REMARKS BY MR. JAVIER GUZMÁN CALAFELL, DEPUTY GOVERNOR AT THE BANCO DE MÉXICO, ON "EMERGING ECONOMIES IN A NEW GLOBAL CYCLE: CENTRAL BANK PERSPECTIVES", AT THE 9TH ANNUAL CONFERENCE ORGANIZED BY THE CENTRAL RESERVE BANK OF PERU AND THE REINVENTING BRETTON WOODS COMMITTEE "NEW CHALLENGES FOR GLOBAL ECONOMIC INTEGRATION". Cusco, Peru, July 24, 2017.[1]

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After having reached a post-crisis low in 2016, global economic activity seems to be transitioning to a faster, although still moderate, growth trajectory starting this year. The recovery is supported by the upturn in global merchandise trade, notably in capital goods, and an improved dynamism in the industrial sector, especially in manufacturing. The improved economic situation in the advanced economies is particularly noteworthy. Naturally, this has enhanced confidence in the global economic outlook and reduced the perception of risks deriving from tail scenarios, although these cannot be completely ruled out.

Notwithstanding these positive developments, the world economy seems to have lost part of the long-term dynamism displayed in the past, as global GDP growth during 2017-2022 is forecast to be, on average, almost one percentage

[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.

point lower than in the pre-crisis years of 2000-2007. Furthermore, the current juncture continues to be characterized by a number of important risks.

To start with, the future evolution of the global economy faces a high level of uncertainty related to the lack of clarity and details about the direction to be taken by economic policy in the United States, particularly on the fiscal, regulatory and trade fronts.

Second, the recent strengthening of a widespread sentiment against globalization, along with the political support it has been able to garner, certainly threatens to stall, and in some instances even reverse, the progress towards the economic and financial integration of the global economy achieved over the last decades.

Third, as the ongoing recovery continues, it is natural to expect that the normalization of monetary policy in advanced economies will begin to generalize. While this should in principle be considered as a positive development, it is not free of risks, as it implies a tightening of financial conditions for emerging market economies (EMEs) and a major policy shift with potential adverse global implications.

Fourth, the generally benign behavior that international financial markets have displayed in recent months could swiftly be disrupted by a number of factors. The latter include a reassessment of the economic outlook by global investors as a result of policy surprises, economic difficulties in key emerging market economies and geopolitical conflicts, among others.

Finally, we should bear in mind that the medium- to long-term outlook for potential growth in both advanced and emerging economies may deteriorate due to persistently weak trends in productivity, demography and the available stock of capital.

What should be done to allow EMEs to thrive in such a complex external environment?

I wish to stress that the main responsibility lies in EMEs themselves. The consequent recommendations in terms of macroeconomic and financial stability and structural reform are well known. In this respect, I would only like to note that notwithstanding the important progress achieved during the last years, major efforts are still needed, as we continue to see high fiscal and current account imbalances, as well as excessive debt levels, in many of these economies. In addition, structural reform policies in EMEs stagnated or even reversed in recent years, with only a few of them announcing comprehensive reform plans.

However, as important as these efforts may be, it is undeniable that the magnitude of the challenges faced calls for increased cooperation of the international community. It is in this area, and especially in the topic of international monetary cooperation, where I would like to focus my remarks.

International policy cooperation faces many challenges. As history has shown, policy cooperation at the international level is particularly strong during episodes of crisis and severe economic and financial distress. Indeed, outside such episodes, the case for cooperation tends to fade, as its benefits become less evident and policymaking therefore has even stronger incentives to favor national over multilateral considerations.

