Policy challenges in a decelerating world economy

Remarks by

Manuel Sánchez

Member of the Governing Board of the Bank of Mexico

at the

Eighth China International Finance Forum

Pudong, Shanghai, China

September 25, 2011

It is a privilege to be back in this beautiful country to participate in the Eighth China International Finance Forum, put together this year with the suggestive theme of green finance development. I would like to thank the organizers of this conference for their invitation to share the podium with distinguished speakers who will address important issues related to the financial opportunities that will continue to support China's outstanding economic development.

On this occasion, I would like to discuss some of the policy challenges posed by the global economic situation and outlook. In particular, I am interested in assessing the recent poor performance of the world economy in order to identify possible underlying problems, which may help to design appropriate economic policy measures. I would also like to examine the implications of the weak world economic evolution for developing countries. Obviously, my comments are entirely my own responsibility and do not necessarily reflect the views of the Bank of Mexico.

The unusual recovery

As you know, since the middle of 2009 the global economy has been in a process of recovery from the deep contraction stemming from the great financial crisis. The improvement has been different from other modern business cycles, because among other factors, this time it has been notably slow and has not followed the typical "V" shape that tends to be sharper the deeper output falls.

The relatively weak world economic recovery has reflected an anemic turnaround of the advanced economies that were most affected by the financial debacle. Specifically, in the United States, the epicenter of the turbulence in 2007 and 2008, real GDP barely attained its pre-crisis level by the second quarter of 2011. Moreover, this indicator has remained well below the real value that would have prevailed if growth had kept up consistently with its secular trend of approximately three percent per year.[1]

The unsatisfactory behavior of industrialized economies was accentuated during 2011. GDP growth showed a declining path in the first half and several activity indicators suggest that this trend has worsened in the third quarter. Furthermore, consensus GDP forecasts for this and the following year have been successively revised downward, at least since last March. Although the world economy is still predicted to continue expanding, this is basically due to the higher expected growth momentum in emerging markets.

In particular, the United States and most advanced countries are expected to grow only modestly in the near future, and some analysts already estimate significant odds for an imminent or even ongoing recession in those economies. Although a global economic contraction is not the baseline scenario for most forecasters, the continuation of downward revisions to growth projections for advanced countries would definitively affect the economic prospects for the rest of the world.

[1] For an analysis of the current deviation of U.S. output from its secular trend and a comparison with that of the Great Depression, see Robert E. Lucas, Jr., "The U.S. Recession of 2007-201?", Milliman Lecture, University of Washington, May 19, 2011.

Possible explanations

What lies behind the disappointing upturn in industrialized economies? A striking feature of the weak and deteriorating nature of the recovery in these countries is that it has occurred in spite of unprecedented expansionary fiscal and monetary policy stances. Large public deficits have resulted from automatic stabilizer mechanisms as well as from special tax relief programs and higher government expenditures, including bailouts of troubled financial and non-financial institutions, aimed at stabilizing financial markets and promoting aggregate spending.

In addition, monetary policy has remained extraordinarily accommodative during recent years. Central banks from the main industrialized countries have combined remarkably low policy interest rates with an increase and change in the composition of their balance sheets. The leader in expansionary monetary policy has been the U.S. Federal Reserve, which has maintained the federal funds rate close to zero since the end of 2008, and has also implemented large purchases of government bonds and private financial assets funded through higher voluntary bank deposits during the last four years.

Among other objectives, through the purchase of financial assets, the Fed sought to meet the extremely high liquidity demand shown by the public during the financial crisis and, more recently, to lower long-term interest rates in order to stimulate private financing and investment. Other monetary authorities have implemented

similar practices. The European Central Bank has participated actively in the markets in an attempt to stabilize the sovereign bond prices of countries experiencing fiscal difficulties.

