**REMARKS BY JAVIER GUZMÁN CALAFELL, DEPUTY GOVERNOR AT THE BANCO DE MÉXICO, AT THE "POLICY DIALOGUE: GLOBAL FINANCE EXPLORATION". INTERNATIONAL FINANCE FORUM 2018 ANNUAL CONFERENCE "NEW GLOBALISATION: A PATH TO THE FUTURE". Guangzhou, China, November 24, 2018.**[1]

Let me start by expressing my appreciation to the organizers for the opportunity to participate in this 2018 edition of the IFF Annual Conference.

Following a period of strong inflows in 2017 and early 2018, nonresident portfolio capital flows to emerging market economies (EMEs) started to reverse in late-April this year, with bond and equity fund withdrawals accumulating to date about US$28 billion. This has responded to a spike in risk aversion, reflected in a series of waves of uncertainty over the year in response to a combination of developments. The latter include upward-trending interest rates in the US, a surge in trade-related tensions, geopolitical developments, a deceleration of the Chinese economy, the decline in key stock markets, heightened political and policy uncertainty in a number of EMEs, as well as sharp declines in oil prices to levels not seen in about a year, among others. As a result, financial conditions in these economies have shown a significant tightening which, according to some estimates, is comparable to that experienced during the taper tantrum episode of 2013.[2]

In the face of mounting pressures, the immediate policy response in EMEs has relied mainly on a couple of tools. First, monetary policy has in general turned more restrictive, with reference rates increasing sharply in specific instances

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[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 (2018): *Global Financial Stability Report*, October.

where conditions deteriorated more severely owing to persistent external vulnerabilities and perceived idiosyncratic risks. Secondly, the exchange rates of many EMEs have adjusted in response to these shocks, with some of these currencies receiving support from foreign exchange intervention, either in the spot market of via derivatives.

Among the factors explaining the reversal of capital flows and consequent tightening in broader EME financial conditions, monetary policy normalization in the United States is particularly noteworthy. Naturally, higher interest rates in the US can be expected to represent a drag on capital flows towards EMEs. Notwithstanding some recent easing, market repricing of upside risks for the future trajectory of the federal funds rate in previous months led to outward pressures stronger than formerly anticipated. In fact, more than 40 percent of the estimated outflows from EMEs in the year through the third quarter of 2018 that can be attributed to external factors was explained by increased market expectations about the Federal Reserve policy rate.[3]

It is worth to highlight that *global* financial conditions remain accommodative in relation to historical standards, albeit tighter than a year ago. There are many factors at play behind such an outcome and their interrelationships are complex. However, two stand out in this respect. First, the tightening bias at the global level that may derive from interest rate increases by the US Federal Reserve is, at least partially, countered by the persistent degree of accommodation pursued by the central banks of other major AEs, in what has turned out to be a divergent monetary normalization cycle in these countries.

[3] International Monetary Fund (2018): *Global Financial Stability Report*, October.

Secondly, in the United States, domestic financial conditions actually loosened even as the monetary policy rate started to increase in December 2015 and the Federal Reserve began unwinding its balance sheet in October 2017. In fact, financial conditions in that country started to tighten only around the beginning of 2018.

Needless to say, such an outcome runs counter to intuition. However, it is important to bear in mind that an economy's financial conditions, broadly defined, are the result of the interplay of a large number of variables whose impact may work in opposing directions. In the particular case of the United States, the strengthening of the short-term growth outlook, resulting partly from the fiscal stimulus underway, may have raised expected corporate profits and thus supported asset prices through most of the run-up to the sharp market corrections of recent. This effect was likely reinforced by the cross-border impact of large-scale asset purchases by central banks in Europe and Japan, hence stimulating demand for higher-yielding US securities. Furthermore, the tightening effects of monetary policy actions in the US may have been hindered by a gradual and in general predictable pace of increase in interest rates in that country.

In view of the difficulties inherent to trying to predict market movements, even more so in the context of unprecedented circumstances such as the ones prevailing at present, it is not at all clear how rapidly global financial conditions will tighten as the Federal Reserve and other major central banks continue (or embark in) their respective policy normalization cycles. To some observers, the recent adjustments in international financial markets (rising interest rates, declining stock indices, and depreciating currencies vis-à-vis the US dollar) are a welcome development as they are consistent with a strong economic outlook, reduced risks of deflation in some AEs and, in general, a thus-far-successful exit from the massive monetary accommodation of the decade following the outburst of the crisis.[4] However, the risk of a sudden, sharp tightening in financial conditions cannot be discarded.

At the current economic and political global juncture, a number of factors increase significantly the risk of a potentially disruptive scenario. Among these, it is worth highlighting, first and foremost, the possibility of surprises in AE monetary policy normalization. This is particularly worrisome in the case of the US, where notwithstanding downward adjustments in market expectations about the future path of interest rates following the recent market rout, inflation could surprise to the upside as a result of ongoing fiscal stimulus measures implemented in the context of an economy operating at, or near, full capacity, in addition to price pressures that may derive from increased import tariffs. Secondly, market sentiment might be adversely affected by increased political and policy uncertainty in a wide range of economies, both advanced and emerging. At the top of these concerns is the further escalation (or, at least, the persistence) of global trade tensions, especially between China and the US, whose broader implications can well go beyond the specific sectors that to date have been targeted. Thirdly, confidence on the resilience and credibility of policy frameworks in EMEs may erode, as external shocks combine with existing vulnerabilities in many of them and growing concerns about central bank independence in some particular instances.

