Global Financial Stability and the Challenges of Countercyclical Policies
Manuel Sánchez, Member of the Board
The XXVII Meeting of the Central Bank Governors’ Club of Central Asia Black Sea Region and Balkan Countries, Baku, Azerbaijan, May 12, 2012
Contents

1 Extraordinary measures for extraordinary times

2 Rethinking regulation

3 Fortunes and perils for emerging markets

4 Mexico’s experience with the global crisis
The depth of the successive crises during the last five years has required extraordinary policy responses.

Bank insolvency risk indicator*
Basis points

Credit Default Swaps
5 years, basis points

* Spread between the Libor and three-year overnight indexed swap (OIS) rate
Source: Bloomberg
... to stabilize the world's financial markets and cushion the fall of output

**World Merchandise Exports**

*In billions of dollars per month*

![Graph of World Merchandise Exports]

Source: CPB Netherlands Bureau for Economic Policy Analysis (CPB)

**GDP**

*Annual change, %, s.a.*

![Graph of GDP]

Source: BEA and Eurostat
Actions undertaken in the U.S. have been effective at avoiding a global financial collapse

- Measures
  - Ample liquidity provision
  - Extraordinary monetary accommodation
  - Bail-out programs for troubled financial and nonfinancial institutions
  - Fiscal expansionary actions

- Results
  - Gradual normalization of credit markets
  - Recovered strength for financial institutions
  - Economic upturn underway and deflation avoided
... notwithstanding crucial pending tasks in that country

- GDP needs to return to its long-term trend
  - Job recovery weak
  - Housing and mortgage markets stagnant
  - Private-sector balance sheet adjustment insufficient
- Long-term fiscal consolidation plan missing
  - Rising entitlements unsustainable
The fiscal and financial complications in the EMU have similarly called for strong policy measures

- **Actions**
  - ECB
    - Asset purchases in market
    - Increasing liquidity provision to financial institutions
  - Support packages for the government debt of certain countries
  - Rescue and stabilization funds

- **Results**
  - Collapse has been averted
  - The Euro area has held together
... although significant obstacles still need to be overcome

- Skepticism over long-term fiscal consolidation plans
- Tensions between needed austerity measures and growth
- Increasing market expectations about size of firewalls
- Banks’ rising loan-losses, deleveraging needs and capital requirements
- High funding costs and liquidity pressures faced by banks
- Lack of competitiveness
Exceptional countercyclical policies in advanced countries were necessary but created some problems

- Significant weakening of public finances and heavy debt burdens
- Perils from unprecedented monetary accommodation
  - Untimely exit
  - De-anchoring of inflation expectations
- Moral hazard
Contents

1. Extraordinary measures for extraordinary times
2. Rethinking regulation
3. Fortunes and perils for emerging markets
4. Mexico’s experience with the global crisis
The crises have required us to thoroughly diagnose the causes of the problems and how to prevent them

- Possible explanatory factors include\(^1\)
  - Misguided economic policies favoring risk-taking
  - Regulatory and supervisory pitfalls
    - Lack of focus on systemic risk
    - Regulatory and supervisory forbearance
- The rethinking has implied
  - The emergence of a macroprudential approach
    - The microprudential approach was deemed inadequate
  - A trend towards re-regulation

The macroprudential approach has built on previous regulatory developments

- Basel III on Basel II on Basel I
  - Leverage ratio and capital enhancement with countercyclical elements
  - Provisioning based on expected losses
  - Liquidity standards
- Widening regulatory perimeter and monitoring shadow banking
- SIFIs, stress tests and expedient resolution mechanisms
- Other issues include narrow banking, consumer protection, restrictions on pay and role of rating agencies
- Emphasis placed on rules though some discretion contemplated

The regulatory reappraisal poses fundamental challenges and risks

- Challenges
  - Measure systemic risk
  - Detect problems and react in time with appropriate tools
  - Coordination among authorities
  - No guarantee that financial crises will disappear\(^1\)

