REMARKS BY JAVIER GUZMÁN CALAFELL, DEPUTY GOVERNOR AT THE BANCO DE MÉXICO, AT THE SESSION "THE TASK FOR EMERGING MARKETS". REINVENTING BRETTON WOODS COMMITTEE–UBS INTERNATIONAL GLOBAL MACRO SEMINAR "MANAGING THE SOFT LANDING OF THE GLOBAL ECONOMY". Washington, DC, April 12, 2019.[1]

I thank the organizers for the kind invitation to participate in this panel.

The deceleration of world economic activity that we have seen during the last years has encompassed both advanced and emerging market economies. However, when we look at projections by the main international institutions both for the short and the long terms, hopes for a recovery from the current weakness fall disproportionately on the shoulders of the emerging market economies (EMEs). For instance, according to the most recent projections by the IMF, the upturn of global growth in 2020 depends entirely on higher growth rates in these countries, and projections for the long term do not show a much different picture. In fact, according to the Fund, emerging markets and developing economies' share in global growth will increase from around 76 percent this year to 85 percent in 2024.[2]

With this as a background, it is obviously important to identify possible roadblocks ahead, not only for the benefit of EMEs themselves, but in the interest of world economic activity. In general, the external environment faced by EMEs at present is quite challenging, and the situation is unlikely to change much in coming years. However, I would like to focus on two issues which, in my view, are of special importance at this stage. The first is related to the

[1] The views and opinions 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] International Monetary Fund (2019): "World Economic Outlook", April.

implications, from a medium- to long-term perspective, of the potential for a more gradual normalization of monetary policy in the advanced economies (AEs). The second focuses on the consequences of the recent protectionist trends for global value chains, and the resulting repercussions on EMEs.

Following a period of turbulence and volatility in late 2018, international financial markets have displayed a more orderly behavior since the turn of this year. This has been particularly beneficial for EMEs. Per some estimates, portfolio capital flows to these countries increased more than three-fold between the last quarter of 2018 and the first quarter of 2019, a development that has been accompanied by an appreciation of these countries' currencies, declines in domestic interest rates and, in general, easier financial conditions.

To a significant extent, shifting market expectations regarding the future path for monetary policy in the main AEs, particularly in the United States, explains this result. Following recent communications signaling patience in determining potential adjustments to its monetary policy stance while maintaining the target range for the federal funds rate, the Federal Reserve has, in its latest monetary policy meeting, substantially revised downwards its projections for this variable over this and the next couple of years. In addition, the pace of reduction of its balance sheet will be slower starting next month, a process that is intended to conclude in September this year.

The expected slower pace of normalization of monetary policy in AEs seems to be well justified in view of the evolution of the main macroeconomic aggregates in these countries. However, is the associated improvement in the financial environment facing EMEs giving us reasons to celebrate? I believe this is far from clear. In fact, this pause in the monetary policy tightening cycle in AEs may result in a more complex and uncertain external setting for EMEs. It is true that the risk of an additional tightening of financial conditions in these economies in the near future appears to have receded. Nonetheless, it should be noted that the sense of relief perceived at present may well be just temporary, and even perilous:

- The flip side of more monetary gradualism in AEs is a downgraded perspective for economic activity in these countries and, consequently, at the global level. As already pointed out, the prospect of lower interest rates abroad should help alleviate some short-term pressures on EMEs, especially in the monetary and financial fronts. However, the fact that this new, more subdued outlook for rates derives from a less favorable real sector evolution in AEs suggests that, from a medium-to-long term perspective, the net effect on EMEs is likely to be detrimental.[3]
- The possibility that risks for financial stability continue to build up in a context of persistently low interest rates and existing vulnerabilities, both in AEs and EMEs, is particularly concerning. The progress achieved in alleviating some of these risks during the years after the Global Financial Crisis is remarkable. However, the task in this respect is far from complete, and ongoing global shifts at the current juncture clearly accentuate the challenges. Among these, it is worth to highlight the still-high debt levels, both public and private, in a number of economies, a situation that is aggravated by potential mismatches between assets

[3] International Monetary Fund (2014): "Underlying Drivers of U.S. Yields Matter for Spillovers", Spillover Feature in Chapter 2 of World Economic Outlook, October.

and liabilities in terms of currencies, liquidity and maturities. In addition, an environment of low interest rates for longer may affect the profitability and risk-taking decisions of banks and other financial institutions, while the valuations of some assets (especially on the risky side of the spectrum) may continue to stretch further.[4]

- The potential of a more pronounced global economic downturn and, paradoxically, of a disorderly tightening of global financial conditions, persists. Even though the global economy and financial system have shown relative resilience to adverse shocks in recent times, scenarios of this type can still be triggered by developments in a number of fronts. These include, beyond the materialization of the above-noted financial stability risks, events that have been in the limelight for some time already, such as the tensions between the US and trade partners, notably China; the Brexit process; weaknesses in the euro area; idiosyncratic challenges in a number of EMEs and, in general, a sharper than expected deceleration of world economic activity as a result of a combination of factors.
- An additional concern relates to the lack of space that monetary policy in the US and other AEs may have to counter an economic downturn. In contrast to the situation of a decade ago (i.e. at the outbreak of the GFC), those economies' central banks at present run the risk of "not having the ammunition" required to face a mild deceleration, let alone a major economic or financial shock. This, as a result of a normalization that has proceeded more slowly than originally thought, and which

[4] International Monetary Fund (2019): "Global Financial Stability Report", April.

appears to have come to a halt in part due to neutral interest rates that are estimated at levels substantially lower than in the past.

