REMARKS BY MR. JAVIER GUZMÁN CALAFELL, DEPUTY GOVERNOR AT THE BANCO DE MÉXICO, AT THE PANEL "POTENTIAL OUTCOME OF THE GREAT EXPERIMENTATION AND IMPLICATIONS FOR THE GLOBAL FINANCIAL ARCHITECTURE". CONFERENCE "THE GREAT EXPERIMENTATION WITH UNCONVENTIONAL MONETARY AND FINANCIAL POLICY", ORGANIZED BY THE BANCO CENTRAL DE RESERVA DEL PERÚ AND THE REINVENTING BRETTON WOODS COMMITTEE. Cusco, Perú, July 3-4, 2013.[1]

First of all let me thank Governor Velarde for his kind invitation to participate in this interesting conference.

I will concentrate my remarks on a few issues that in my view are important to increase the possibility of a successful outcome from UMPs, including some related to the international financial architecture, as requested by the organizers.

UMPs have had thus far important beneficial effects both on the implementing countries and the overall world economy. They have contributed substantially to strengthen confidence, restore the functioning of interbank markets, support financial intermediation, lessen vulnerabilities in the banking system, and reduce long term yields and tail risks. Most importantly, UMPs have allowed to prevent a collapse of the world financial system, which would have most probably implied a cost in terms of output and employment well above what we have seen up to date.

Nevertheless, these policies have also given rise to a number of risks. The latter include the effects of UMPs on capital flows to and outflows from emerging market economies and the related macroeconomic and financial stability challenges; the implications for financial stability of prolonged periods of low interest rates; the potential impact on inflation of exceptionally easy monetary policies; the challenges for central banks resulting from the fundamental change in the size and composition of their balance sheets deriving from UMPs; a possible reputational cost if expectations on the benefits of UMPs are too high and run beyond what central banks can reasonable achieve; and of course, as evidenced by recent events, the difficulties related to exit from UMPs.

Let me note in this last respect, that a withdrawal of monetary stimulus resulting from the prospect of a sustained economic recovery should have beneficial medium and long term effects. However, one of the main problems here is timing of the exit itself, since central banks may move prematurely to a policy setting that might not prove sufficiently accommodative to ensure a sustainable recovery. As shown by the events of recent weeks, volatility in the financial markets and a more rapid than expected increase in long term interest rates is another possible result of an unwinding of UMPs.

[1] The views expressed herein are strictly personal and do not necessarily coincide with those of the Banco de México.

It is clear, then, that ensuring a successful outcome of UMPs requires simultaneous action in a number of fronts. I would like to refer briefly to three of them which in my view are particularly important:

a. As I mentioned before, the potential impact of UMPs on financial stability is a source of concern. Both low interest rates resulting from UMPs, and alternatively a sharp increase in long term rates linked to the withdrawal of monetary stimulus, give rise to financial stability risks. The standard recommendation nowadays is to use macroprudential tools as one of the main lines of defense. I fully share the view that under current circumstances the attainment of financial stability requires a new policy focus in which macroprudential measures have a more prominent role than in the past. However, we must also be aware of the limitations that we face. In particular, further research is needed to provide the theoretical backing required for the design and setting in motion of integrated policy frameworks in this area. In addition, the authorities must make sure that they have in place the institutional framework required for a proper use of these instruments. Furthermore, the coordination of macroprudential policies with monetary, fiscal and microprudential policies in the pursuit of financial stability must be carefully assessed. Therefore, expectations on the potential contribution of macroprudential policy to financial stability should remain within realistic boundaries.
b. Over a relatively short time span, communication policy at central banks has undergone a radical transformation. To put it simply, after a long period of opacity, around two decades ago a move towards more transparency among central banks gained strength. Thus, by the early years of this century some central banks began to use communication as a primary policy tool, i.e. as an independent tool for influencing the economy. Communication has become even more important after the onset of the financial crisis. With interest rates near zero and the introduction of UMPs, extensive new communication has been needed to establish a link between these policy instruments and macroeconomic objectives. Naturally, communication should also play a key role when the time comes for a withdrawal of the extraordinary monetary accommodation provided by UMPs. The problem is that although communication has changed, demands from financial markets and from the public in general have also rapidly evolved. As the events of the past few weeks suggest, we are shooting at a moving target. This underlines the importance of an extremely careful communication policy. Moreover, additional efforts are needed to ensure that we have an adequate understanding of how communication can influence the effectiveness of monetary policy.
c. Although UMPs have been fundamental to overcome the challenges that have emerged as a result of the global financial crisis, monetary policy cannot solve its ultimate causes. Ensuring debt sustainability, strengthening the private sector´s balance sheet, enhancing the economy´s competitiveness, and undertaking other structural reforms are well beyond the reach of monetary policy. Therefore, one of the most important actions that advanced economies can do to contribute to a successful outcome of UMPs, is precisely to set in

