Remarks by Alejandro Díaz de León, Governor of Banco de México, on the occasion of the “Third International Finance and Economics Program Meeting of the Central Bank Research Association”

Mexico City, December 5, 2019

Good morning, everyone. On behalf of Banco de México, I am pleased to welcome you to the “Third Annual International Finance and Macroeconomics Program Meeting” of the Central Bank Research Association, sponsored by Banco de México and the Inter-American Development Bank, and co-organized by the Research Departments of these two institutions jointly with the Federal Reserve Bank of San Francisco.

This year, Banco de México is celebrating 25 years of independence. This is certainly a good occasion to reflect on the functions and challenges currently faced by central banks.

The set of sessions will address various topics that conform a very solid program, covering issues such as Spillovers of Conventional and Non-Conventional Monetary Policy; the role played by Global Banks; and the Spillovers of News and Uncertainty. They will also address the

Interactions of Macroprudential and Monetary Policy and the debate around the "Policy Trilemma", and to what extent it is actually a "Dilemma" for policymakers.

These are all topics that have been at the heart of Banco de México's concerns and decision-making over the past decade, and are highly relevant given the world and the country's current circumstances.

First, I would like to give some brief remarks on these "spillovers" and on how the Mexican experience since the 2000's relates to some of the main topics that will be discussed in the conference.

As to the spillovers onto emerging markets from Advanced Economies, let me describe, briefly, the current environment. Trade tensions have become a major obstacle to global economic growth, with significant effects on manufacturing production, investment, and business confidence, especially in economies more open to trade and with large export volumes to the United States.

The baseline scenarios for global growth have already been affected and large downside risks prevail, as a more hostile environment to trade and investment seems to be more permanent, including, also, technology supremacy and immigration issues.

The prevailing environment of polarization of political and economic narratives has fostered short-term policies and approaches for political gains, imposing pressure on domestic institutions, including central banks.

This is the result of deep and complex transformations, which are related to:

i) The rapid insertion into a globalized world of labor-intensive economies and regions;

ii) The direct and indirect costs of the major financial crisis;

iii) The revolution in information technologies and its impact on labor and daily life; and,

iv) The growing gap between citizens' expectations and their development opportunities.

While long-term policies and structural reforms are much needed, escalating geopolitical and trade tensions have put pressure on central banks' aggregate demand management responsibilities, increasing the challenges and trade-offs for monetary policy.

Regarding monetary policy, it is essential to note that its role in smoothing the business cycle has become more complex.

1. Advanced economies (AEs) operate in the "new normal" of low-interest rates. Lower r* and the lack of inflationary pressures pose serious challenges to monetary policy:
   - First, a more limited policy space when facing the downward phase of the business cycle.
   - Second, it may lead to excessive risk taking, thus posing financial stability risks at the national and international level.
   - An abrupt risk-off episode could expose financial vulnerabilities accumulated during years of low-interest rates and depress

global growth as highly leveraged borrowers could find it difficult to roll over debt.

- As you will be discussing in one of the sessions, this requires a better integration of monetary and financial stability issues.

2. In emerging markets, even though we have more policy space, central banks must be mindful that global risk appetite and portfolio adjustments in response to idiosyncratic risk factors pose serious constrains for monetary policy. Thus, making it harder to focus on domestic cyclical conditions and making it necessary to better integrate monetary, capital flows and financial stability considerations.

In this context, central banks face the challenge of both fulfilling their objectives and communicating more effectively the benefits that can be attained with, their mandates, their independent status and their actions on the wellbeing of citizens and on development opportunities.

Now let me comment on some of the other issues that will be discussed in the conference. Regarding the interaction of monetary policy and financial stability, around the world, albeit under different institutional arrangements, central banks have renewed their critical role in addressing financial stability challenges.

The benefits of attaining monetary policy and financial stability goals tend to mutually reinforce each other. Thus, the instruments to achieve such goals are characterized by a certain degree of interaction, but also by clear differences that must be considered. Along this line, a central bank must take three elements into account:

1. *Separability between monetary policy and financial stability goals.* Although monetary policy actions can contribute to stabilize the economic cycle, it is key to keep in mind the differences between these and the financial cycle, since they are generally not synchronized and have different timeframes or temporality. There are also clear differences between the best instruments to achieve price stability and financial stability, given that the regulatory and supervisory policies can address the specific challenges of financial stability.

2. *Interconnection between monetary and financial policies.*

   Despite their distinct character, there is also a close interconnection between monetary policy and financial stability that must not be underestimated. Many emerging economies have experienced episodes of macroeconomic weaknesses, which have intensified due to financial crises. As a result, financial stability considerations have been a very important component of risk assessments for monetary policy decisions in these countries. Whereas prior to the Global Financial Crisis financial stability was taken for granted in advanced economies, after this episode these economies have given a more prominent role for financial stability within their policy framework. In this sense, it is imperative that the challenges and risks associated with the interconnection between monetary policy and financial stability are considered.

3. *Carry out an integrated policy assessment.*

   In order to assess the type of stress scenarios to which an economy's financial system is subject to, it is essential to thoroughly analyze the interaction between several policies. This is better done by an integrated policy approach that takes into account the interrelation of monetary policy, the exchange rate regime, fiscal policy and macroprudential measures. It is necessary to comprehensively model the risks to which the economy is subject to, in order to adopt the most appropriate policies.

In sum, considering these three dimensions of the analysis can lead to a more effective central bank decision-making process and help attain the central bank price stability and financial stability objectives.

Finally, it is important to be mindful of the accumulation of risks that can take place over time, especially in a scenario like the present one where the monetary policy stance of the advanced economies have become more accommodative, and therefore the search-for-yield phenomenon is likely to become an important driver of capital flows.

It is very clear to us that there is a significant need for a better understanding of the mechanisms by which monetary and macroprudential policy interact and global financial cycles propagate and impact our own financial system.

To conclude, I would like to restate that Banco de México considers each of these topics highly relevant for monetary policy under the changing global conditions, and thus the importance of the research being discussed in this conference.

Once again, I welcome you all to Banco de México and thank you in advance for your valuable contributions to these topics of interest to all of us.