Moreover, the usefulness and feasibility of international policy cooperation is a subject of debate. At one level, some argue that under floating exchange rates countries are effectively isolated from external shocks and policy choices, and thus free to set a monetary policy stance appropriate for their own economies, rendering international cooperation unnecessary.[2] Even for some of those who challenge the isolating properties of floating exchange rates, potential conflicts with the domestic mandates of central banks can make international monetary cooperation difficult to attain.[3]

In my view, the merits of international cooperation outweigh by far its potential disadvantages. In fact, the global financial crisis provides unquestionable evidence in this respect, since its costs would have been much higher in the absence of cooperation. But more generally, I would underline the following:

[2] See, for instance, Friedman, Milton (1953): "The Case for Flexible Exchange Rates", Essays in Positive Economics, pp. 157-203.
[3] See, for instance, Rey, Hélène (2015): "Dilemma not Trilemma: The Global Financial Cycle and Monetary Policy Independence", NBER Working Paper No. 21162, May; and Rogoff, Kenneth (1985): "Can International Monetary Policy Cooperation Be Counterproductive?", Journal of International Economics 18:199-217, May.

- From a theoretical point of view, the existence of spillovers implies the presence of externalities. If not taken into account properly, i.e. internalized, the latter will imply inefficient results. In other words, policy cooperation is needed. This applies even under flexible exchange rates, since they do not fully insulate countries from external shocks.
- The close linkages and interconnections currently existing in a highly interdependent global economy set the stage for a spillover-rich environment, as shocks and policy choices in one country or region are easily transmitted to the rest of the world.[4] Naturally, the potential implications for worldwide output, inflation and financial stability from policy choices in systemically important economies are especially relevant.
- The analysis of the nature, magnitude and direction of spillovers from monetary policy can be further complicated by the use of unconventional monetary policy measures. For instance, according to recent studies,[5] the implementation of such policies by the US Federal Reserve has had a greater impact on economic and financial variables of EMEs than in the US economy itself. Additional challenges relate to

[4] For instance, the Bank for International Settlements estimates that a 100 basis-point change in the 3-month interbank rate in the US induces a 34 basis-point change, in the same direction, in the corresponding interest rate abroad, while the effect is nearly twice as large in the case of 10-year government bond rates. In regards to *pure* monetary spillovers, policy rates abroad are also found to respond to changes in the monetary policy stance in the United States, as a 1 percentage-point change in the federal funds rate is associated with changes between a quarter and a half that magnitude elsewhere. See Hofmann, Boris and Előd Takáts (2015): "International Monetary Spillovers", BIS Quarterly Review, September.

[5] See Chen, Q., A. Filardo, D. He and F. Zhu (2016): "Financial Crisis, US Unconventional Monetary Policy and International Spillovers", Journal of International Money and Finance 67:62-81, October.

potential spillovers from prolonged use and subsequent exit from these measures.

- External shocks resulting from spillover effects will normally be absorbed to a significant extent through exchange rate adjustments in those countries with flexible rate regimes. The empirical evidence shows that after a certain threshold the depreciation of a currency can have non-linear effects on inflation and other macroeconomic variables.[6]
- A situation of uncertainty, like the one we face today, enhances the case for policy cooperation, since by increasing volatility it is equivalent to an additional spillover effect.

Which are the possible areas for enhanced international monetary cooperation?

Paradoxically, there are actions at the national level in advanced economies that can be seen as a way of international cooperation in view of their potential global repercussions.

The first one relates to communication. As I noted above, in the current setting, a latent source of spillovers derives from a still-substantial degree of uncertainty regarding the future course of monetary policy in advanced economies. In particular, market anxiety revolves around the timing and path for exit from the unconventional measures, and the overall normalization of

[6] See, for instance, Caselli, F. and A. Roitman (2016): "Non-Linear Exchange Rate Pass-Through in Emerging Markets", IMF Working Paper No. 16/1, January; and Jašová, M. R. Moessner and E. Takáts (2016): "Exchange Rate Pass-Through: What Has Changed Since the Crisis?", BIS Working Paper No. 583, September.

the monetary policy stance in those economies. In order to contain the risks to macroeconomic and financial stability that may ensue, a clear and effective communication strategy takes center stage. Although significant progress has been made in this regard in recent years, in large part as a result of the experience with the "taper tantrum" episode of mid-2013, the misunderstandings that we have continued to see regarding possible monetary policy actions in some advanced economies are a reminder of the extreme market sensitivity to their central banks' remarks.

