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The Importance of Confidence in Macroeconomic Stabilization Efforts

By

Agustín Carstens[1]

Introduction

Good afternoon. First of all, I would like to warmly welcome you to Mexico and thank you for attending this conference co-sponsored by the IIF and the Mexican Financial Authorities. In particular, I would like to express my appreciation to Charles Dallara and his team at the IIF for their dedication and effectiveness in putting this outstanding event together in a very short period of time, and to Grupo Financiero Banamex and BBVA Bancomer for their sponsorship.

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[1] Governor, Banco de México. Speech delivered at the High Level Public-Private Sector Conference organized by the Institute of International Finance in Mexico City.

During the last four years, the financial crisis, which started in advanced economies and then spread to most of the rest of the world, has captured the attention of policymakers and market participants around the globe. 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 pull out of it and authorities' capacity to use traditional policy instruments to support economic activity has diminished over time.

In this context, during the second half of 2011 two unprecedented events led to a period of heightened uncertainty in financial markets and significantly deteriorated global economic prospects: first, the downgrade of the U.S. sovereign debt by one credit rating agency in early August, and second, the worsening of the sovereign debt crisis in Europe, combined with a heightened perception of weakness in the European banking system, followed by the increasing risk of contagion across markets and countries. These events, along with authorities' inability to implement credible and timely policies to address the fiscal and financial problems in advanced economies, led to a significant deterioration in confidence among economic agents.

Therefore, the perceived risk of a catastrophic event, such as a sovereign default episode in Europe with great disruptions in financial markets and economic activity, sharply increased. This situation has led firms in advanced economies to postpone or even cancel investment projects and households to further reduce consumption expenditures. Under these circumstances, the absence of confidence has contributed to decreasing the growth prospects for most advanced countries and, for that matter, for the world economy. In turn, weak economic dynamism has further deteriorated fiscal positions and financial conditions in some European countries, leading to an even worse situation, generating an adverse feedback loop. Moreover, given increased trade and financial linkages across countries the decoupling between advanced and emerging economies disappeared.

During early December, the European Central Bank adopted powerful unprecedented policy measures, as it implemented the long-term refinancing operation program and broadened the scope of acceptable collateral. This program has averted a full-blown liquidity crisis, given that it eased rollover funding pressures on many banks. However, this welcomed policy action by the ECB can only provide temporary breathing space, since by itself the program does not solve the underlying weaknesses of the banking system, which to a large extent respond to the weak growth prospects and difficult fiscal position in many Eurozone member countries.

Under this scenario, in order to break in a definite and conclusive fashion the adverse feedback loop between the deterioration of economic activity and the fiscal and financial conditions in Europe, it is crucial for authorities to implement urgently policy actions aimed at restoring confidence as soon as possible among economic agents. In particular, it is necessary to adopt credible measures in order to consolidate fiscal accounts, to assure the sustainability of public debt, to recapitalize troubled financial institutions and to facilitate the deleveraging of households. This would generate a virtuous circle, where firms would be more willing to invest, households would increase their spending, and investors would renew their interest in European sovereign debt and bank issued debt, leading to stability and a rebound in economic activity. In turn, a strong economic recovery would further strengthen fiscal positions and improve financial conditions, reinforcing confidence among market participants. The bottom line is how can we transit from a vicious cycle in expectations to a virtuous one.

For decades, Latin America suffered from recurring financial crises that brought about hovering economic, political and, above all, social costs. These recurring crises have proven to be devastating for affected nations. Recurrence undermines the hopes of generations, causing discouragement and, if the basic solutions are postponed or applied only partially, the end result is a downward spiral of mistrust and confusion. A hesitant attitude increases the costs related to adjustment, often exponentially.

Financial crises usually involve fiscal dislocations, restrictions on bank lending and / or imbalances in the external accounts, all of which reflect, in one way or another, an overspending in the economy financed in an unhealthy way. The measures to solve the crisis will definitely imply generating a new balance between spending and financing. The unavoidable remedial measures in the short term can deepen the impact of the crisis over economic activity, unemployment and poverty, but these costs tend to be much higher if the adjustment measures are postponed or adopted only partially.

