a world trade intensity (that is, the sum of world imports and exports as share of GDP) about 22 percentage points higher than in a baseline scenario in which protectionism remains at present levels.

At the current juncture, nonetheless, the fact is that access to some markets, especially in the AEs, may become increasingly more difficult to obtain and preserve. In such a context, EMEs will need to consider options to broaden the scope of trade and to deepen its reach. A first possible course of action in this direction is to look for a more extensive and ambitious network of free trade agreements (FTAs); experience shows that this has the potential to boost trade flows.[9] Further to this, FTAs foster greater integration into global value chains

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[8] See Organisation for Economic Co-operation and Development (2016): "Cardiac Arrest or Dizzy Spell: Why Is World Trade So Weak and What Can Policy Do About It?", OECD Economic Policy Paper No. 18, September.

[9] According to recent estimates by the World Bank, preferential trade agreements accounted for nearly 14 percent of world trade growth between 1995 and 2014, equivalent to a 0.6 percentage point increase in its

(GVCs), although it is also true that this will frequently require additional efforts towards the improvement of the economy's infrastructure, particularly in transport and information and communication technology. Lastly, trade in services appears to be an area largely unexploited, given its relative underdevelopment in comparison to that in goods, as well as the sector's growing importance. In more general terms, and as noted before, it is important to keep in mind the key role of structural reform in increasing the economy's competiveness in international markets, as well as its appeal to foreign (particularly direct) investment flows.

To conclude, I just want to note that notwithstanding its beneficial effects, globalization is accompanied by social costs, as wages and employment in those sectors more exposed to competition from abroad may be adversely affected. It has also been noted that globalization may give rise to an increase in income inequality, although the evidence here is not fully clear.[10] In any event, as the recent experience demonstrates, the costs resulting from globalization, either real or merely perceived, can be significant enough to trigger a reaction that may stall, and even reverse, this process.

Indeed, if global integration is to continue, it is essential to design and implement policies geared towards the effective mitigation of the associated

annual growth rate. See Constantinescu, C., A. Mattoo, and M. Ruta (2017): "Trade Developments in 2016: Policy Uncertainty Weighs on World Trade", World Bank Global Trade Watch, February.

[10] Recent empirical evidence shows that, while *trade* globalization appears to be associated with lower inequality, *financial* globalization does have an adverse effect on the distribution of income in both advanced and EMEs. However, this effect seems to be modest in comparison to those derived from other factors, such as skill-biased technological change and less regulated labor markets. For further details, see Dabla-Norris, E. et al. (2015): "Causes and Consequences of Income Inequality: A Global Perspective", IMF Staff Discussion Note No. 15/13, June.

costs. A first line of defense should aim at ensuring the availability of efficient and well-targeted social safety nets that limit the potential damage to the most vulnerable, and that better equip them to face a far more competitive environment. But seen from a broader perspective, there is a need for development strategies that explicitly foster more inclusive and sustainable growth paths. To be sure, the nature of the challenges involved in fighting poverty, lowering inequality, and providing adequate social protection under situations of stress, implies the simultaneous use of multiple policy levers, including fiscal, regulatory and structural reform measures, among others. Furthermore, macroeconomic and financial stability are a precondition for these efforts to succeed.