Emerging Market Economies: Challenges and How to Move Forward

By Agustín Carstens

Governor, Banco de México

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It is a pleasure and privilege to have the opportunity to address such a distinguished audience, in this venerable fora that is over 100 years old. I thank Roger Ferguson for having invited me and Bill Dudley for his kind words of introduction.

The topic I would like to develop relates to the challenges that Emerging Market Economies (EMEs) are facing today and in the near future, and at the same time I will attempt to delineate a path on how should they respond and move forward. At the outset I would like to recognize that there is substantial heterogeneity among EMEs, and by doing this type of grouping I run the risk of making sweeping generalizations that may be unfair to some countries. At the same time, it is undeniable that EMEs, Mexico included, face common challenges derived from our participation and interaction in the global economy. This in fact is recognized by financial markets, which oftentimes consider EMEs' assets as an asset class by itself, opening the possibility of contagion among countries.

Allow me first to go back a few years to provide appropriate background. It is fair to say that in 2007-2008, when the global financial crisis erupted, EMEs were by and large well prepared. After many countries in this grouping suffered sequential crisis in the seventies, eighties and nineties, with huge economic, social and political costs, we learnt important lessons. These led to the adoption of key policy actions, of which I would like to highlight the following:

- The establishment of flexible exchange rate regimes;
- The enhancement of the degree of autonomy of central banks, with primary mandate of price stability. These led to a wide adoption of inflation targeting and probably more important for a number of countries, to the end of fiscal dominance;
- Consciousness about the relevance of fiscal discipline and the preservation of public debt sustainability;
- Deeper trade liberalization;
- Keeping up to speed in financial sector supervision and regulation, which has produced well-capitalized banking systems.

The result of this behavior was that most EMEs did not have any major economic imbalances in 2008. Previous to the global financial crisis, EMEs were not in the radar screen of vulnerable economies. In support of this claim, let me say that in October 2006, when I left the IMF to become Mexico´s Finance Minister, the main concern at the institution was that the number of countries under IMF programs had shrunk to an all-time low, generating concerns about the budgetary sustainability of the Fund!

Then September, 2008 arrived with the bankruptcy of Lehman Brothers, among other systemic financial institutions. The jolt to the world economy was immediately felt, through exacerbated financial volatility and a sudden collapse in world trade and economic growth. But EMEs recovered very quickly, as trade and growth bounced back in early 2009, with an almost generalized recognition of financial resiliency. Access to international financial markets was reinstated and no lasting consequences in local markets were apparent. Given the prevailing situation then in advanced economies, talk started about EMEs decoupling from advanced economies. In this context, many EMEs jumped into the bandwagon of trying to defeat the world's business cycle by implementing countercyclical fiscal and monetary policies – Mexico did not – , as advocated by fora like the G-20 and the IMFC. The consensus was that it was the turn of EMEs to become, at least in the foreseeable future, the main engine of growth in the world economy. My sense is that this was a premature conclusion.

Better growth and stability prospects in EMEs, combined with the understandable adoption of unconventional monetary policies in the main advanced economies, triggered massive capital inflows into EMEs. This phenomena was interpreted by many authorities as a ratification of the perceived economic strength of EMEs. For a while, those flows also reinforced the acceleration of growth in EMEs. In addition, China´s double digit growth, among other factors, provoked a significant spike in commodity prices, benefiting mostly EMEs. Taking all these elements into account, the perception for a while was that nothing could go wrong with EMEs.

But under the surface, problems were brewing. Massive capital inflows into EMEs persisted, fed primarily by carry trades explained supposedly by ex-ante uncovered interest rate arbitrage opportunities. Needless to say, this has generated asset mispricing in many EMEs, including excessive real exchange rates appreciations, and logically has opened the door for sudden capital flow reversals. In addition, the quick recovery in EMEs post 2008, the ample liquidity and opportunities for leverage, and the positive terms of trade shocks that were not taken advantage off to strengthen macrofundamentals, induced some countries to believe that they had some degrees of freedom in macropolicy management that they really did not have.

Almost a year ago, the global financial cycle was more clearly transmitted to EMEs, probably due to the fact that the process of policy normalization in key advanced economies, markedly in the United States, started. The beginning of the end of the era of low interest rates and ample liquidity, together with the correction in commodity prices that has followed the economic slowdown in China, has invited a reevaluation in EMEs prospects. As a result, vulnerabilities in economic fundamentals in several EMEs have been exposed, in particular in those with high levels of public and private leverage, which in turn have produced relatively high fiscal and current account deficits. Tighter financial conditions, together with the terms of trade corrections and the lasting real effects of prolonged and excessive currency appreciation, have been reflected in a widespread slowdown in EMEs economic growth.