While the extraordinary actions undertaken by the Fed as a lender of last resort during 2008 appear to have contributed effectively to the normalization of non-bank financial markets, the impact of accommodation by this and other central banks on aggregate demand has been less clear. Questions arise in light of the ambiguous effects of monetary policy on long-term interest rates, the still weak credit channels of monetary policy transmission, and poor output performance and expectations. Similarly, the net effect of fiscal policy on spending may have been weak given that policy measures were probably perceived as temporary, potentially inducing savings in view of higher taxes expected in the near future to finance them. In any case, regardless of their actual effectiveness, the presence of highly expansionary fiscal and monetary stances suggests that the unsatisfactory recovery in advanced economies does not reflect a lack of stimulus measures.[2]

On the other hand, recent negative supply shocks have affected the performance of the world economy and particularly that of the United States. These shocks included bad weather, high oil prices which have partly reversed course, and the tragic events in

[2] Questions about the effects of monetary policy on aggregate demand are found in Frederic S. Mishkin, "Monetary Policy Strategy: Lessons from the Crisis," *NBER Working Paper* No. 16755, February 2011. For a discussion of the possible limitations of fiscal stimulus, see Robert J. Barro and Charles J. Redlick, "Macroeconomic Effects from Government Purchases and Taxes," *Quarterly Journal of Economics* 126(1): 51-102, February 2011.

Japan during the first quarter of 2011. Yet, independently of their importance, these events have been transitory and, therefore, the extent to which they explain the sluggish rebound of advanced countries since 2009 is necessarily limited.

The previous observations suggest the need to search for the existence of possible fundamental obstacles to a stronger economic recovery in industrialized countries. While in the current complex economic situation many factors certainly interact, some features stand out.

In particular, in the United States, there seem to be two important sources of growth-limiting factors. One is the sequel to the financial crisis summarized by the consumer debt overhang, slow debt restructuring and foreclosed home sales, and high risk aversion and contingent reserve provisioning by banks. The resolution of the problematic debt and credit legacy from the previous asset price bubble, as illustrated by the large number of households with negative home equity, is taking a long time, as seems to be the case in the aftermath of any big financial crisis. This impasse contributes to an explanation of the virtual stagnation of mortgage lending and residential construction in the United States.[3]

[3] Based on international experience, Reinhart and Rogoff found that deleveraging after big financial crises is a lengthy process and the resulting negative deviation from pre-crisis per-capita income typically takes more than four years. See Carmen M. Reinhart and Kenneth Rogoff, *This Time is Different: Eight Centuries of Financial Folly*, Princeton, NJ: Princeton University Press, 2009.

A second source of obstacles in the United States appears to be the unintended consequences from the corrective measures after the crisis, which might have resulted in heightened uncertainty. These actions include the discussions of eventual fiscal consolidation in terms of future higher taxes and expenditure cuts to confront the unsustainable path of projected public debt, and the implementation of new regulations to prevent financial crises. To some extent, this environment of uncertainty may have partly induced the recent reduction of producer and consumer confidence.

Additionally, the European Monetary Union (EMU) is severely affected by the fiscal fragility of some of its member countries, which since the financial crisis have exhibited sharp rises in their public debt-to-GDP ratios, with projected paths that are judged to be unsustainable. Some states have already received substantial financial support from the European community and the International Monetary Fund, and are implementing strict fiscal and structural adjustment programs. However, the perception of credit risk of the corresponding governments, as summarized in the spreads paid for credit default swaps, has continued to portray the deteriorating trend observed since 2010 and has reached worrisome levels.

Several concerns apparently lie behind market skepticism surrounding remedial actions in the EMU. One is the difficulty of resolving the troubled governments' debt burden through austerity programs and ever-increasing support funds. Another factor is the negative impact that the worsened public finances of any country can have on others within the Union, given the fact that their financial systems are interlinked and

their institutions, notably banks, are significant holders of government bonds. Contagion fears have spread to other regions outside the EMU, where financial intermediaries may also have substantial exposures to European sovereign bonds, either directly or indirectly. In the past weeks the urgency of finding a solution to these problems has become even clearer. Uncertainty on future developments in the Monetary Union hinders growth prospects in this area and fuels sharp volatility and an investor rush to safety, factors that have recently deepened in international financial markets.

Policy challenges

The existence of fundamental factors that, to a large extent, explain the meager growth of the world economy poses important challenges to policy makers. First, short-term economic policies are facing significant limits in advanced countries. The high and rising public-debt ratios in many economies call for substantial fiscal consolidation efforts in order to make public finances sustainable and, hence, supportive of financial stability and long-term growth.

Monetary policy is already extraordinarily accommodative, and authorities will need to continue monitor the anchoring of low inflation while at the same time remain ready to function as lenders of last resort to guarantee the integrity of their payment systems. As noted earlier, slow growth after the crisis seems not to reflect a lack of economic stimulus policies. Authorities should exercise caution in considering further

accommodative policies, as negative side effects on expectations could offset their intended benefits.

