**Remarks by Alejandro Díaz de León, Governor of Banco de México, at the 2020 Institute of International Finance G20 Conference**

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Good afternoon. I would like to thank the Institute of International Finance (IIF) for the invitation to discuss some of the challenges Mexico and other Latin American economies are facing from the point of view of the Central Bank.

Trade integration has been widely debated in the last few years and, going forward, we are likely to see a less global and a more regional trade integration. Today, I would like to address some of the challenges associated to global financial integration. This integration has brought, undoubtedly, many benefits. But changes in global risk appetite and the portfolio reactions to idiosyncratic risk factors pose additional challenges and trade-offs for monetary policy.

**Benefits and Challenges of International Financial Integration**

Let me begin by highlighting some trends that I believe are important to understand the context in which emerging markets' central banks operate. Deeper financial integration among countries has caused not only increased volumes of capital flows but also large exposures through derivatives

markets, where non-residents and non-traditional financial institutions play a larger role.

According to the BIS Triennial Central Bank Survey for 2019, global trading in FX markets reached $6.6 trillion per day in April 2019, up from $5.1 trillion three years earlier.[1] The growth of FX derivatives trading, FX swaps in particular, outpaced that in spot markets. In addition, trading in emerging market currencies has increased, reaching a market share of 25% of the overall global turnover. In the case of Mexico, the survey puts the peso as the second most liquid currency in emerging markets with a daily volume of 114 billion USD and 83% takes place between non-residents, making the peso a global currency.

In addition, the persistent accommodative monetary policy stance adopted by central banks in advanced economies since the Global Financial Crisis (GFC), has been an important factor leading investors to search for higher returns. Thus, foreign investors' demand for emerging markets' assets has increased considerably. This has helped the development of domestic markets and has diversified the investor base for emerging markets, but it has also increased the exposure to global risk factors and has amplified the

[1] This is the most comprehensive source of information on the size and structure of global foreign exchange (FX) and over-the-counter (OTC) derivatives markets.

trade-offs when facing idiosyncratic shocks. For example, the sensitivity of emerging markets' asset prices to changes in global risk appetite or in safe havens' interest rates, has increased substantially since the GFC. This correlation has proved to be even higher in episodes of high volatility.

It is important not to forget some of the key benefits from cross-border financial integration, since capital inflows complement local savings, provide a larger availability of financial resources for the economy and foster economic growth. Additional benefits from financial integration may be obtained, conditional on the institutional arrangement of each emerging market.

For example, in Mexico's case non-resident capital flows have played a key role in developing local financial markets, diversifying the investor base and improving the price-discovery process in FX, debt and equities markets. This is particularly valuable when local and non-residents face uncorrelated shocks, but may pose considerable challenges when facing a material common risk factor (like in a "flight to quality" episode). This is more relevant when the institutional set-up combines a highly open capital account and a deep and liquid FX market in your local currency.

Thus, even-though financial globalization has clear benefits for emerging markets, it also entails additional trade-offs and potential spillovers from external macroeconomic shocks, since domestic financial conditions are more influenced by global factors. In fact, these costs have led some to even consider that restrictions to the free movement of capital or the so-called capital flow management measures may be a viable alternative, even when using such restrictions on capital may significantly push-back the development of local financial markets.

Therefore, I believe it's better to aim for the first-best, develop deep and liquid local markets with efficient price discovery processes. Also, this is a more time-consistent and better long-term alternative to reduce both the likelihood and the impact of capital flow reversals. To attain this, it is also critical to:

i) Develop a fully convertible FX market with a deep derivatives market and incentives for adequate risk management,
ii) Maintain strong macroeconomic fundamentals,
iii) Promote a stable and resilient domestic financial system, and
iv) Promote economic agents' sound balance sheets.

The recent Mexican experience suggests that the benefits obtained from an economy with an open capital account, a flexible exchange rate regime and sound macroeconomic fundamentals outweighs the tradeoffs in terms of increased volatility in domestic asset prices under certain scenarios.

**Recent Developments in the Global Economy**

Having broadly discussed the benefits and tradeoffs of financial globalization, I would like to talk about the challenges faced by central banks in the current juncture. As we all know, in 2019, the global economic environment was marked by uncertainty. Global growth recorded its weakest pace since the GFC. This reflected the effects of protracted trade tensions, high geopolitical risks and idiosyncratic factors in key emerging market economies. In this context, while some recovery is expected in the global economy, growth prospects for 2020 have continued to be revised downward.[2]

This weak economic outlook, along with the persistence of inflation below most central bank's targets, has led to more accommodative monetary policy stances in advanced and emerging economies. The easing of global

[2] In particular, analysts' consensus expect the United States to grow at a slower pace in 2020, reflecting an expected return to a neutral fiscal stance and anticipated fading support from further loosening of financial conditions. Meanwhile economic growth is projected to remain subdued in the euro area and in the United Kingdom on the back of the decline in economic sentiment indicators, which reflects the ongoing weakness in global trade in an environment of continued global uncertainties.

financial conditions registered since last September, the recent decrease in uncertainty coming from lower trade tensions and diminished fears of a hard Brexit, has supported investors' risk appetite, which has increased capital flows to emerging economies, particularly to fixed income assets. However, towards the end of 2019, financial markets in some Latin American countries were briefly affected by social and political tensions that complicated the outlook and increased the challenges for economic policy management.

