REMARKS BY JAVIER GUZMÁN CALAFELL, DEPUTY GOVERNOR AT THE BANCO DE MÉXICO, AT THE PANEL ON "SETTING THE SCENE: THE INTERNATIONAL LANDSCAPE AND DIRECTION OF THE GLOBAL ECONOMY". SCOTIABANK/OMFIF (VIRTUAL) SEMINAR "CANADA, THE AMERICAS AND THE GLOBAL ECONOMY: INVESTING IN AN INTERCONNECTED WORLD", October 13, 2020.[1]

I appreciate the invitation to participate in this panel.

After having posted during the first half of this year what probably is the sharpest contraction since the Great Depression, the global economy has begun a gradual process of recovery. In addition, positive economic surprises over the summer, especially in advanced economies (AEs), have led to a slight improvement in the outlook for 2020-2021, with a less severe decline expected for this year, to be followed by a somewhat less vigorous bounce next year. It should be noted, however, that although improving, global economic activity remains very weak and an extraordinary level of uncertainty surrounds the baseline scenario, as the COVID-19 pandemic is still unfolding.

In the specific case of emerging market and developing economies (EMDEs), notwithstanding a slight downward revision in the growth forecast for 2020, the nearly twice-as-large rebound expected for 2021 gives the impression of a reasonable overall outlook for this year and the next. Nonetheless, caution is called for when looking at projections for this group of economies as a whole, as they mask salient divergences and a high degree of heterogeneity in terms of individual economies' and regional performance. For instance, if China is excluded from the calculations, the remaining EMDEs are expected to contract

[1] The views and opinions expressed in this document are the sole responsibility of the author and do not necessarily represent the institutional position of the Banco de México or of its Governing Board as a whole.

much more severely this year, and the subsequent rebound would be insufficient to recover the lost ground. The case of Latin America is illustrative in this regard, with a GDP fall of 8.1 percent anticipated for 2020 and a modest 3.6 percent expansion in 2021.[2]

The above-noted divergences in the trajectory of the individual economies owe to a wide array of factors. The evolution of economic activity seems to correlate highly, on the one hand, with the results of the measures implemented to cope with the pandemic and, on the other, with the nature, timeliness and overall effectiveness of the stimulus policies to support it. Naturally, said divergences are also shaped by compounding structural characteristics, such as, for instance, the importance of the services sector, particularly tourism and hospitality at large, in terms of both output and employment, as well as the size of the economies' informal sector, their reliance on revenues from commodities for balance of payments and fiscal purposes, and their openness to trade and financial flows.

It is important to underline that the challenges posed by the pandemic are far more complex in EMDEs than in their advanced counterparts. This is the result of a combination of factors:

a) Initial conditions are more precarious in EMDEs in a number of areas, as denoted, for instance, by frequently insufficient, underfunded and readily overloaded public health care systems; deficient, or in many cases virtually non-existent social safety nets, which fail to provide the formal support and the degree of certainty required for individuals to face the consequences of

[2] International Monetary Fund (2020): "World Economic Outlook", 13 October.

the shock; and less solid financial systems which, in spite of the accommodative monetary policy stances and additional support measures implemented by their central banks and financial authorities, are more likely to actually tighten the credit conditions faced by local households and firms.

b) Further to the pandemic-related supply and demand disruptions, which of course are common to AEs as well, EMDEs face a number of additional shocks whose severity has the potential to inflict considerable damage. Chief among these is the financial challenge represented by the massive retrenchment of portfolio capital flows recorded during the early stages of the pandemic which, despite some recent recovery, remain of a speed and magnitude unrivaled by other sell-off episodes in recent years and have actually persisted in some instances. In addition, the fall in external revenue from tourism and commodity exports due to both quantity and price effects is also worth noting. Thus far, revenues from remittances in many EMDEs have remained resilient despite the pandemic, but the risk of deterioration remains, particularly given the weakness of labor markets in host countries, and as employment protection schemes and unemployment benefits in these economies are rolled back or withdrawn.

c) The overall policy space available to adequately respond to the situation is more limited in EMDEs. This is particularly the case in the fiscal arena as, notwithstanding the additional short-term space that may be provided by lower interest rates, many of these economies show high levels of public –and private– debt, relatively low tax revenues, or other fiscal challenges. Naturally, under these circumstances tighter financing constraints have been more binding for the deployment of emergency spending and tax relief measures.