[4] See, for instance, Stephen S. Poloz (2018): "Making Sense of Markets", remarks before the Canada–UK Chamber of Commerce, 5 November.

In addition, challenges of a structural nature may complicate matters further. First, as noted above, the context in which monetary policy normalization in the US and other AEs is taking place is unprecedented, making in turn its potential ramifications difficult to assess and foresee. For one, interest rates had never been so low for this long, while the unwinding of the stimulus provided by unconventional monetary policy measures adopted at such a large scale remains untested. In light of these and other uncertainties, including the ones related to the characterization and definition of "normalcy" itself, it is evident that the potential for policy mistakes is sizable.[5] On the one hand, adjusting policy too fast may, among other risks, prompt disruptive responses in international financial markets with adverse implications for the real economy, both at the domestic and international levels. On the other hand, moving too slow may encourage the continued accumulation of debt as well as the buildup of risks and vulnerabilities in the financial sector.

Secondly, on account of the greater financial integration across markets and economies that has been brought about by globalization, the control of domestic financial conditions by policy makers may prove to be quite challenging. As per some estimates,[6] about 20 to 40 percent of the observed variation in *domestic* financial conditions can be explained by a single, common factor, namely *global* financial conditions, an effect that tends to be larger (over 60 percent in some instances) in EMEs. The situation is further complicated by the fact that local financial conditions tend to react faster and more strongly to external shocks than to adjustments to the domestic

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[5] Bank for International Settlements (2018): "Monetary Policy: A Narrow Normalization Path", Chapter II of *Annual Report*, June.
[6] International Monetary Fund (2017): Global Financial Stability Report, April.

monetary policy stance. Furthermore, it is not rare to see external financial conditions being driven to a larger extent by factors other than macroeconomic conditions, such as abrupt swings in investor sentiment, financial contagion, or regulatory changes, where the tools available to counter them may be more limited or ineffective.

Thirdly, the global financial structure has undergone profound changes in the post-crisis years, that remain to be fully tested in situations of widespread stress. One of them relates to evidence suggesting an increased segmentation of market liquidity, and the consequent risk that lower levels of liquidity enhance the potential for wide fluctuations in asset prices and financial instability. In this respect, it is important to bear in mind that the abundant liquidity resulting from overly expansionary monetary policies in AEs is anticipated to decline significantly in coming years. Another change is the increased presence of foreign investors in local EME bond markets. It is true that the level of risk is a function of the type of investor, with large institutional investors showing in general a higher degree of stability. It is also the case that at the end, both foreign and domestic investors will have a similar reaction to episodes of acute turmoil. However, it can also be argued that nonresident holders of domestic assets may be more sensitive to the impact of shocks, especially in those cases where we see a significant share of investors operating through mutual funds and exchange traded funds.

In light of the above, it is clear that EMEs should stand ready to face the materialization of these and other risks. While isolation from changes in global financial conditions is unfeasible, the evidence clearly shows that domestic policies do make a crucial difference. As in previous episodes of turmoil, during the current one global investors have differentiated among EMEs on the basis of their economic fundamentals and other idiosyncratic factors.[7] For instance, the deterioration of indicators of creditworthiness and currency depreciations have been sharper in countries facing more important economic and political challenges. Similarly, although estimations of correlation of the idiosyncratic component of market exchange rates, or more generally of contagion among different EMEs, have increased recently, they remain at low levels.

It would be both naïve and unfair, however, to assume that EMEs will be able to overcome these challenges by themselves. Global financial stability is a very complex task, and therefore its attainment and preservation is a shared responsibility that requires coordinated efforts from all the parties involved. The role of AEs in this task is paramount to its fulfillment. Indeed, a careful communication of monetary policy decisions, a proper evaluation of spillover effects, strong support for the creation of an adequate global financial safety net, and even coordinated policy action whenever needed, among other actions, should be key ingredients of this cooperative approach.

AEs have a clear responsibility for the current state of the world economy and therefore they should assume an equally important role in overcoming the consequent challenges. But beyond this, it is evident that they have a lot to gain from a solid performance of EMEs and stable financial markets at the global level.

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[7] Organisation for Economic Co-operation and Development (2018): OECD Economic Outlook 2018, Issue 2, November.

It should suffice to recall that, by virtue of their growing importance and integration into the global economy and financial system, the scope for spillovers from EME shocks into AEs has risen over the past decades to significant levels. According to IMF estimates, more than a third of the variation in AEs stock market returns and in their exchange rates in recent years can be traced to spillovers from EMEs. Moreover, given the extent of financial market integration and the particular features of international financial markets at present, financial volatility in EMEs may be widely transmitted even in the absence of crisis or near-crisis episodes.

In other words, policy makers in AEs need to carefully consider not only the consequences of their policy decisions on EMEs, but also the risk of spillbacks from EMEs as a result of policy actions in AEs.

The implications for international policy cooperation are evident.