REMARKS BY MR. JAVIER GUZMÁN CALAFELL, DEPUTY GOVERNOR AT THE BANCO DE MÉXICO, AT THE POLICY PANEL ON "REFORMULATING MONETARY POLICY IN EMERGING MARKETS AND THE NEED FOR MACROECONOMIC POLICY COORDINATION". CONFERENCE ON GLOBAL ENVIRONMENT AND POLICY CHALLENGES IN EMERGING MARKETS ORGANIZED BY THE CENTRAL BANK OF THE REPUBLIC OF TURKEY. Antalya, Turkey, December 2, 2017.[1]

Largely as a result of the difficulties faced following the outburst of the Global Financial Crisis, macroeconomic policy coordination has gained increasing relevance in recent years. This has two dimensions. Domestically, a context characterized by stubbornly low rates of inflation and deflationary risks, anemic economic growth or outright contraction, as well as monetary policies constrained by the zero lower bound on interest rates, particularly in the advanced economies, underline the need to jointly activate different policy levers in order to effectively overcome such a situation.[2] In a second dimension, the growing and increasingly complex interlinkages in the world economy brought about by the ongoing process of economic and financial globalization have increased the potential for spillovers and boomerang effects of domestic policy measures in the major economies, thus highlighting the importance of coordinating actions at the international level under certain circumstances, for instance, in the presence of global shocks

[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.

[2] See Jazbec, Boštjan and Biswajit Banerjee (2017): "Rethinking Monetary-Fiscal Policy Coordination", Proceedings of a Seminar Jointly Organised by the Bank of Slovenia and the International Monetary Fund.

While the above arguments apply fundamentally to advanced economies, clearly, the importance of an adequate coordination of macroeconomic policies is nowadays more pressing for emerging market economies (EMEs) as well. In fact, the challenges resulting from globalization can be even more acute for these countries. It is also worth noting that the policy response in advanced economies to the Global Financial Crisis has sharply increased the volatility of capital flows to EMEs, with episodes of large inflows alternating with bouts of outflows. Simultaneously, the crisis has reduced the global growth potential, fostered anti-globalization sentiment and, in general, substantially increased uncertainty.

In light of the above, the following remarks will focus on the domestic dimension of policy coordination in EMEs, including measures beyond the strictly macroeconomic realm.

The advantages of a coordinated and balanced approach to policy rest on a number of merits. Among these, it is worth noting the potential to exploit the synergies of multiple policies acting simultaneously.[3] In addition, reliance on a multi-pronged strategy reduces the likelihood of an over-burden of policy instruments when these are used in isolation,[4] while the possibly adverse effects on the overall performance of the economy arising from the implementation of some policies may be compensated by action in other fronts.

[3] See Gaspar, Vitor, Maurice Obstfeld and Ratna Sahay (2016): "Macroeconomic Management When Policy Space Is Constrained: A Comprehensive, Consistent, and Coordinated Approach to Economic Policy", IMF Staff Discussion Note No. 16/09, September.
[4] See Davig, Troy and Refet S. Gürkaynak (2015): "Is Optimal Monetary Policy Always Optimal?", Federal Reserve Bank of Kansas City Research Working Paper No. 15-05, July.

Seen from the perspective of monetary policy, which are the key areas for coordination that deserve to be underlined?

A first one is exchange rate policy. In theory, flexible rate regimes allow countries the implementation of a fully autonomous monetary policy. In addition, they are widely regarded as an efficient mechanism for the adjustment of the economy to external shocks. Nonetheless, as volatile flows of capital across borders have led to acute swings in exchange rates, doubts have emerged as to the degree to which such frameworks isolate economies from developments abroad. In particular, sharp fluctuations of the exchange rate can have significant effects on the real economy, domestic prices and the financial sector, especially in EMEs. Of course, this does not imply that floating rates should be discarded in favor of alternative regimes. Instead, the issue is how to increase the efficiency of floating exchange rates during episodes of disruptive volatility. A frequently noted option is the temporary use of complementary intervention mechanisms to support the adequate functioning of currency markets.[5]