- While concern is reasonably concentrated now on the possibility of a significant weakening of global economic activity, we must not lose sight of the other side of the coin, i.e. the potential for a surprise that forces the resumption of monetary policy normalization at a faster pace than currently anticipated. In particular, while a lot of attention is paid to the increased probability of a recession in the United States, the baseline scenario for growth above potential this year and not far from this level for 2020 is usually not attached the same importance. Clearly, the disruptive impact of a surprise along these lines could be far greater under current expectations.

A second aspect of today's global economic landscape that is worth highlighting relates to the turn towards protectionism of recent. The costs, both in the short and the long terms, impinged on the world economy from increased tariffs and other barriers to trade have been extensively discussed, and the impact is already evident in international trade figures. In fact, the WTO recently reduced projections for global trade growth for 2019 to the lowest level in three years, to a significant extent as a result of rising commercial tensions and tariffs.[5] The implications for trade in intermediate goods within the framework of global value chains (GVCs) is particularly worrisome for a number of reasons:

[5] World Trade Organization (2019): "Global Trade Growth Loses Momentum as Trade Tensions Persist", Trade Statistics and Outlook, Press Release No. 837, 2 April.

- The proliferation of GVCs lost momentum since 2011, and this trend has probably been accentuated by the aforementioned protectionist actions. However, their importance at present remains significant: around 70 percent of international trade is for production under these arrangements, a figure that can be roughly translated as trade in intermediate goods and services being about twice as large as that serving final demand.[6]
- Notwithstanding their prominence, GVCs are particularly at risk due to ongoing trade conflicts. This is mainly due to the cumulative effect that tariff increases have on the total production cost of final goods, given their multiple border crossings within these frameworks, a principle that applies to other trade barriers as well.[7] Additionally, a deeper sense of caution may hinder further country integration (both at the intensive and extensive margins) into GVCs, in view of the magnification of spillovers from bilateral tariff increases that they bring about.[8] Thus, it would be reasonable to expect a further, albeit probably protracted, retrenchment in GVCs as regional and global production arrangements adjust to environments characterized by higher barriers to international trade.
- GVCs are an important driver of productivity gains in the partaking economies through a number of channels. In addition to the innovation,

[6] Carstens, A. (2018): "Global Market Structures and the High Price of Protectionism", remarks at the Federal Reserve Bank of Kansas City's 42nd Economic Policy Symposium, Jackson Hole, Wyoming, 25 August.
[7] Organisation for Economic Co-operation and Development (2018): "Trade Policy Implications of Global Value Chains", Trade Policy Brief, December.
[8] International Monetary Fund (2019): "The Drivers of Bilateral Trade and the Spillovers from Tariffs", Chapter 4 of World Economic Outlook, April.

technology adoption and knowledge spillovers arising from the close interaction between firms in less developed economies and foreign counterparts that may be at, or close to, the technological frontier, productivity is enhanced internally by the specialization, external competition and the increased access to higher-quality and more cost-effective inputs inherent to GVCs, while the scope to leverage scale economies may as well play an important role.[9]

- Closely related to the above, GVCs are to a significant extent responsible for some beneficial macroeconomic outcomes of recent times, including subdued price pressures resulting from lessened bargaining power in a number of industries and input markets.
- Uncertainty related to trade frictions and the ensuing decline of cross-border flows of goods and services, is most probably behind the recent moderation of industrial activity, particularly in sectors that are heavily reliant on GVCs, such as manufacturing.[10] The downshift that has been observed in global industrial production since last year is partly the result of transitory shocks such as the ones experienced by the European auto industry a few months back. However, manufacturing and other industrial activities are clearly facing significant headwinds from protectionism and dislocations to GVCs, that may intensify in coming years should risks to international trade continue to materialize.

[9] Criscuolo, C. and J. Timmis (2017): "The Relationship Between Global Value Chains and Productivity", International Productivity Monitor, No. 32:61-83, Spring; and International Monetary Fund (2018): "Is Productivity Growth Shared in a Globalized Economy?", Chapter 4 of World Economic Outlook, April.

[10] The annual growth rates of industrial production, as well as the level of manufacturing PMIs, have dropped to readings not seen since 2016.

I would like to conclude by noting that although, as I said at the beginning, expectations of an improvement in the world economic situation in the short and long terms depend crucially on the performance of EMEs, their realization is far from assured. Potential growth in these countries has fallen during the last decade and the possibility of further declines down the road is high.[11] While part of the explanation lies in the evolution of demographic dynamics, low investment rates and dismal productivity growth are at the heart of these trends. In view of the complex nature of the factors behind long-term developments such as these, major efforts must be made to sustainably enhance these economies' productive capacity. Domestic policy efforts have a central role in facing these challenges. However, it is unclear whether achieving this objective will be feasible in an external environment that, partly as a result of the factors explained above, is creating an atmosphere of uncertainty and adversely affecting productivity, thus pushing just in the opposite direction.

[11] World Bank (2019): "Global Economic Prospects", January.