motion, the sooner the better, the actions needed to tackle the root causes of the current difficulties.

Is reform of the international financial architecture relevant for a successful outcome of UMPs? The answer is clearly positive. The potential of financial volatility and instability in the world economy is likely to persist, and strengthening the international financial architecture can contribute a lot to counter some of the resulting risks. In this connection, I would like to make a few remarks on the role of the IMF first and then on the global financial reform agenda.

With respect to the Fund, it is evident that in a situation like the one we are facing, it is more important than ever to endow the IMF with an adequate financial capacity. During the past few years, the Fund's financial resources have been strengthened through quota increases, supplemented by an enlargement of the NAB, and more recently by the bilateral borrowing agreement framework implemented during the Mexican presidency of the G20.

The last two initiatives have been extremely useful to allow the Fund to respond to member countries' needs in the aftermath of the crisis. However, they are unlikely to represent permanent sources of financing for the Fund. In addition, contributions through these channels are not reflected in decision making at the institution. Therefore, they must not be considered as a substitute for quota increases.

Moreover, present Fund financial capacity may fall short of the amounts needed in the current circumstances.

a. The growth of IMF available resources has been below that of the global economy in the last decades, and too small in comparison with the growth of the global financial system.
b. The situation is even more worrisome when the actual and potential demand for Fund resources by some advanced economies is taken into consideration.
c. The globalization of financial markets makes it more likely than before that the IMF will have to address financial crises that affect more than one country at a time.

The risks stemming from this situation are clearly large. Therefore, the international community should be open minded when assessing the adequacy of Fund resources in the context of the 15th General Review of Quotas (scheduled to be concluded by January 2014). Naturally, an important prerequisite here is to ratify, as soon as possible, the 2010 quota and governance reform. On the other hand, cooperation between the Fund and regional financing arrangements (another important player of the existing international financial safety net) should be further enhanced, among other means through closer communication and joint work in crisis prevention and resolution.

Besides financing capacity, the Fund needs to have in place adequate financial facilities. Indeed, the IMF has done a good in job in overhauling its lending toolkit. Systemic costs and spillover effects are much higher in cases of crisis resolution. Therefore, I welcome in particular the efforts made to provide more and better crisis prevention instruments.

The Precautionary and Liquidity Line (PLL) and the Flexible Credit Line (FCL) have been a major achievement in the efforts made by the Fund to improve its preventive capacity and strengthen the international safety net. These facilities have the great advantage of stimulating sound policy frameworks, while supporting confidence and diminishing the need to accumulate international reserves. Furthermore, they are fully driven by member countries' policy commitments and therefore alleviate the stigma traditionally associated with Fund programs.

The Board of the Fund will be discussing later this year the effectiveness of the FCL and the PLL. On the basis of Mexico's successful experience with the FCL, I am convinced that they are an essential component of the international financial architecture. Moreover, in my view the Fund should explore possible means to stimulate a wider use of the available instruments, as well as the feasibility of putting in place other facilities of a preventive nature.

My final comment on the IMF relates to its surveillance function. First of all let me stress that the recent strengthening of the Fund's surveillance framework is a step in the right direction. I am very glad to see the deepening of multilateral surveillance activities, the inclusion of assessments regarding financial stability and spillover effects in Article IV Consultation reports, and the evaluation of risks originating in the main systemic countries. The series of papers that have been prepared on different aspects of unconventional monetary policies is also welcome.