Fiscal policy is a second crucial area of coordination for monetary policy. The erosion of space following the Global Financial Crisis, in combination with the end of the commodities boom that preceded it, has to a large extent constrained the role of fiscal policy in many emerging market economies. In light of the extant evidence, both theoretical and empirical, suggesting the pernicious effects that weak fiscal positions can have on the overall performance of the economy, for instance through an adverse impact on

[5] See Blanchard, Olivier, Giovanni Dell'Ariccia and Paolo Mauro (2013): "Rethinking Macro Policy II: Getting Granular", IMF Staff Discussion Note No. 13/03, April.

expected inflation, interest rates and the exchange rate,[6] it should not come as a surprise that the typical policy response in these countries has sought to favor the rebuilding of fiscal strength even under conditions of weakness in economic activity.[7] In fact, the potentially compensating effects on the latter deriving from the strengthened credibility of the macroeconomic policy framework and the lessened upward pressure on current and expected interest rates further justify this as a sensible course of action. However, the usefulness of fiscal policy measures to counter negative shocks to our economies should not be disregarded, particularly in a context of solidly anchored fiscal accounts.

The active implementation of measures directly oriented to the financial sector represent a third fundamental component of a coordinated policy package. In particular, as the experience of the recent and previous episodes demonstrates, a healthy financial system is of paramount importance for the efficient transmission of monetary policy to the rest of the economy. In fact, failure to set in motion the measures needed to reestablish the well-functioning of the financial sector in case of disruptions would imply a heavy burden on monetary policy. Furthermore, the margins of maneuver for the latter, e.g. the possibility to increase interest rates in the face of inflationary pressures, may be constrained under situations of fragility in the former.

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[6] See, for instance, Sargent, Thomas, Noah Williams and Tao Zha (2009): "The Conquest of South American Inflation", Journal of Political Economy Vol. 117(2):211-256, April; Bianchi, Franceso and Cosmin Ilut (2017): "Monetary/Fiscal Policy Mix and Agents' Beliefs", Review of Economic Dynamics Vol. 26:113-139, October; and Woodford, Michael (2001): "Fiscal Requirements for Price Stability", Journal of Money, Credit and Banking Vol. 33(3):669-728, August.

[7] See Végh, Carlos, Luis Morano, Diego Friedheim and Diego Rojas (2017): "Between a Rock and a Hard Place: The Monetary Policy Dilemma in Latin America and the Caribbean", World Bank LAC Semiannual Report, October.

On the other hand, the build-up of financial imbalances and vulnerabilities that might ensue following a relaxation of the monetary policy stance, especially if sustained over a prolonged period of time, can effectively be countered by targeted micro- and macroprudential measures. Conversely, situations that require a tighter monetary policy stance, but for which a more nuanced effect on the real economy is desired, may call for a simultaneous relaxation of prudential measures that perk up economic activity via easier lending conditions, provided the health and stability of the financial system remain within safe margins.[8]

Lastly, although generally operating over a longer-term horizon, structural reform should also be a strategic part of policy coordination in emerging market economies. By providing incentives to improve the overall functioning of domestic input and product markets, increasing their competitiveness and strengthening the institutions within which they operate, policies that overhaul structural aspects of the economy foster efficiency gains that increase its productive potential.

Thus, a successful implementation of structural reform can ultimately result in strengthened buffers in other areas of policy as, for instance, an expanding productive capacity may offset the potentially adverse impact of restrictive fiscal and monetary policies on economic activity; increased competition and efficiency resulting from structural reform alleviate inflationary pressures; and possibly higher fiscal revenues in a context of faster economic growth, both

[8] See García-Cicco, Javier, Markus Kirchner, Julio Carrillo, Diego Rodríguez, Fernando Pérez, Rocío Gondo, Carlos Montoro and Roberto Chang (2017): “Financial and Real Shocks and the Effectiveness of Monetary and Macroprudential Policies in Latin American Countries”, BIS Working Paper No. 668, October.

actual and potential, reduce the level of public debt relative to the economy's GDP.

Naturally, the implementation of structural adjustment policies faces a number of challenges and some resistance is likely to arise, mostly as a result of the redistributive effects, both across time and across sectors, inherently imbedded in them. Thus, it will frequently be important to place actions in this realm within the context of a broader-ranging plan that contemplates countering, and coordinated, measures in other fronts. For instance, fiscal and monetary easing may reduce the short-term output costs associated to the economy's process of adjustment in the aftermath of structural reform, while the enhancement of the social safety net and the enactment of other targeted programs may alleviate the costs of transition.

