REMARKS BY MR. JAVIER GUZMÁN CALAFELL, DEPUTY GOVERNOR AT THE BANCO DE MÉXICO, ON "MONETARY POLICY AMID VOLATILE CAPITAL FLOWS". SCOTIABANK GLOBAL CENTRAL BANK & PUBLIC INSTITUTIONS CONFERENCE. Miami, April 6th, 2017.[1]

First of all let me say that I am very glad to participate in this Conference. My sincere thanks to Scotiabank and especially to Alejandro García for the invitation.

The implementation of monetary policy under volatile capital flows has for long been a challenging issue for emerging market economies (EMEs). Naturally, with globalization and the consequent increased integration of the world economy, the difficulties have become more acute. As is well known, the combination of a number of factors, including domestic financial liberalization, a widespread removal of cross-border controls, and the development of financial technology, has brought about a dramatic expansion of international financial transactions in recent decades.

But the complexities of these trends have been substantially accentuated as a result of the global financial crisis. The pressures resulting from the crisis forced the central banks of many advanced economies (AEs) to reduce short-term interest rates to very low, even negative levels, which resulted in turn in historically low figures for long-term rates. This led to an aggressive search for yield and a boost to capital flows towards EMEs, giving as a result macroeconomic and financial stability challenges for these countries.

[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.

Subsequently, as the situation has begun to improve in the AEs, and especially in the United States, EMEs have faced the need to cope with the opposite challenge, i.e. a tightening of external financial conditions and episodes of capital outflows, although in a context of wide swings, with the corresponding stresses on domestic and external stability. The situation has been further complicated by divergent monetary positions among the main AEs and by periodic bursts of turbulence.

Naturally, the challenges deriving from the global financial crisis do not end here. On the one hand, it has had long-term effects on the world economy, including a lower rate of potential growth, a decline in commodity prices, and a substantial increase in global uncertainty, among others, that have significantly deteriorated the external environment faced by EMEs. On the other hand, the costs that have accompanied the crisis have underpinned a backlash against globalization, which is threatening to undermine the economic progress achieved over many decades of efforts.

At the same time, the crisis has given rise to deep question marks about our understanding of economics, in general, and of monetary policy in particular. For instance, it has become increasingly evident that while the possibility of implementing an independent monetary policy is greater under exchange rate flexibility, floating implies costs that set limits on the degree of independence a central bank can enjoy. Furthermore, doubts have emerged regarding the adequate monetary policy framework under current circumstances, the merits of intervention in the foreign exchange market, the role to be played by monetary policy in the preservation of financial stability, and the use of capital controls as a means to counter the adverse effects of volatile capital flows, among others.

How has monetary policy in Mexico responded to these challenges?

At present, the implementation of monetary policy in Mexico rests on four pillars.

First, an independent central bank with the mandate to focus on achieving a low and stable rate of inflation. Both features, as well as the key provision that no authority will be able to order the Banco de México to provide financing, are stipulated at the constitutional level.

Second, an inflation targeting regime, with a specific target for headline CPI annual inflation of 3 percent within a variability interval of +/- 1 percent, and where convergence to the target is sought at the lowest possible cost in terms of economic activity.

Third, a commitment with transparency and clear communication of actions and goals of the Central Bank.

Fourth, awareness that under a situation of high uncertainty, there are clear merits of an approach emphasizing prudence and readiness to act on a preventive basis whenever this is considered convenient.

Naturally, an efficient achievement of the macroeconomic objectives requires a balanced policy approach. It may be useful to note, for instance, that the global financial crisis has evidenced the costs derived from a policy response that relies excessively on monetary policy. In the case of Mexico, two elements are central in this regard:

- The implementation of measures aimed at fostering an orderly functioning of the foreign exchange market in a context of sharp depreciation and high volatility of the peso-dollar rate. With the support of a comfortable level of international reserves and a Flexible Credit Line with the IMF, actions taken by the Foreign Exchange Commission[2] have varied according to circumstances, and have included pre-announced or sporadic discretionary interventions in the foreign exchange market and, more recently, the introduction of a new mechanism for the hedging of foreign exchange risk for an amount of up to USD 20 billion, which in fact does not imply the use of international reserves. The latter has contributed to the significant appreciation shown by the peso in recent weeks.

  It is important to note that this approach is fully consistent with a flexible exchange rate regime that plays a key role as a shock absorber, which operates under the premise that the level of the equilibrium real rate must be determined by market forces, and where the value of the domestic currency is supported mainly by economic fundamentals.

- Against the background of an increase in public debt as a share of GDP, a major fiscal adjustment has been announced for 2017 and subsequent years. Indeed, the strict implementation of these measures should allow

[2] Integrated by representatives of the Banco de México and the Secretaría de Hacienda y Crédito Público.

more flexibility in the conduct of monetary policy and, therefore, a more efficient economic adjustment to an adverse external environment.