To be sure, to have advanced economies, which represent approximately 50 percent of world’s GDP, growing below potential, has not helped EMEs growth either. So, with the benefit of hindsight, my estimation is that the hypothesis of "EMEs decoupling" was more a mirage than reality.

From a financial stability point of view, given these underlying conditions, the main risk for EMEs is to be confronted with sudden massive capital reversals, which so far have not happened; incipient reversals yes, but not massive. To address this issue, it is useful to try to identify which could be the triggers of perverse market reactions. There could be both domestic and external triggers. On the domestic side:

- Poor macroeconomic policy management, in particular if the objective is to artificially stimulate economic growth; and
- Concerns related to growing internal and external imbalances; for the latter not only the current account matters, but also the magnitude and composition of gross asset flows.

In turn, as external triggers we could have at least four:

- Abrupt changes in monetary policy in advanced economies;
- An interruption in the ongoing strengthening in the European Union;

- Contagion, given the interconnection in financial markets and the possibility of sudden rebalancing of investors' portfolios, and
- Geopolitical risks.

Therefore, from a political economy point of view, taking a perspective that goes beyond the domain of central banks, I would say that the main challenge for EMEs boils down to how to stimulate growth without compromising financial stability, facing at the same time an external environment plagued with uncertainties. The question then is, how to move forward?

One option would be to try to engineer some form of international coordinated policy response, bringing on board both EMEs and advanced economies. But at this stage, this option does not seem to be feasible. As the late Anna Schwartz used to say: "international policy coordination is a fair weather phenomena". Right now we don't have "fair weather", and I am not referring to New York City. Since 2008 we have had some policy coordination, mostly among central banks and financial sector authorities, but primarily to tackle specific vulnerabilities in global financial markets. The bottom-line is that EMEs should take policies in advanced economies as given. The governments of these economies have to deal with their own problems, which are not negligible. If they succeed, the world will be better off.

So EMEs have to find their own way out. In my mind, a three- pillar approach should be followed.

First Pillar. Strong macrofundamentals and policy settings are of the essence. Basically there is no room for poor fundamentals.

In particular, it is very important for EMEs to limit financial needs to what is feasible under stress scenarios. This calls for moderate fiscal policies and to use aggregate demand management to avoid large current account deficits. Monetary policy should concentrate in keeping inflation under control, since this is a prerequisite for the flexible exchange rate to be able to perform as a shock absorber. The domestic financial markets should be monitored with a hawkeye; early adoption of the enhanced regulatory regime produced under the auspices of the FSB and the Basel Committee should be pursed. On macroprudential policies, they might work under specific circumstances, but they are not substitutes for core policy actions.

Second Pillar. External sector resilience under stress scenarios should be a policy objective. This is very important to avoid capital reallocations resulting in bad equilibria in financial markets. So to start with a strong balance of payments is needed. Flexibility in interest and exchange rates, anchored by strong fundamentals, should be part of the adjustment process. But, given the sheer size of capital inflows to EMEs so far, this might not be sufficient. So to count with large international reserves and other forms of backstops, like the IMF's flexible credit line, is highly advisable. Also, the public and private sectors should pursue proactive debt management strategies, avoiding bunching of maturities, lengthening durations, and keeping an eye on foreign exchange rate mismatches.

Third Pillar. Promote economic growth by making the economy more competitive, increasing total factor productivity and thus potential GDP growth. This takes us down the road of structural reforms, which have huge potential in EMEs. This is the hard way to achieve sustainable GDP growth, but is the only reliable one that is left.

So, in summary, the first and second pillars are meant to guarantee financial stability, not necessarily inhibiting economic growth. The real lever for promoting growth lies in the third pillar. As the saying goes: plan for the worst, hope for the best.

Let me conclude by saying that I am an optimist, even though my remarks might not project that. As you know, we central bankers, by design, are overly cautious, and we are "worriers". All things considered, EMEs have sailed through the global financial crisis relatively well, notwithstanding the bumpiness in the ride. Required policy responses have been implemented on a timely basis in most cases, and the underlying fundamentals are still strong.

With regard to my own country, Mexico, I can say that we have in place a plan that fully complies with the three pillar approach I just presented to you. Macrofundamentals are in good shape, we have a strong external position, even under stress scenarios, and unprecedented structural reforms are under way.

All this, hopefully with stronger economic growth in the United States - our main trading partner - should allow us to preserve financial stability even under turbulent times, and increase gradually potential GDP growth to reach a level close to 5 percent at the end of President Peña Nieto´s Administration.

Thank you very much for your attention.