The Quest for Successful Policy Responses to Sovereign Crises

by

Agustín Carstens

Governor, Banco de México

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Introduction

Good morning. It is a pleasure and an honor to be in Singapore, a country that I deeply admire, to deliver the 2013 Monetary Authority of Singapore (MAS) Lecture. I certainly would like to thank Managing Director Ravi Menon for having invited me to address such a distinguished audience.

As soon as I accepted to deliver this prestigious lecture, I started to think about the topics I should cover in my talk. Central banking related issues seemed a logical choice. But what novelty can you uncover for a country that has the enviable record of an annual average rate of growth of 6.2 percent and an annual average inflation rate of only 1.9 percent during the last twenty years, that is ranked as the second most competitive country in the globe according to the World Economic Forum, and that basically follows best practices in all fronts? A traditional speech about central banking and monetary policy would have been akin to lecture Michael Phelps about how to win gold medals in Olympic swimming competitions.

These considerations made me decide to concentrate on the economic and financial crisis that started in 2007 in the advanced economies and then spread to the rest of the world. Given the magnitude and severity of the crisis and its adverse impact on economic activity, it has been characterized as the worst financial crisis since the Great Depression. Unfortunately, the world economy has not been able to fully pull out of it, and we should be prepared to further face an environment where weaknesses and vulnerabilities persist for a while - and I am talking here years, not just months. This factor is particularly relevant for countries like Singapore and Mexico, whose economies are very open, and therefore their performance in many aspects depend critically on the state of the world economy and the international financial markets.

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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 so as to restart the intermediation of financial resources across countries and regions, 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, an incipient sense of achievement started to appear, as it can be exemplified by some of the remarks by the former IMF´s Managing Director, Dominique Strauss-Kahn, made precisely here in

Singapore in November 2009 as he delivered his MAS Lecture. Let me quote:

> *"While I am hopeful that the global economy has turned the corner, the recovery remains fragile. Policy makers should therefore keep supportive measures in place until a recovery is firmly established and conditions for unemployment to recede are in place.*
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> *………..*
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> *Regardless of the extent of economic recovery, it makes sense for policy makers in all countries to start planning their exit strategies now."*

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. This situation induced firms in the most affected advanced economies to postpone or even cancel investment projects and households to further reduce consumption expenditures.

In turn, weak economic activity further deteriorated fiscal positions and the health of banking institutions, leading to an even worse situation, generating 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, by far 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, which in a way triggered 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 supposed to happen only in weak emerging markets, not 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. 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: their currencies depreciated, borrowing costs increased, as well as CDS spreads. 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 reigned.

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 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 hopefully will anchor the 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, causing mispricing in some asset classes. Concern of asset price bubbles fed by credit booms are starting to appear in some economies.

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. So some setbacks are still likely. 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. The expectation is 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 have been left with no option but to massively deleverage.

- 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 independently some important advanced economies are actively pursuing a depreciating real exchange rate strategy.

All in all, a sobering picture I would say.

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Now let me transit from the conjunctural to the strategic.

The international financial community has deployed major efforts to extract the main lessons from the crisis that is still in the process of being resolved. Work has concentrated on prevention; on strengthening the international financial institutions, in particular their ability to perform better multilateral surveillance and incorporate into their analysis the spillover effects of policy decisions of major economies; in the case of the IMF, its lending capacity has been substantially increased. Lastly, attempts have continued to forge a cooperative solution to global imbalances, and to reinvigorate policy coordination among countries, which has waned down after 2009 – 2010. But, I ask myself, is this all what we can do to enhance our capabilities to face crises?

From my detailed exposition on the state of current affairs, it is clear that the world was not properly prepared to address the major crisis that erupted. This was a significant drawback that no doubt was very costly. In principle we should have much better guidelines to assist authorities in steering the process of resolving a crisis. And it is not that we do not have enough experience to draw lessons from. According to Reinhart and Rogoff (2011), since 1970 we have had 140 financial crises, 42 only in Latin America.

I can accept the notion that each crisis is different and also that the powers and capabilities among governments vary a lot. Soon after it gets going, a financial crisis becomes a politically loaded affair, a fact of life that makes a systematic treatment of crises quite challenging. But this does not take away the possibility of trying to identify some stylized facts that are inherent in each crisis, that would help us in distilling some essential elements that should be present in every crisis resolution. Let me take a shot at this, proposing a check list of steps or actions that in my view should be part of every crisis resolution strategy.

The first task in the quest for successful resolution should be to stabilize expectations as soon as possible. In other words, the immediate goal should be to move from a vicious to a virtuous cycle in expectations formation. Let me illustrate the wisdom of this through an example: at some point buying medium term debt issued by a sovereign at a spread of 450 basis points – after it deteriorated for a while – could be very unattractive but, it also could be just the opposite if the destabilizing expectations disappear rapidly, thereby inducing significant reductions in interest rates. Lower interest rates stimulates GDP growth, which in turn facilitates the stabilization process by increasing tax collection and payment capacity of debtors, and consequently reducing the social and political costs inherent to the adjustment. By improving the fundamentals of the economy, expectations keep improving, thus strengthening the virtuous circle.