Precisely because of the huge costs involved it is necessary for all advanced economies to devote themselves immediately to resolve the crisis and lay solid foundations to prevent new crises from taking place. This attitude has been crucial for countries like Mexico in the past. Having laid the foundations during the last 15 years for macroeconomic stability is what has allowed us to grow in today´s turbulent times, despite the magnitude and intensity of the external shocks that we have faced.

Mexico and other Latin American countries not only overcame that stage of great economic and financial vulnerability during the seventies, eighties and part of the nineties, but also focused on creating institutional arrangements capable of preventing and avoiding the reemergence of those crises.

Every financial crisis is particularly different; however, there are certain stylized facts inherent in all of them that can help us identify some elements that could be extremely useful in the resolution process. Allow me to present to you the stylized facts drawn from the Latin American experience, that I think could represent guidelines for solving the current crisis in Europe.

Stylized Facts of the Resolution of Financial Crises

First, during financial crises, expectations must be stabilized as soon as possible. In other words: the immediate goal should be to move from a vicious to a virtuous cycle in expectations. For example: buying now medium-term debt of a country in crisis at spreads of 450 basis points can be very unattractive, but it could be quite 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 intellectually honest diagnosis.

• Respond quickly and decisively.

• Be aware - and know how to convey this conviction to society- that the stabilizing measures are inevitable.

• Assure that the government will not fall short on the adjustment, as it would seriously damage its credibility and, consequently, the costs would grow exponentially.

Third, once a country is immersed in a crisis, governments often lack the necessary credibility, thus making it imperative to “import” such credibility. At the beginning of a crisis, it would be very difficult for the government in charge to have the credibility needed to make a strong economic adjustment if it failed to prevent the crisis when it had the opportunity to do so. How can this be achieved in the short term without changing the government? The answer lies in mobilizing the external financial support and accepting that this support be subject to conditionality. Credibility indeed increases directly according to the amount of financial support, which is recommended to be plentiful, and to the quality of conditionality, which normally consists of corrective measures the country must adopt in any case. Credibility would continue to increase to the extent that the adjustment program is implemented in a timely fashion.

It is for this that it would be useful at this time to strengthen international and multilateral cooperation bodies, such as the International Monetary Fund, and that currently being built by Europe, for the time being represented by the European Financial Stability Fund. The strengthening of the IMF´s lending capacity will be an issue that will be discussed in tomorrow's G20 Meeting.

Fourth, debtor countries should engage in a constructive relationship with creditors, following the "Principals for Stable Capital Flows and Fair Debt Restructuring" that have been developed under the auspices of the IIF.

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, 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 quick structural reforms that generate rapid advances in productivity and foster a more rapid recovery of competitiveness.

Certainly, these general principles are applicable to Europe today. They stem from experience, which means that they work even though each crisis has its own singularities and the political and social environment is different in each country.

Concluding Remarks

By sharing these ideas born from experience, my ultimate objective is not to teach lessons but to convey a message of optimism and hope: the problems many European countries are facing today have a solution, if they act decisively and on time. If this is done, sooner rather than later we will see a promising future in the global economy. No one wants the crisis from dragging on indefinitely, or that every time expectations of a solution emerge they are quickly refuted by new shocks or setbacks. In order to reach as soon as possible a definite solution, the countries must first take strong, painful but necessary actions, as indeed they have been doing in many cases, and second, the international community must join these efforts, support them, and thereby facilitate the solution.

It is this spirit of collaboration and cooperation in solving global problems that Mexico wants to build and consolidate during its period of leadership in G-20. These are no times to be enclosed behind borders, waiting illusory for the end of the storm. It is a time for collaboration and cooperation, for free trade, and for enhancing globalization.

An essential condition for sustainable economic growth in advanced economies, mainly in the U.S. and the Euro zone, is the recovery of confidence. Therefore, these economies should invest their energy and political capital in pursuing macroeconomic stabilization in the short run through well designed and decisive measures. To the extent that confidence among economic agents is reestablished the negative feedback loop between low economic growth, the deterioration of fiscal accounts, and the fragility of banking systems, finally will be broken.