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Monetary policy and balance sheet adjustment

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I would like to thank Mario Draghi, Peter Praet and Benoît Cœuré for having invited me to participate in this first gathering of the ECB Forum on Central Banking. The topic assigned to this panel, monetary policy and balance sheet adjustment, has many different facets. Given my comparative advantage, I will provide an emerging market economy (EME) point of view.

During the last years, events in advanced economies (AEs) have been a very important determinant of EME performance – if not the most important. In 2007-2008, when the global financial crisis erupted, EMEs were by and large well prepared. After many countries in this grouping suffered sequential crises in the 1970s, 1980s and 1990s, with huge economic, social and political costs, they learnt important lessons. These led to the adoption of key policy actions, from which I would like to highlight the following:

- The establishment of flexible exchange rate regimes.
- The enhancement of the degree of autonomy of central banks, with the primary mandate of price stability. This led to a wide adoption of inflation targeting and, probably a more important consequence for a number of countries, to the end of fiscal dominance.
- Consciousness about the relevance of fiscal discipline and the preservation of public debt sustainability.
- Deeper trade liberalisation.
- Keeping up to speed with financial sector supervision and regulation, which has produced well-capitalised banking systems.

The result of this behaviour was that most EMEs did not have any major economic imbalances in 2008. Previous to the global financial crisis, EMEs were not on the radar screen of vulnerable economies.

Then September 2008 arrived, with the bankruptcy of Lehman Brothers, among other systemic financial institutions. The jolt to the world economy was immediately felt, through exacerbated financial volatility and a sudden collapse in world trade and economic growth. But EMEs recovered very quickly, as trade and growth bounced back in early 2009. Access to international financial markets was reinstated and no lasting consequences in local markets were apparent. Given the prevailing situation in AEs, people started talking about EMEs decoupling from AEs. In this context, many EMEs jumped on the bandwagon of trying to defeat the world's business cycle by implementing counter-cyclical fiscal and monetary policies – Mexico did not – as advocated by fora such as the G20 and the International Monetary and Financial Committee.

At the same time, recovery in the United States was very sluggish, with growing unemployment, while several euro area member economies faced major fiscal and financial imbalances, to the extent that, starting in 2011 and up to the second half of 2012, major doubts about the sustainability of the euro as a single currency were prevalent. Growth plummeted in Europe and unemployment reached extremely high levels. In most AEs, the feasibility of stimulating the economy through fiscal policy rapidly came to an end, as debt-to-GDP ratios exploded. The only stabilisation policy instrument left was monetary policy, and therefore the main AE central banks adopted, at different times, speeds and with different modalities, unprecedented expansionary policy stances. The Federal Reserve System led the way, followed by the Bank of England, the European Central Bank and the Bank of Japan. These policies guaranteed sharp declines in interest rates across the yield curve, to the point that the zero lower bound in the policy reference rate became binding in most cases (eventually in all), and quantitative easing actions and forward guidance for the policy rate needed to be implemented. A side effect was a sharp increase in the balance sheets of the central banks of AEs.

Faster growth and stability prospects in EMEs, combined with the adoption of unconventional monetary policies in the main AEs, triggered massive capital inflows into EMEs. This phenomena was interpreted by many authorities as a ratification of the perceived economic strength of EMEs. For a while, those flows also reinforced the acceleration of growth in EMEs. In addition, China's double digit growth, among other factors, induced a significant spike in commodity prices, benefiting most EMEs.

But under the surface, problems were brewing for some EMEs. Massive capital inflows into EMEs persisted, fed primarily by carry trades explained by ex ante uncovered interest rate arbitrage opportunities. This generated mispricing in some assets in many EMEs, excessive real exchange rates appreciations, and opened the door for sudden capital flow reversals. In addition, the quick recovery in EMEs post-2008, the ample liquidity and opportunities for leverage, and the positive terms of trade shocks that were not taken advantage of in order to strengthen macro fundamentals, induced some countries to believe that they had some degree of freedom in macro policy management that they did not really have.

In April/May 2013 the reality check arrived. At that time, the global financial cycle was more clearly transmitted to EMEs, triggered mostly by the start of the discussion of monetary policy normalisation in the United States, as the "taper talk" got going. This, together with the correction in commodity prices that has followed the economic slowdown in China, invited a re-evaluation of the prospects for EMEs. As a result, vulnerabilities in economic fundamentals in several EMEs were exposed, in particular in those countries with high levels of public and private leverage, which in turn had produced relatively high fiscal and current account deficits. Tighter financial conditions, together with terms of trade corrections and the lasting real effects of prolonged and excessive currency appreciation, were reflected in a widespread slowdown in economic growth in EMEs. AEs, which represent approximately 50% of the world's GDP, and which had been growing below their potential for several years, did not help the EMEs' growth either. So, with the benefit of hindsight, the perception of "EMEs decoupling" from AEs was more a mirage than reality.