The second one has to do with the policy mix in advanced economies. It is well known that the policy response in these countries to the global financial crisis has relied excessively on monetary policy, without adequate support from fiscal and especially structural adjustment measures. In the absence of alternative sources of support for economic activity from either the demand or the supply sides, interest rates have been lower than we would have seen under a more balanced policy mix, thereby giving rise to stronger international spillovers.

But beyond these actions at the national level, many possible options exist to enhance policy cooperation from a strictly international point of view. Some of them can be implemented relatively easily. In other cases, however, a strong political will and an awareness of the self-interest deriving from international cooperation would be required. Let me give you a few examples:

- Advanced economies need to be fully aware of the international repercussions of their monetary policy actions. Failure to recognize the extent and magnitude of the associated spillovers certainly exacerbates the difficulties that the economies abroad, particularly emerging markets, may face.[7] This also complicates life for advanced economies, since spillovers can certainly have a boomerang effect. Although some progress has been made in this regard, this is still far from satisfactory. Advanced economies should regularly carry out deeper evaluations of the cross-border and boomerang repercussions of their policy choices, particularly as the tightening of global financial conditions resulting from the eventual exit from ultra-accommodative monetary policy stances may pose serious threats to emerging market economies and affect advanced economies themselves.
- Closely linked to the above, we need more research on monetary policy spillovers and spillbacks from different sources. It is widely agreed that our understanding of this issue is relatively modest. However, efforts to overcome this situation are still insufficient.[8] I am of the view that this is a task that should be undertaken by multiple parties, including international institutions, advanced economies, EMEs and academia. The input of many sources of research is particularly important given the

[7] For a review of the effects that unconventional monetary policies in the advanced economies had on emerging markets in the aftermath of the global financial crisis, see for instance Özatay, Fatih (2016): "The Policy Response in Emerging Market Economies in the G-20", Chapter 8 of "Managing Complexity: Economic Policy Cooperation after the Crisis", Brookings Institution Press.

[8] See, for instance, Chen, Q., A. Filardo, D. He and F. Zhu, Op. Cit.; International Monetary Fund (2014): "2014 Triennial Surveillance Review—Overview Paper", IMF Policy Paper, July; Blanchard, Olivier (2017): "Currency Wars, Coordination, and Capital Controls", International Journal of Central Banking 13(2):283-308, June; and Rogoff, Kenneth (2013): "Comment on 'International Policy Coordination: Present, Past and Future' by John B Taylor", in BIS Working Paper No. 437, December.

potential for contradictory conclusions from the studies carried out by official sources from the involved countries.

- We need a strong, efficient and adequately funded global financial safety net. Although it can be argued that the latter has already strengthened due to individual country efforts, particularly in the emerging markets, to accumulate international reserves, relying exclusively on this strategy would be costly, inefficient and potentially distortionary.[9] A more balanced approach towards the enhancement of the global financial safety net should consider a number of additional actions. First, the International Monetary Fund must consolidate its position as the central element of the global financial safety net, through the increased availability of own resources, which it should be better able to mobilize via more and improved lending facilities for its membership. Secondly, as demonstrated by the experience during the early stages of the global financial crisis, world liquidity provision may be efficiently expedited by the availability of bilateral swap lines between central banks.[10] Lastly, more work should be done to enhance the role of regional financial arrangements (RFAs), including through better coordination with the IMF.[11]

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[9] In addition to the country-borne financial costs of the needed sterilization operations, possibly amplified by the uncertainty regarding their optimal level and the consequent over-stocking, international reserve accumulation may have important effects abroad, including the exacerbation of global current account imbalances, downward pressures on international interest rates, distortions in the valuation of assets, and investor strategies emphasizing a search for yield.

[10] Reserve currency issuers, in particular, remain reluctant even to restore the network of swap lines introduced in the context of the crisis, due mainly to concerns regarding the increased moral hazard it may generate among emerging market economies, in addition to other risks that are not easily dealt with through the use of collateral.

