The G20 Agenda under the Russian Chairmanship

Luncheon Keynote Address

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First of all, allow me to thank the IIF for having invited me to participate in this very relevant conference, organized in partnership with the Ministry of Finance of the Russian Federation, at the outset of the G20 ministerial meetings. It is a great pleasure for me to have the opportunity to address this distinguished audience again.

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Let me start by presenting my view on the world economy, focusing on the epicenter of the crisis – the advanced economies. The crisis erupted in full in late 2008, at the time of the Lehman Brothers collapse. The virulence of the consequences of this event brought a sense of common purpose among the most important countries in the world. In foras like the G20 and the Fund´s IMFC a coordinated policy response was instrumented, having as main objectives to stabilize financial markets, and to implement countercyclical fiscal and monetary policies to contain the contractionary forces in economic activity and employment. At the same time, the process of the dearly needed redesign of the international financial architecture was initiated.

The signs in 2009 and 2010 were relatively encouraging. The forceful measures implemented in the United States to backstop its financial markets and institutions were successful; it seemed at the time that the contagion to European financial institutions and economies was under control, and some advanced economies (like Singapore, Australia and Canada) and a broad number of emerging economies (like China, India and México) were experiencing a very strong rebound in economic activity. As a matter of fact, towards the end of 2009 and 2010, a sense of achievement started to appear.

But during the second half of 2011 two unprecedented events brought us back to a period of heightened uncertainty in financial markets and significantly deteriorated global economic prospects: first, the downgrade of the US sovereign debt by one credit rating agency in early August, and second, the worsening of the sovereign debt crisis in Europe, followed by the increasing risk of contagion across markets and countries. These events, along with the respective authorities´ difficulties to implement immediate credible policies to address the ongoing fiscal and financial problems, led to a noticeable deterioration in confidence among economic agents.

The perceived increase in the probability of a tail risk event, such as a sovereign default episode in some Euro zone member countries and, to a lesser extent, in the United States, produced great disruptions in international financial markets and economic activity worldwide. In turn, weak economic activity further deteriorated fiscal positions and the health of banking institutions, leading to an even worse situation, making it clear that we were in an adverse feedback loop. Given tight trade and financial linkages across countries, the decoupling in terms of growth between advanced and emerging economies that was apparent after the first quarter of 2009, disappeared.

Needless to say, the situation required immediate policy response by authorities. In the United States, given that entrenched political positions made it impossible to make meaningful progress in the fiscal front, the Federal Reserve continued to carry the brunt of the adjustment, as it expanded its accommodative monetary policy stance, using extensively quantitative easing combined with prospective interest rate guidance. All this with the objective of taking the pressure off the bond market, flattening the yield curve and by these means stimulate aggregate demand and employment.

The situation in Europe, at least from my point of view, was, and still is, more challenging. The main reason was that the drastic deterioration of the fiscal position and the health of the banking system in some peripheral countries in the Eurozone elevated to hazardous levels what has been called fragmentation risk, which in plain English means the risk of a breakdown of the European currency union as we know it. This led to sudden stops in the financing of some sovereigns and their banking system, triggering also massive capital outflows. All this in turn fed back into higher fragmentation risks, creating a very pervasive vicious cycle.

The materialization of sudden stops in the Eurozone caught many by surprise. This type of phenomenon was not supposed to happen in mature economies protected by a supposedly strong anchor in the form of a credible exchange regime, i.e. the European currency union.

But the problem precisely was that the perception of a strong external anchor made it feasible for some countries to let their guard down, manifested in policy complacency in the good years when huge and persistent net capital inflows were the norm. This situation resulted in: a) unprecedented external indebtedness in some countries, and b) banking institutions with bloated balance sheets supported by very fragile funding. This combination of factors made the sudden stops in some European countries much more pronounced than the ones experienced in previous decades in Latin America or during the Asian crisis in the nineties.

The financial sector and sovereign distress in Europe demonstrates once more that an exchange rate regime *per se* cannot be a substitute for policy discipline. As a matter of fact, the problems faced by Europe since mid-2011 are not different from the ones resulting from a speculative attack against an exchange rate regime sparked by the loss of consistency between the token regime and the rest of the macroeconomic framework. When such inconsistencies appear, the confidence in the sustainability of the regime is lost, and the attack by market participants is immediately unleashed.

The sudden stops in capital flows in some European countries provoked steep increases in sovereign and financial institutions borrowing costs and CDS spreads, and a noticeable deterioration in liquidity conditions in the region´s money markets. Access to the interbank funding market for many banks was abruptly interrupted, and the government securities market of the weakest European countries dried up for practical purposes. As the perception of the likelihood of a catastrophic event in Europe increased, major reallocation of portfolios took place, as resources were diverted to safe assets. Emerging markets were not spared of this reallocation of assets: their currencies depreciated and borrowing costs increased. More importantly, the contraction in economic activity in the most advanced economies reduced emerging markets´ exports and their rates of growth. Contagion in international financial markets was rampant.