The role of monetary policy in preserving or restoring financial stability is a subject of much debate. Macroeconomic stability is a necessary although insufficient condition for financial stability, and of course monetary policy is a key element in this regard. But the role of monetary policy beyond this is not always clear. In my opinion, although there may be instances where monetary policy actions can be usefully steered towards financial stability, frequently its effects on the broader economy beyond the financial sector will make it a blunt and inefficient tool. For this reason, it will often be better to rely on the implementation, with the involvement of all the corresponding authorities, of macroprudential policy measures specifically tailored to fend off risks to the stability of the financial system, and which in general do not have consequences beyond their intended purpose. It should be noted, on the other hand, that financial stability is a complex objective that will many times require coordinated actions in several fronts, including, in addition to macroprudential instruments, fiscal, monetary and microprudential policy tools. The Financial System Stability Council (CESF), created in Mexico in mid-2010, and which encompasses all the authorities in charge of macroeconomic policy, and financial regulation and supervision, represents an effort in this direction

Naturally, the pernicious implications of volatile international capital flows on macroeconomic and financial stability are hard to avoid. In this context, the possible implementation of measures to “manage” the flows of capital to and from an economy has been gaining adherents. However, the distortions introduced by capital controls are likely to offset any potential benefits, and markets, one way or another, always find a way to circumvent them. Consequently, this has not been considered a sensible course of action in the Mexican case, and the country remains one of the most open to capital flows among emerging market economies.

The approach I just described has allowed a flexible implementation of monetary policy in Mexico with satisfactory results. Let me illustrate this with the experience of recent years.

In the aftermath of the global financial crisis, as in other EMEs, significant downward pressures on economic activity emerged in Mexico. As a result, the Central Bank embarked on an aggressive cycle of cuts to the policy rate, which during the six-month period from January to July 2009 declined by nearly 400 basis points. External developments also played an important role in this outcome. In particular, the Federal Reserve's lowered the target for the federal funds rate by about 500 basis points over the 15 months between September 2007 and December 2008.

Subsequently, following a relatively prolonged period with an unchanged monetary policy stance, the reference rate in Mexico was reduced by an additional 150 basis points between March 2013 and June 2014. The combination of a negative output gap, easy external financing conditions[3] (barring the "taper tantrum" episode of mid-2013) and a generally stable exchange rate, allowed the simultaneous achievement of record-low inflation

[3] The Federal Reserve adhered during most of this period to an accommodative monetary policy stance, as the target for the federal funds rate remained in the 0-0.25% range from December 2008 to December 2015, and several rounds of quantitative easing measures were implemented in this lapse.

and policy interest rates. In particular, the reference rate remained constant at its lowest historical level of 3 percent for slightly over a year and a half, while overall inflation fell below the 3 percent target.[4]

More recently, with the beginning of the normalization of interest rates in the United States in December 2015, an upward trend in interest rates in Mexico has started. This has responded to a combination of factors, including of course the higher federal funds rate, but also a preventive response by the Banco de México during 2016 to the potential impact of the significant depreciation of the peso on domestic prices and, since early this year, the need to avoid second round effects from an inflation spike deriving from the liberalization of energy prices, an adjustment of the minimum wage and a more evident pass-through from the exchange rate to prices.[5] Thus, from late 2015 to March 2017, the reference rate has been increased on 8 occasions, to a level of 6.5 percent.

The monetary policy framework adopted in Mexico in recent years has been fundamental to preserve macroeconomic stability in a context of highly volatile capital flows and severe external shocks, such as the sharp decline in oil prices, bouts of uncertainty in international financial markets linked to geopolitical or other factors, the increase in interest rates in the United States and the results of the electoral process in that country. Furthermore, together with micro- and macroprudential measures implemented over the course of many years, it has contributed to the preservation of financial stability.

[4] The annual rate of growth of the CPI recorded figures below 3 percent during the period May 2015-September 2016.

[5] Headline inflation, as measured by the CPI, increased to 5.29 percent at annual rate in the first fortnight of March 2017.

Naturally, many challenges remain. The most evident one in the short term is to ensure that the recent increase in inflation does not affect medium- and long-term inflation expectations and the process of price formation in the economy. In this respect, it is worth to note that the fact that the impact of the most recent shocks on prices has concentrated mostly on short-term inflation expectations, with a sharp downturn in price growth anticipated since early 2018, attests to the merits of the actions undertaken thus far and in general to the credibility of monetary policy. On the other hand, it is evident that monetary policy in Mexico will continue to be implemented under very uncertain and changing conditions. Therefore, the Central Bank will need to be ready to adapt the monetary policy stance as needed to ensure an efficient accomplishment of its mandate.