Despite the improvement in global financial markets, there have been volatility episodes generated by geopolitical tensions and, more recently, from the outbreak of the coronavirus (COVID-19). This adds to the list of downside risks to global growth and has generated the expectation that monetary policy easing in advanced economies will be maintained, or even increased.

## Challenges for the Conduct of Monetary Policy

In this context, I would like to discuss some challenges that central banks face when conducting monetary policy. First, in the case of advanced economies, against a backdrop of high levels of household and government debt with low inflation and already low levels of interest rates, monetary policy space has diminished significantly. In this regard, economic literature

is advancing towards the explicit modelling of the pervasive effects of a large stock of debt on aggregate demand ("indebted demand theory" by Mian, Straub and Sufi). Perhaps an even more important challenge for monetary policy, is to fully understand and assess the persistent downward pressures this context exerts on the natural interest rate.[3]

For emerging markets, both global and idiosyncratic risk factors could increase monetary policy tradeoffs faced by central banks, thus, requiring a prudent approach. In particular, the role of monetary policy in smoothing the business cycle in small open emerging markets, which are highly integrated into global financial markets, implies additional challenges. For emerging markets' central banks, in addition to the usual cyclical considerations about inflation and output gaps, there is a need to consider external and internal determinants of inflation, which include the interaction of global risk appetite and the effects of idiosyncratic risk factors on capital flows and financial stability.

Let me illustrate the Mexican experience over the last few years. In the context of an open capital account and a flexible exchange rate regime, a cautious approach of monetary policy in Mexico has allowed to address a

[3] Mian, A., Straub, L., & Sufi, A. (2019). Indebted Demand. Unpublished.

series of shocks that led to an environment of uncertainty and higher risk premia. Among the aforementioned shocks the following stand out:

i) A permanent reduction in oil prices in the second half of 2014;

ii) A contraction of domestic oil production;

iii) Trade-related uncertainty (from NAFTA to USMCA);

iv) Tighter (or less accommodative) monetary policy in the US, and

v) Idiosyncratic risk factors (Mexico specific).

This complex environment required a considerable real-exchange rate depreciation, of around 30%, which previously had only taken place under a severe balance of payments crisis and high, double digit inflation episodes.

In this context, monetary policy was tightened to allow for an orderly adjustment of the economy and domestic financial markets. Thus, the policy response to these shocks helped to avoid disorderly adjustments in the FX markets and second round effects on the price formation process. In spite of the significant depreciation of the currency, the pass-through to prices remained at low levels, reflecting an efficient functioning of the economy's nominal system.

In the second half of 2019 and early 2020, as inflation moved towards the target with an increasing output gap and looser global financial conditions, monetary policy has reduced the target interest rate in the last 5 meetings.

**Central Banks and Financial Stability**

As I have already mentioned, in light of more integrated global financial markets, emerging markets' central banks need to consider, in addition to the traditional cyclical considerations (output and inflation gaps), capital flows and financial stability issues that may arise in periods of stress. Specially as vulnerabilities may build up gradually and at some point might suddenly lead to a non-linear, portfolio adjustment or stress event in local financial markets.

Hence, in addition to strengthening and consolidating macroeconomic fundamentals, emerging markets need to adopt and maintain strong micro and macro-prudential measures to ensure an adequate functioning of the financial system and limit systemic risk. Also, even-though micro and macro prudential policies have their own set of instruments, stress-test scenarios have to be modelled in a framework that incorporates monetary policy.

## Final Remarks

I would like to conclude by highlighting that the global economy will continue to operate in an environment of high-uncertainty. This imposes important tradeoffs for emerging markets' central banks, as higher cross-border financial integration has amplified emerging economies' exposure to developments in global markets. In spite of that, experience shows that the benefits that are inherent to a higher global financial integration outweigh the costs.

In this context, authorities in both advanced and emerging economies should avoid adopting measures that could limit financial flows across countries. Overall, economies should focus on strengthening their financial systems and, in general, their macroeconomic policy frameworks. The challenge is to minimize potential costs associated with greater international financial integration without reducing the benefits that this process has generated.

Once again, I would like to thank you for the invitation.