Urgent policy response by the Eurozone became unavoidable. But I think it is fair to say that the European Union was not prepared to respond to a challenge of this magnitude, basically because of what I already mentioned that by design the problems that they confronted then, caused by the surge in fragmentation risk, were not supposed to happen in the first place. An obvious additional complication was that any solution would have to be agreed by the seventeen Eurozone member countries through their political instances. After many months of hesitation and confusion, a successful two-pronged stabilization strategy was finally implemented:

First, through different facilities, the European Central Bank eventually guaranteed the provision of sufficient liquidity to backstop the interbank and government debt markets; it is worth mentioning the unlimited financing through the Target 2 mechanism, the LTRO (Long-Term Refinancing Operation), and the OMT (Outright Monetary Transactions).

Second and more fundamentally, structural reforms in the European Union were credibly committed to firmly establish the congruency between the exchange rate regime and the rest of the macroeconomic and institutional framework of the Eurozone. Here I would like to highlight the following policy decisions:

- The creation of a strong European Financial Stability Mechanism;
- The reinforcement of fiscal policy governance, falling just short of the establishment of a fiscal union;
- A proposed banking union, supported by centralized supervision and a Eurozone-wide resolution regime; and

- A major drive to enhance competitiveness in the region, to increase potential growth and employment creation.

No less important has been the gigantic political drive by the European leadership to stick together and ratify their joint commitment to a single currency.

A cornerstone in all this construct has been the OMT facility, since it bridged the short-term emergency liquidity provision and backstopping measures with the more long term, fundamental reforms that is anchoring the so far credibility of the single currency. Recall that through the OMT facility the ECB is willing to acquire unlimited amounts of sovereign debt, provided that the issuer has basically accepted the conditionality established by the European Union, and it is acting in accordance. This was a master stroke by the ECB.

After all these difficulties and tribulations, we started 2013 with more optimism about the future of the world economy. Key factors to improve market sentiment have been:

- In the United States, the avoidance so far of the fiscal cliff;
- The permanence of Greece in the Eurozone;

- That many countries in the periphery have made sustained progress in their fiscal and external sector adjustments, regaining market access;
- The gradual but steady progress in the design and implementation in the structural reforms in Europe; and
- The faster growth in China.

Risk appetite among investors has returned and the search for yield is in full force. There have been substantial capital inflows to Europe, together with an internal redistribution of resources in the Eurozone, which has produced a remarkable improvement in the borrowing costs for peripheral economies. Resources have also poured into emerging markets generating a compression of spreads and domestic currencies appreciation. The mood swing has been so strong, that some fears have been expressed about financial markets being too optimistic, with the potential of mispricing in some asset classes. Concern of asset price bubbles fed by credit booms are starting to appear in some economies, although not yet in Mexico, I would like to clarify.

A word of caution is in order though. Substantial vulnerabilities and downside risks still persist. Let me cite the most significant:

- The United States economy still could be affected by the fiscal cliff. Not only the potential fiscal adjustment is a matter of concern, but also investment and expenditure decisions are being postponed due to the related uncertainty;
- Stability in the Eurozone is still fragile, given that it continues to be dependent on massive support from authorities, in particular from the ECB;
- Even though progress has been made in delineating the substantive policy actions that are essential to reestablish the consistency of the Eurozone exchange rate regime with the rest of the macroeconomic and institutional framework, relevant details are still in the drawing board, and once they are decided, they need to be legislated and implemented. Delays and/or incomplete adjustments could trigger the erosion of incipient market confidence.
- The Eurozone has been in a recession for quite some time with very high unemployment, with the expectation that this

will continue to be the case for 2013. Reigniting growth has been a challenge given the fiscal constraints that many European countries face, the need for households balance sheet repair and the present limitations of credit institutions which are in the process of deleveraging.

- It is to be noticed an incipient trend led by some advanced countries, like Japan, but including also some emerging markets economies, to use exchange rate policy as an instrument to enhance (or at least defend) competitiveness, promote exports and by these means growth. The problem with this approach is that by manipulating nominal exchange rate adjustments the impact on effective competitiveness tends to be temporary at best, while incurring in two big risks: a) that the pursuit of a “short cut” towards growth and prosperity could delay the adoption of structural reforms that genuinely would generate the desired effects on competitiveness and growth, and b) the possibility of retaliation by other countries, which would trigger severe turbulence in international financial markets.

- In emerging markets economies, even though most of them have structurally sound economies, large capital inflows can generate financial stability vulnerabilities through credit booms and asset price bubbles, and the concomitant domestic currency appreciation in real terms could affect growth, in particular given that as I already pointed out, independently some important advanced economies are actively pursuing a depreciating real exchange rate strategy. As I mentioned in a recent speech in Singapore, my fear is that a perfect storm might be forming as the result of: first, massive capital flows to some emerging market economies and some strong performing advanced economies; second, the surge of bubbles, characterized by asset mispricing; and third, the potential reversal in flows when the major advanced economies start exiting their accommodative monetary policy stance.

This oversimplified sequence of potential events poses a major financial stability challenge for many capital recipient countries.