Let me turn now to Mexico's experience regarding the role of policy efforts in the above-mentioned areas in overcoming the macroeconomic challenges faced in recent years.

Inflationary pressures in Mexico have increased significantly since early 2017, owing to a sharp depreciation of the peso and a number of supply shocks. Thus, the rate of growth of the headline consumer price index rose from 3.36 percent in December 2016 to 6.59 percent in the first half of November of this year. The Banco de México's response to these developments has been aggressive, as the reference rate has risen by 400 basis points over the course of the two years since December 2015, to a level of 7.0 percent at present.

While the task is not finished yet, the results thus far can be deemed as satisfactory, since inflation is expected to decline sharply in 2018 and long-

term inflation expectations have remained stable. Furthermore, macroeconomic stability has been preserved, in the context of a sharp decline in oil prices, stints of uncertainty in international financial markets, the increase in interest rates in the United States, and the results of last year's electoral process in that country. At the same time, economic activity has shown resilience to shocks thus allowing a moderate rate of growth.

However, it is important to note that the above developments have also benefitted from a balanced recourse to monetary and other policy instruments. In particular:

1. Given the high volatility of the exchange rate, a number of measures have been implemented to ensure adequate conditions of operation in the foreign exchange market. In particular, the Foreign Exchange Commission has introduced a mechanism for the hedging of foreign exchange risks of up to US$20 billion, that does not imply the use of international reserves. This strategy is consistent with a flexible exchange rate regime that plays a key role as a shock absorber, allows market forces to determine the equilibrium real rate, and rests on the premise that the value of the currency is supported mainly by economic fundamentals.
2. Challenges for the implementation of monetary policy in Mexico were compounded, particularly in 2014 and 2015, by concern regarding the country's fiscal position, in view of the marked increase in public sector's debt. However, the fiscal authorities have embarked on a consolidation strategy, a policy shift that is yielding a primary surplus and a drop in public sector indebtedness relative to the economy's output this year

for the first time in a decade. This indicator is, according to the latest projections, expected to continue trending downwards in the foreseeable future. However, it is also true that public finances still face significant challenges over the long term that will need to be addressed in due course.

3. Thanks in large part to the continued efforts undertaken over several decades, which have gathered momentum since the Global Financial Crisis, Mexico’s financial system is profitable, liquid and well-capitalized, and supported by moderate levels of private sector debt, including households, and the absence of evident risks of a systemic nature. Far from representing an obstacle to its implementation, the health of our financial system has proven to be a most valuable asset for Mexico’s monetary policy, as it has allowed an efficient operation of transmission mechanisms, and a sharp increase in interest rates without significant adverse side effects on banks or other financial institutions.
4. Structural reform policies spanning through a wide array of sectors have made important strides over the last few years. Although it may still be too early to draw conclusive assessments of the efforts undertaken, as most of these changes are still in their implementation phase, a number of positive results are already evident. Of particular importance for monetary policy are the beneficial effects that increased competition across a number of key markets, and especially in telecommunications, has had on the evolution of domestic prices, both directly and indirectly. The structural reform of the Mexican economy is a long-term endeavor that will take several years to fully materialize, whose potential is

conditional on its correct implementation, and which needs to be complemented by efforts in other areas. But it is certainly reassuring that the process has, to a significant extent, lived up to the expectations it has generated.

All in all, a policy approach encompassing multiple instruments has undoubtedly ameliorated the magnitude of the challenges for monetary policy in Mexico. However, as is natural to expect, it has not fully eradicated them. At the current juncture, the Mexican economy is facing a deceleration of economic activity, a rapid although expected to decline rate of price growth, and a situation of higher-than-usual uncertainty deriving from a number of factors, of both domestic and external origins, with the normalization of monetary policy in the United States, the renegotiation of NAFTA and presidential elections in 2018, among them. In virtue of the potentially opposing implications that the realization of alternative scenarios may have for the conduct of monetary policy, it will be essential to adhere to an approach emphasizing prudence and timely action, and the continued support of policy measures in other areas.