Second and, perhaps, more importantly, significant measures will have to be implemented in order to overcome the underlying difficulties that seem to explain low growth in industrialized countries. Obviously, the sooner these actions are taken the better, as the postponement of solutions may increase their cost. Given that public finances are at the root of problems in many advanced nations, fiscal reforms that reduce uncertainty and permanently enhance incentives toward productivity are necessary. Also, deregulation and better regulation that can make markets more efficient and amicable for innovation, investment, and hiring should take priority.

In the aftermath of the financial crisis, a crucial challenge will potentially be the design of programs to help the resolution of the consumer debt overhang in the United States and other countries, possibly through more expeditious restructuring and further bank balance-sheet cleanups, which, in turn, may reinvigorate the mortgage and housing markets.[4]

By far, the most serious task is the definitive solution to the fiscal difficulties of the vulnerable EMU member states, which implies imaginative plans needed for both debtors and creditors. The choices faced are certainly hard. The solution must

[4] For an interesting proposal to facilitate mortgage debt renegotiation in the United States, see Eric A. Posner and Luigi Zingales, "A Loan Modification Approach to the Housing Crisis," *American Law and Economics Review*, 11 (1): 575-607, 2009.

inevitably include adding capital to banks. However, these steps are a prerequisite for the stability of the financial system and the resumption of economic expansion.

Implications for emerging economies

The expected lower dynamism in advanced economies will necessarily limit growth momentum for the rest of the world. In particular, as was clearly shown during the great contraction of 2009, emerging economies will not be immune to the pressures faced by industrialized nations. The possible negative effects on specific emerging economies will necessarily be higher the more integrated they are with slowing economies.

For example, the Mexican economy is highly interrelated with that of the United States, especially through manufacturing production and trade. Although Mexico has recently fared well in terms of external demand, in part because of gradual geographic diversification, dampened activity in the United States is already affecting Mexican growth performance and forecasts.[5]

Despite these constraints, emerging economies are in a better situation than those of advanced countries. Largely as a result of the lessons learned from previous crises, in general, most of these economies have maintained relatively strong public finances

[5] From February to September of 2011, Blue Chip growth forecasts for 2011 and 2012, respectively, fell from 4.4 and 4.1 to 3.8 and 3.0 percent in the case of U.S. industrial production, and from 3.9 and 3.8 to 3.9 and 3.5 percent for Mexico's GDP.

with reduced exposures to foreign currency liabilities. Additionally, regulation and supervision and the business models of financial intermediaries have improved substantially. As a consequence, financial systems showed a high degree of resilience during the great international turmoil and thus far have remained sound.

Hence, from the point of view of their fundamentals, developing countries should likely continue to be a positive factor for global economic growth. This is all the more important, as now the emerging economies account for almost half of world GDP. Within this contribution, China is expected to maintain its key role as an engine of global economic expansion.

The favorable contribution of developing nations to the world economy will require that these countries continue profiting from their own experience and that of advanced nations. In particular, exceptionally expansionary policies have been a response to serious drawbacks in developed countries and may involve unknown future costs. To the extent that such difficulties are absent in emerging economies, they do not need to take these risks. Although inflation remains relatively contained, in some developing countries there are signs of overheating. Thus, monetary authorities will have to continue monitoring inflationary pressures to act appropriately. In short, the maintenance of price stability, strong public finances, strict prudential oversight of financial systems and openness to international trade continues to be the safest road to growth in emerging market economies, especially during these volatile times.

Concluding remarks

The lackluster economic performance of advanced countries, which largely explains the weak upturn of the world economy from the great contraction, does not seem to reflect a lack of stimulus policies or just the influence of temporary events. The anemic growth has been a lasting phenomenon which reveals deep factors that fuel uncertainty and pessimistic expectations. The main contributing elements include the consumer debt overhang and unintended consequences from corrective measures after the financial crisis in the United States, and the worsening fiscal and financial troubles in the EMU.

The root causes of the deceleration of advanced economies pose significant challenges for policy makers. Their response will certainly imply hard choices that need to be made in a timely way in order to avoid aggravation. In this context, while they will not be decoupled from the developed countries, emerging economies will continue to face relatively better conditions for growth, provided that solid economic fundamentals are maintained.