Second, in order to adjust expectations the necessary measures must be adopted in a credible way. The perception of markets and society must be that the effort is not only serious but that it will be enough to reverse the situation. In order to achieve this it is essential to:

- Rely on an uninhibited, far reaching diagnosis about the sources of the crisis;
- Respond quickly and decisively, directing policy response to address the fundamental causes of the crisis;
- Governments should be aware – as I am sure they are most of the time – that given the eruption of the crisis they will be facing a credibility deficit. This makes it of the essence for governments to be sure that they will not fall short on the adjustment, as it would seriously deteriorate further its credibility and, consequently, the costs would grow exponentially. In some cases, this type of considerations might make advisable some short-term overshooting in the adjustment process.

Third, under a crisis authorities will be facing an extremely volatile scenario. Typical macroeconomic models brake down, so to an extent it is like navigating without instruments in a storm. This makes it essential for governments to be flexible and agile in their policy response, developing at the same time an effective communication strategy to address markets and society in general. Flexibility should not be confused by the population with a perception of lack of commitment with the adjustment process. Once the course is set, strict implementation should follow.

Fourth, complacency should be avoided. At some point in time, there will be a positive response to the implementation of policy measures, and this will happen very likely in the midst of a very painful adjustment process in the economy. Given that adjustment fatigue kicks in at a relatively early stage in the process, there will be numerous voices that will call for a declaration of victory and the abandonment of the reform process ahead of time. The danger of falling in this trap is that the country would be sawing the seed for the next crisis, entering into a recurrent crisis cycle that is very difficult to leave, as many Latin-American countries can attest to.

Fifth, it is very important to implement various programs to mitigate, to the extent possible, the social consequences of adjustment. These programs should seek to maintain a basic support network, for instance in health and education for the unemployed, focusing specifically on the most vulnerable and poorly equipped population to withstand shocks and adjustments.

Sixth, an adjustment program without subsequent economic growth is ephemeral, especially if the country is not able to do a correction in the exchange rate regime. Therefore, the adjustment program should be accompanied by structural reforms that generate quick advances in productivity and foster a more rapid recovery of competitiveness.

Certainly, these general principles are applicable to every country under a financial crisis. They stem from experience, which means that they work even though each case has its own singularities and the political and social environment is different in each country. I hope that this initial effort to try to identify best practices in establishing a crisis resolution strategy is taken up by the international financial community, so as to have a more complete toolbox to deal with difficult unexpected circumstances.

Before I move to my concluding remarks, let me just make a quick point on our collective efforts to prevent crises. As I already mentioned, 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.

Today, my fear is that a perfect storm might be forming as the result of:

1. Massive capital flows to some emerging market economies and some strong performing advanced economies;

2. This could lead to bubbles, characterized by asset mispricing; and
3. Then face a reversal in flows as the major advanced economies start exiting their accommodative monetary policy stance.

This very simplified outlook poses a major financial stability challenge for many capital recipient countries. Given this, I find it fully justified for some countries to adopt thoughtful macroprudential policies. Singapore is a leader in this front.

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Let me conclude my remarks with a positive note: there is life after crisis, as Mexico can testify. We experienced recurrent crises in the seventies, eighties and nineties, four fully-blown crises in thirty years. But we have been crisis-free for the last eighteen years. We broke the spell by following very simple, even common sensical principles.

First, by reassuring markets and society that fiscal discipline will be maintained. Mexico has been more than seven years under a Fiscal Responsibility Law, which requires balanced budgets under normal circumstances. As a result Mexico has had very low fiscal deficits in recent years, keeping the ratio of public debt to GDP at levels just above 30%, a third of the ratio observed now in most advanced countries.

Second, by maintaining an active and prudent management of the public debt. Together with fiscal discipline, public debt must be managed in a way to optimize maturities and costs. In particular, it is essential to avoid a concentration of maturities, imbalances between domestic and foreign debt, and to encourage that sovereign debt instruments are held in steady hands. In this area, Mexico has adopted the best practices and is leader among many advanced and emerging countries. Today the average duration of Mexico's public internal debt is longer than that of the United States, something unimaginable a decade ago.

Third, by having full central bank independence in conducting a monetary policy geared to achieving an inflation objective. The autonomy of Banco de México is well established, and has allowed us to get inflation close to 3 percent, among the lowest in emerging countries.

Fourth, by establishing a flexible exchange rate regime, with a well-developed foreign exchange market. For a very open economy as the Mexican, exchange rate flexibility is very important to absorb external shocks. The Mexican peso is one of the three emerging countries' currencies most traded, and Mexico has the most liquid foreign exchange market in Latin America.

Fifth, by maintaining an adequate level of international reserves. Through mechanisms designed to preserve a consistent floating regime, Banco de México has built up reserves to cover twice the external public debt and the entire foreign debt of the country, without considering the flexible credit line we contracted with the IMF.

Sixth, by avoiding protectionist measures, which at best provide ephemeral relief and certainly produce perverse incentives that do not favor the country's competitiveness. In recent years Mexico not only has not adopted protectionist measures, but has also accelerated the opening of the economy.

Lastly, by ensuring adequate supervision and financial regulation. Mexico learned its lesson after the 1994-1995 crisis and over the years the authorities have implemented a strict system of financial regulation and supervision. Mexico is among the first countries to fully embrace the new international standards embodied in Basel III.

In all these years of building financial and macroeconomic resilience, often we have been inspired by success stories, such as Singapore.

Thank you very much for your attention.