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Needless to say, what I just outlined makes still at best for a sobering picture. This is the background scenario that we are facing today here in Moscow at the outset of Russia´s G-20 Presidency. I would rate this starting situation as better that the one the world was at the beginning of France´s and Mexico´s G-20 Presidencies, but certainly not better enough that would allow us to declare victory. Therefore major challenges are still present, leaving no room for complacency.

What does this mean for the G-20? At a minimum we should persevere in accomplishing the main commitments we made in Mexico last year. The agenda is comprehensive and ambitious, and it is urgent that we deliver. But that does not take away the possibility of new issues being brought to the fore, nor that we shouldn´t concentrate our efforts in some specific, more pressing goals. In this regard, let me mention, from my point of view, which should be our priorities.

First, the G-20 should regain its sense of common purpose. As the business and credit cycles in different parts of the world have diverged, the consensus and drive towards policy coordination and collaboration have been weakened. We should not forget that we live in an interconnected world, thus a collaborative solution to the problems we face today would be far more rewarding in terms of benefits manifested in faster economic growth and employment creation in the context of financial stability, as well as in terms of minimizing the unavoidable adjustment costs. In this regard, it will be of the essence for countries to avoid the use of proactive exchange rate policies in pursuit of relative competitive advantages. In the same vein, we should avoid weakening the potential of the major reforms in financial sector regulation and supervision that are under way, by countries in the implementation face deviating from the level playing field objective that has been a keystone in our discussions and decisions. To illustrate what I mean, I find it a source of uncertainty that is delaying the full recovery of international financial markets the surge of different expressions of the reform in the form of the Volker rule, the Vickers solution or the one contained in the Liikanen report. Regulatory harmonization would benefit everybody, so deviating from this objective would be detrimental to the recovery process.

Second, in terms of the international financial architecture, we should not weaken our commitment to strengthen key international financial institutions, like the IMF. In Mexico, we delivered in terms of enhancing the Fund´s lending capacity by many countries committing to lend resources to the institution, but this came with the understanding that we would move forward also with the quotas review and the redesign of the quota´s formula. I am a firm believer that the Fund will remain relevant as long as its lending capacity is quota based, and as long as the quota distribution gives legitimacy to the institution. I regret the lack of progress in the front, and I hope that this process can be reinvigorated here in Moscow.

I also think we have not made enough progress in our collective efforts to prevent crises. This is a very important workstream in the reform process of the international financial architecture. Sometimes I have the sense that we are not inquisitive enough in actively asking ourselves from where the next crisis will come from. I say this because more often than not we are caught by surprise as a crisis erupts from an unsuspected source. Financial crises tend to mimic strokes trigged by high blood pressure. As you now, high blood pressure is referred in the medical jargon as the “silent killer”. I fear that we are exposed to too many “silent killers” in modern financial systems, and it is our duty to enhance our capabilities to uncover them in time. In this sense, I feel very keenly that we need to improve our early warning systems, broaden the practice of stress testing and dwell further in multilateral surveillance and the identification of spillover effects of major economies´ policy decisions.

Third, we should be able to react on a timely fashion to the threats to financial stability that might be brewing today and that we have identified already. I refer for example to the probability of a perfect storm that I alluded before. There is no doubt that the monetary policy implemented by major advanced economies have contributed to create an environment for huge capital reallocations among countries and markets, guided by the search for yield. But at the same time, I believe that those policies have been essential in the resolution of the crisis, and they will continue to be, so we need to learn to live with them. Also, emerging markets have to accept the fact that given the two-speed recovery process, with emerging markets growing much faster and on a stronger footing than advanced economies, some degree of currency appreciation is to be expected. On the other hand, capital recipient economies, primarily emerging ones, have a limit to the amount and speed of capital inflows that they can manage, after which asset mispricing can result, including non-equilibrium currency appreciations, which could generate financial stability vulnerabilities. What can be done then in this respect?

To start with, recipient countries could try to expand their capacity to accommodate capital inflows, by adjusting their fiscal stance and by implementing structural reforms to amplify the potential productive use of additional resources. But regretfully, there is also a limit to this. As a matter of fact, some countries have already exhausted this instance. The only alternative left would be the application of macroprudential policies. These policies can be implemented by using three types of instruments: a) capital-based instruments, like countercyclical capital buffers, or dynamic provisioning; b) liquidity-based instruments, like countercyclical liquidity requirements; and c) asset-side instruments, like LTV and DTI restrictions. Intervention in the forex markets and lowering of reference interest rates should also be considered, in particular if the zero-bound is not yet a restriction, but I would be less inclined towards the use of capital controls. Now in all this what can a fora like the G-20 contribute? I would say that in two aspects.

Fist, even though I already said that we should be in general supportive of advanced economies monetary policies, I think that we are entitled to request their upmost effort to implement them, in particular when the time to exit comes, in a way to minimize volatility in international financial markets; and

Second, to develop a consensus towards good practices in macroprudential policies implementation and design so that they are transparent and targeted to prevent exclusively financial stability vulnerabilities, avoiding their use to introduce protectionist measures through the back door.

Thank you very much for your attention.