Although a lot has been achieved, there is still substantial room for improvement:

a. Many Fund member countries find little value added in the institution's advise, especially that provided in the context of bilateral surveillance. It is often argued that this advise is too generic or based on a one-size-fits-all-approach.
b. There is a clear need to deepen the understanding of macrofinancial linkages, and to reflect this knowledge in the analytical frameworks used and in the implementation of the surveillance work, both at the bilateral and multilateral levels.
c. The perception that Fund recommendations are not evenhanded continue to be a barrier to effective surveillance. In a recent survey carried out by the Fund's Internal Evaluation Office (IEO), about a third of country authorities and half of the mission chiefs interviewed did not believe that the IMF has become more evenhanded since the onset of the global financial crisis.[2] Recent Fund programs in the advanced economies of the European Union was mentioned as an example of lack of evenhandedness.
d. The Spillover Reports fill an important gap and are likely to improve a lot our understanding of interconnections in the world economy. However, as the Fund itself recognizes, much further effort is needed, since this work is only in its initial stages and its value as a surveillance tool is yet to be established.

[2] Also, half of the surveyed mission chiefs of systemically important advanced economies admitted that the systemic importance had influenced the degree of candor of the dialogue. See IEO, "The Role of the IMF as Trusted Advisor", January 17, 2013.

e. The old problem related to Fund surveillance remains: it lacks teeth. I am aware that this is an extremely complicated issue, but we must not surrender and keep on trying to find ways to enhance the practical impact of this crucial Fund activity.

Let me turn now to global financial reform.

A positive aspect of the global financial crisis is that it has elicited an unprecedented effort to reform the international financial sector. Contrary to previous episodes, on this occasion the response has been faster and it has involved a greater number of countries and international institutions.

In general terms, the main objectives of the reform have been to strengthen the international financial system and the capacity to respond to crises. Some of the measures considered have a preventive nature (e.g. increasing the quality and quantity of banks' capital, reducing leverage and enhancing supervision). Others are aimed at limiting the impact of financial institutions' failures (e.g. cross border cooperation on crisis management and developing effective resolution regimes for banks), and the rest focus on strengthening the financial infrastructure and limiting the risk of contagion (e.g. standardization and central clearing of OTC derivatives). In my view, these efforts take into account all the major elements needed for a fundamental overhaul of the international financial architecture. In fact, their effects are already evident in a number of areas.

Naturally, the road ahead is not free of challenges. In this respect, let me note the following:

a. One of the most difficult issues for regulators is to find an appropriate balance between a weak worldwide economic outlook and stricter regulatory policies. We do not know with certainty what will be the impact and effect of stronger regulatory requirements on the world economy. There is consensus that global financial stability facilitates strong economic growth in the long run. However, there is also a possibility of increased funding costs for global banks, banks' deleveraging to meet tighter capital requirements, and a reduction in the volume of credit, in the short term.
b. Progress is uneven regarding implementation of the recommended measures. This is the case for instance of Basel III capital requirements. In addition to the implications for the strength of the financial system, this may lead to regulatory arbitrage opportunities, as institutions will try to do business in countries characterized by more lax regulatory frameworks.
c. Significant progress in some areas, such as shadow banking, is yet to be seen. The situation is particularly important in this case, since a substantial amount of funds may be migrating to new unregulated activities.
d. Since the crisis began in advanced economies, the reforms were designed to meet the needs of these countries. As a result, some of the recommended measures may have undesirable side effects on emerging market economies.

To conclude, let me say a word about emerging market economies. On several previous occasions, major crises in these countries have been preceded by significant increases in international interest rates after a prolonged period of abundant liquidity. I fully agree that there are many elements that suggest that it may be different this time. In particular, a radical improvement of economic fundamentals has been observed vis-à-vis the situation prevailing during those previous episodes. Perhaps the most compelling evidence in this regard lies in the fact that according to IMF figures, these economies have accounted for around three quarters of world economic growth during the last five years. Nevertheless, a complacent attitude would be a mistake. To start with, as shown by the recent turbulence in international financial markets the road ahead is likely to be bumpy. Furthermore, major differences from one country to another prevail, and even among many of those that have made most progress, a number of macroeconomic and/or structural challenges need to be tackled. To sum up, homework is far from finished and the strengthening of economic fundamentals needs to continue in this group.