- The central danger is overregulation with possible negative consequences on financial intermediation and economic growth
  - Regulatory circumvention
  - Hindrances to financial innovation
  - Financial repression

## Contents

1. Extraordinary measures for extraordinary times
2. Rethinking regulation
3. Fortunes and perils for emerging markets
4. Mexico’s experience with the global crisis
Unusually low interest rates in developed nations help explain large capital inflows to emerging markets

Source: EPFR
... driving up the prices of financial assets
... and commodities, giving rise to highly interventionist policies

**Commodity Spot Price**

1967=100

- All Commodities (CRB)
- Raw industrial
- Food
- Fats and oil
- Metals (right)

**Crude Oil Price**

Dollars per barrel

- Brent
- WTI

Source: Bloomberg

Global Financial Stability and the Challenges of Countercyclical Policies
Emerging economies have long used discretionary countercyclical tools that pose challenges

- Mitigation objectives\(^1\)
  - Credit growth
  - Leverage
  - Liquidity risk
  - Capital flows and currency fluctuations

- Challenges
  - Knowledge of the policy-maker assumed to be substantial
  - Evidence of tools’ effectiveness is preliminary
  - Possible time inconsistency
  - Costs imposed on the financial system and economic efficiency
  - Moral suasion: a preferable alternative to quantitative tools?

---

Contents

1. Extraordinary measures for extraordinary times
2. Rethinking regulation
3. Fortunes and perils for emerging markets
4. Mexico’s experience with the global crisis
In Mexico, the recent crises resulted both in temporary financial volatility and lower output.

**EMBI**

Basis points

**GDP**

Annual change, %, s.a.

Source: JP Morgan

Source: INEGI and BEA
Mexico’s policy response to the U.S. financial turmoil was guided by cautiousness

- The financial shock was basically handled with the use of transitory FX interventions and special liquidity provisions
- The response to the real economic shock was conservative, given that the key trigger came from the U.S.¹
  - Fiscal deficit slightly increased
  - Moderate interest rate cuts
- As a result
  - No legacy of a public debt problem
  - No monetary exit challenge
- Public debt and inflation remained low and the banks’ balance sheets strong

¹/ See Banco de México (2009), Financial System Report 2008, pp. 45-46
The crisis also led to several domestic macroprudential initiatives

- Higher accumulation of international reserves
- Further strengthening of the financial system
  - The banking system was well capitalized and relied on conservative business models
  - Some measures
    - Forward-looking provisioning regime
    - Stricter limits on lending to related parties
- Mexico’s Financial System Stability Council
  - Identifies systemic risks and proposes policies and solutions
Mexico’s perceived risk is currently lower than that of some developed countries.

Credit Default Swaps
5 years, basis points

Source: Bloomberg
Recent volatility derived from EMU problems has shown up mostly in exchange-rate fluctuations

- The flexible exchange and interest rates act as shock absorbers
- The FX market is highly liquid and the peso is used as a hedge currency
- The search for yield has favored the peso market
  - Unprecedented holdings by foreign residents of Mexican public debt denominated in pesos
- Some volatility probably stems from uncertainty about the U.S. economic recovery and fears of problems in Spanish banks with subsidiaries in Mexico
There are some risks to Mexico’s financial system that bear careful monitoring

- Risks arising from abroad
  - Deterioration of the world economy
  - Spillovers from a worsening of the European scenario
  - Sudden capital stops and reversals

- Domestic vulnerabilities
  - Bank industry highly concentrated
  - Some lending portfolios carry a heavy weight of loans to subnational governments
  - Some banks exposed to liquidity risk if faced with higher market volatility
Final remarks

- Recent severe crises have required sound policy responses
- U.S. reactions effective but incomplete, while European countries still must overcome important fiscal and financial obstacles
- Developed-country policy responses have given birth to new risks, and macroprudential measures pose new challenges
- Some nations have reacted to the threat of further asset bubbles with interventionist policies
- Mexico’s response to the crises has been adequate but strengthening of the financial system is a continuous endeavor
Mejoran las perspectivas económicas mundiales