[11] Of course, RFAs face many other challenges, such as unequal access across countries, limited availability of resources, rigid criteria for financial support and uncertainty due to the lack of relevant evidence regarding their reliability beyond short-term periods.

- The current international governance framework continues to be characterized by a structural underrepresentation of emerging market economies, as it has failed to adapt, even after accounting for the steps taken in the midst of the global financial crisis, to the changes implied by the increasingly important role of these economies in the international economic and financial systems.[12] Of course, other recent developments, such as the elevation of the G-20, including the main advanced and emerging market economies, as a major forum for international cooperation, are steps in the right direction. However, should existing shortcomings persist, the credibility and legitimacy of the major multilateral institutions, and thereby their relevance for international policy cooperation, are at risk of being further eroded.
- Although surveillance mechanisms have been well established for long, their failure to timely identify the build-up of macroeconomic and financial risks and imbalances leading to the global financial crisis, is a clear indication of their lagging behind with respect to the increasing and complex interlinkages across both countries and policies. The multilateral and domestic efforts that have since taken place in order to expand and strengthen surveillance are certainly welcome.[13] However, if these monitoring mechanisms are to represent a fundamental piece of international policy cooperation, a number of challenges need to be

[12] For instance, the IMF's 14th General Review of Quotas considered, within the context of the doubling of Fund quota resources, a shift in emerging market and developing economies' quota shares of around 3 percentage points, to 42.4 percent. However, such an allocation still falls short of the nearly 60 percent share of these economies in total global output (measured in PPP-adjusted terms).

[13] Among these, it is worth to highlight the G-20's Mutual Assessment Program; the European Union's Macroeconomic Imbalance Procedure; the increased focus on spillover effects by the IMF, and on financial surveillance by this institution and bodies such as the BIS and the Financial Stability Board; as well as other oversight mechanisms embodied in regional agreements like East Asia's Chiang Mai Initiative.

properly addressed. One of them is related to the importance of a better understanding of spillovers and boomerang effects mentioned before. Another is the need for increased efforts towards the formulation of more explicit, unambiguous recommendations for avenues of international policy cooperation, together with adequate coordination between the institutions involved—for instance through the IMF—and a periodic follow-up of results achieved. Even though external, unbiased and credible assessments from one or multiple technically qualified bodies constitute a valuable input for domestic policymaking, as well as an important guidepost for directing international cooperation efforts, its combination with concrete proposals on the latter can enhance substantially the usefulness and effectiveness of the surveillance work.

The challenges for surveillance are further compounded by the difficulties to compel participating countries to adhere to the derived policy and cooperation proposals. To this end, pure peer pressure, although desirable and indeed helpful, has proved to be insufficient. On the other hand, a compulsory approach would understandably be rejected in view of its implications for sovereignty. Ex-ante agreed sanctions have been tried in regions with a strong political commitment to integration. However, as is well known, even in these isolated and difficult to replicate cases, the results have been so far unsatisfactory. The difficulties linked to efforts to furnish the surveillance function with "teeth" are illustrated by the reluctance of some multilateral institutions to use tools legally available to them but with potentially controversial implications.[14] This is clearly a very complex subject, but we should continue to search for efficient enforcement mechanisms, and at least encourage international institutions to draw upon all instruments at their disposal whenever needed.

To conclude, I only wish to note that in the face of a world economy which is improving but that still faces formidable challenges, the need to supplement any required policy efforts in EMEs with international cooperation should in my view not be the subject of much debate. There are many possible avenues to move in this direction, with a varying degree of complexity. Unfortunately, notwithstanding the measures adopted as a result of the global financial crisis, as in previous similar episodes the drive towards cooperation has lost considerable force. The consequent risks are obvious. I hope that we are not witnessing again the historical experience of swings in international cooperation that will make us wait for another crisis to achieve perceptible progress towards the results we need.

[14] For instance, the IMF has resorted to special bilateral surveillance procedures with member countries (currently in the form of *ad hoc* Article IV consultations) in only very few occasions, in spite of this being a measure that has been in place for nearly 40 years.