The turbulence in EME financial markets that followed the initiation of the "taper talk" was not homogeneous. The most severe cases happened in countries with weak fundamentals, mostly judged by the size of their current account and fiscal deficits. In these cases, sharp depreciations in local currencies took place, together with disproportional increases in interest rates, in particular for the long tenors, and plummeting stock markets. National authorities reacted by intervening in the foreign exchange markets, facilitating the reduction of durations in investors' portfolios, and more importantly, by tightening fiscal and monetary policies. In contrast, many other EMEs managed to sail through this episode by reinforcing their policy stance, and allowing the exchange and interest rates to make the adjustments, without any market interventions. We could say that many EMEs came out strengthened from this period of volatility.

During 2014, important adjustments were made in the monetary policy stance in the United States and the euro area:

- The tapering of securities purchases by the Federal Reserve started in January 2014 and is programmed to end in October. At the same time, the Federal Open Market Committee enhanced the clarity of forward guidance, creating the expectation of policy rate adjustments until next year.

The combination of these events has limited the upward trend in long-term rates, preserving the ones in the short end of the curve at extremely low levels.

- In the euro area, major concerns became evident about sluggish economic growth and massive unemployment, together with inflation rates substantially below the ECB target. This generated the expectation of significant additional monetary policy easing by the ECB, leading to historically low levels of interest rates in euros.

These events have generated quite surprising results in financial markets. Owing mostly to the search for yield, dispersion in spreads in credit markets is unusually low, volatility in all asset classes is also exceptionally low, and capital flows recovered and by mid-2014 were abnormally high, both to EMEs and some AEs. It would be fair to say that there is the potential of major mispricing in credit markets, which poses the risk that once such mispricing is revealed, there will be an overcorrection in markets, threatening the fragile state of financial stability. In AEs financial instability could abort the still incipient recovery. In EMEs the threat would be not only sudden stops in capital flows, but even sudden massive reversals. The trigger of these events could be abrupt changes in AEs' monetary policy stances.

Taking all these elements into account, the main challenge for EMEs boils down to how to stimulate growth without compromising financial stability, facing at the same time an external environment plagued with uncertainties. The question is then, how to move forward.

The governments of AEs have to deal with their own problems, which are not negligible. This means that there is scant hope for AEs internalising the spillover effects on the rest of the world generated by their policies. Therefore, EMEs should take policies in such countries as given. At least if they succeed, the world will be better off. So EMEs have to find their own way out. In my mind, a three-pillar approach should be followed by EMEs.

First Pillar. Strong macro fundamentals and policy settings are of the essence. Basically there is no room for poor fundamentals. In particular, it is very important for EMEs to limit financial needs to what is feasible under stress scenarios. This calls for moderate fiscal policies and the use of aggregate demand management to avoid large current account deficits. Monetary policy should concentrate on keeping inflation under control, since this is a prerequisite for the flexible exchange rate to be able to perform as a shock absorber. The domestic financial markets should be monitored closely; early adoption of the enhanced regulatory and supervisory regime produced under the auspices of the Financial Stability Board and the Basel Committee should be pursued. Macro-prudential policies might work under specific circumstances, but they have not proven to be the silver bullet we were all hoping for.

Second Pillar. External sector resilience under stress scenarios should be a policy objective. This is very important to avoid capital reallocations resulting in bad equilibria in financial markets. To start with, a strong balance of payments is needed. Flexibility in interest and exchange rates, anchored by strong fundamentals, should be part of the adjustment process. But, given the sheer size of capital inflows to EMEs so far, this might not be sufficient. So to count on large international reserves and other forms of backstops, such as the IMF's flexible credit line, is highly advisable. Also, the public and private sectors should pursue proactive debt management strategies, avoiding the bunching of maturities, lengthening durations and keeping an eye on foreign exchange rate mismatches.

Third Pillar. Economic growth must be promoted by making the economy more competitive, increasing total factor productivity and thus potential GDP growth. This takes us down the road of structural reforms, which have huge potential in EMEs. This is the hard way to achieve sustainable GDP growth, but is the only reliable one that is left.

So, in summary, the first and second pillars are meant to guarantee financial stability. The real lever for promoting growth lies in the third pillar.

With regard to my own country, Mexico, we have in place a plan that fully complies with the three pillar approach. Macro fundamentals are in good shape, we have a strong external position, even under stress scenarios, and unprecedented structural reforms are under way. All this should allow us to accelerate growth and to preserve financial stability even during turbulent times generated by major balance sheet adjustments in the central banks of AEs.