Monetary policy has stepped forward to dampen the impact of the associated shocks and support economic activity and financial markets, including through unconventional measures. However, in light of potential implications for inflation expectations in countries with complicated inflationary records, concerns about the sensitivity of foreign capital flows to interest rate movements, and in some cases a net inflationary impact of the pandemic, at least in the short term, the margins of maneuver for this policy lever will normally not be as ample as in AEs.

In this context, limits for the implementation of expansionary demand management policies in some EMDEs may have already been reached. Furthermore, the much-justified support measures being deployed at present have implications that will have to be dealt with at a later stage, chief among them the resulting deterioration in fiscal positions and associated risks. This will probably complicate matters further for many EMDEs.

d) In contrast to previous experiences, the current crisis is not the outcome of macroeconomic imbalances derived from policy mismanagements. To be sure, there are pre-existing vulnerabilities that have surfaced more evidently, but the fact that the source of the shock is exogenous and that its aftermath is taking place in the context of financial systems that are inherently less fragile than in past decades, certainly feed the temptation to anticipate a swift recovery.

However, the reality is that the effects of the shock beyond the short term are largely unknown. To begin with, the outlook and timeline for the development of a vaccine and/or effective therapeutic treatments remain highly uncertain and prone to setbacks. Moreover, even in a scenario in which a vaccine is successfully developed, production at the required scale and its subsequent distribution may face delays and bottlenecks that limit its availability, while the probability that ample sectors of the population show reluctance to be inoculated in view of opaque testing and approval procedures, or for other reasons, cannot be disregarded. The consequent persistent fears of contagion, coupled with weak labor markets and a situation of high uncertainty, could limit the recovery of consumption and investment. In short, even with a vaccine at hand, the possibility of subdued, protracted, and uneven recoveries is a real one.

Should scenarios of this type materialize, adverse long-term effects on growth can ensue. More tangibly, prolonged spells of depressed investment and high unemployment may impinge on the economy's productive capacity through, respectively, their negative effects on the stock of physical capital and the labor force, including in the case of the latter via hysteresis effects. In addition, in an environment of a sharp short-term contraction of economic activity and fragile levels of confidence, many firms will not be able to survive. Increased bankruptcies can inflict additional long-term damage to the economy.

Simultaneously, our economies' productivity may be hampered via lower investment in both physical and human capital –with the latter aggravated by school closures-, and the reallocation of resources to strengthen workers' safety and firms' financial positions. Other possible avenues include the higher survival of otherwise unviable (i.e. "zombie") firms due to extended policy support, as well as negative feedback loops between the financial sector and private firms, that obstruct an adequate functioning of the system´s resourcechanneling role. Meanwhile, new equilibria arising from permanent or persistent changes in human and firm behavior (e.g. social and economic arrangements with less built-in interactions, higher savings rates due to precautionary motives, reduced international travel, reconfiguration of value chains, etc.) may further drag on long-term growth.

While the possibility of lower potential rates of growth as a result of these factors encompasses both AEs and EMDEs, for obvious reasons the risks are much higher for the latter.

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To sum up, it is clear that the costs, both actual and potential, in the short as well as in the long run, derived from the COVID-19 pandemic are enormous. Furthermore, the humanitarian and social tolls cannot be overlooked. For instance, recent World Bank estimates predict that the extreme poverty headcount will increase by up to 150 million people worldwide by next year relative to pre-pandemic projections.[3] As a result, income inequality, which had already shown a significant increase prior to the crisis, will inevitably display a further deterioration.

In light of the above, firm, carefully designed, comprehensive, and timely implemented national policy responses are of the essence. This should include a meticulous evaluation of the strategies adopted by those countries that have successfully contained the pandemic. Naturally, even the best of efforts

[3] World Bank (2020): "Poverty and Shared Prosperity 2020: Reversals of Fortune", 7 October.

exerted from the part of individual societies will be insufficient to achieve first-best outcomes globally against this common challenge.

Therefore, a complementary, concerted and multipronged cooperative approach from the international community is of utmost importance. This includes efforts both to ensure a global health policy response to the pandemic, and to digest the lessons learned from this experience to minimize the damage of similar episodes in the future. But in view of the challenges, cooperation is required well beyond the area of health. Indeed, the future path of many countries, especially among the EMDE group, will crucially depend on the expedite availability of emergency liquidity provision and, more generally, of adequate external financial support, as well as open borders to trade and investment flows.