REMARKS BY JAVIER GUZMÁN CALAFELL, DEPUTY GOVERNOR AT THE BANCO DE MÉXICO. PANEL ON "END OF QE AND RISING INTEREST RATES: IMPLICATIONS FOR ADVANCED AND EMERGING MARKET ECONOMIES". UBS 24TH RESERVE MANAGEMENT SEMINAR. Thun, Switzerland, June 26, 2018.[1]

I am very glad to have the opportunity to participate in another UBS Reserve Management Seminar. I thank the organizers for their kind invitation.

Over the several years that have followed the outburst of the Global Financial Crisis (GFC), Emerging Market and Developing Economies (EMDEs) have been able to sustain a satisfactory pace of expansion, with 2018 expected to record the third consecutive year of accelerating activity.

The expansion of EMDEs has been partly nurtured by the aggressive relaxation of monetary policy stances in the Advanced Economies (AEs), which implied a significant easing of external financial conditions, as evidenced by the vast amounts of international funds made available to emerging markets at historically low costs. For instance, bond spreads on EMDE sovereign debt were around 137 basis points lower in 2010-2018 than in the years preceding the GFC.

Given the prolonged period over which such a situation was sustained, as well as the magnitude of the adjustment needed to accommodate the surge in global liquidity, it comes as no surprise that this phenomenon has given rise to a gradual, albeit significant, buildup of vulnerabilities in the global economy and financial system. In fact, since the early stages of this process, warnings

[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 Board of Governors as a whole.

have been made about its likely pernicious effects on the performance and stability of EMDEs and their financial markets, including through the potential acceleration of domestic credit cycles and appreciation of local asset prices (notably exchange rates) beyond what fundamentals would suggest. Thus, challenges have emerged as this process is reversed.

Since the onset of the global market correction of mid-April this year, the accumulated portfolio flows (in both equity and debt) of foreign capital to emerging markets have been negative. Portfolio flows exiting EMDEs amounted to USD 17.1 billion over the 40-day period that followed the start of the event, a figure comparable in magnitude to that observed in the equivalent period after the 2013 "taper tantrum" and the 2016 US presidential election (USD 18.7 billion and USD 18.8 billion, respectively).[2] Furthermore, continuing with the deceleration that has been registered since 2011, foreign direct investment (FDI) inflows to EMDEs declined from 2.0 percent of GDP in 2016 to 1.8 percent in 2017, and a further reduction, albeit marginal, is expected this year.

This has been the result of an atmosphere of uncertainty and a consequent higher perception of risk deriving from a combination of factors.

To start with, the withdrawal of monetary stimulus in the US and other AEs, either through the unwinding of their heavily-expanded balance sheets or hikes in their reference rates, is exerting upward pressures on international interest rates at all maturities. The situation is considered as particularly

[2] These figures pale in comparison to the portfolio outflows recorded during the GFC, at nearly USD 150 billion between the third quarter of 2008 and the first quarter of 2009.

perilous since the tightening of monetary policy in AEs may proceed at a faster pace than currently anticipated by market participants. This is especially the case of the United States, where fiscal stimulus measures are being implemented in an economy that appears to be operating at, or very close to, full capacity. In this context, any direct benefit to commodity-exporting EMDEs of the recovery of commodity prices would be partially offset, as this would also exert additional pressures on inflation in AEs.

Upward pressures on interest rates in the United States have been accentuated by the rapid widening of the fiscal deficit in this country. In fact, a number of analysts have noted that both the government's increased borrowing and the expected increase in public debt are already increasing long-term interest rates. The deficit of the Federal Government is projected to rise by 3 percentage points of GDP from 2015 to 2022, and remain at elevated levels thereafter. Consequently, the upward trend of public debt would accelerate over the next decade, to 96.2 percent of GDP by 2028, nearly 20 percentage points above the level recorded last year.[3] Notwithstanding the short-term boost of these measures to economic activity, their potential to accentuate vulnerabilities in both the US and the global economy is substantial. In addition to the already mentioned challenges, the risk of a future recession in the US cannot be discarded as the effects of the current stimulus fade and the need for a fiscal correction accentuates.[4]

[3] Congressional Budget Office (2018): "The Budget and Economic Outlook: 2018 to 2028", 9 April.
[4] International Monetary Fund (2018): "United States of America: Staff Concluding Statement of the 2018 Article IV Mission", 14 June.

As a result of the above, and of other concurrent forces, long-term interest rates in the US have recently displayed a marked, and generalized, upturn. For instance, the yield on 10-year US Treasury bond has shown an increase of about 160 basis points from a record low of just 1.37 percent nearly two years ago. Although part of the adjustment associated to the electoral process of 2016 reverted in subsequent months, the above-noted upward trend in long-term yields resumed in September last year. Since then, they have increased by nearly a full percentage point. To add some perspective to these developments, the corresponding figure during the "taper tantrum" episode of 2013 amounted to some 130 basis points between May and September of that year.

Not surprisingly, under a situation of pressures on interest rates from several sources and a general environment of uncertainty, concern about the potential decompression of term and other risk premia has increased. Although a misalignment of term premia with economic fundamentals in the United States is far from evident, the possibility of a sudden, significant tightening of financial conditions is clearly present given the sensitivity of those premia to expectations about inflation, growth and monetary policy.

The observed increase in interest rates in the United States, the prospects that this trend will continue during this year and the next, and the materialization of a higher risk-aversion environment, have led to an appreciation of the dollar. In fact, since mid-April of this year emerging market currencies have shown a generalized weakening. Naturally, the accompanying risks are particularly manifest in those countries with a disproportionately large share of foreign currency liabilities, currency mismatches and other vulnerabilities.

Uncertainty in the world economy has also been significantly affected by the rising trend in trade protectionism. In addition to adversely affecting resource allocation and economic activity, this may have an impact on confidence. According to recent estimates, an escalation of tariffs up to legally-allowed rates could translate into a decline in global trade flows of around 9 percent, a drop similar in magnitude to the one recorded during the Global Financial Crisis of 2008-2009.[5] Other factors that have impinged on the perception of risk include geopolitical tensions, notably in Asia and the Middle East, as well as recent and upcoming electoral processes, both in advanced and emerging market economies, given their potential implications for global economic integration. As per some measures, economic policy uncertainty has continuously increased during 2018, although it is still below the historical maximum reached in 2016.[6]

Going forward, there is little doubt that external financial conditions faced by EMDEs are set to tighten further. Obviously, projections for capital flows to these countries in the next couple of years are subject to a lot of uncertainty. However, recent estimates by the IMF provide an idea of the challenges faced. According to this institution, portfolio inflows to emerging markets would decline by about USD 40 billion on average per year over 2018-2019 under a smooth Fed normalization scenario, and by up to USD 60 billion if policy tightening were to be accompanied by a rise in risk aversion.[7]

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[5] Kutlina-Dimitrova, Z., and C. Lakatos (2017): "The Global Costs of Protectionism", World Bank Policy Research Working Paper No. 8277, December.
[6] World Bank (2018): Global Economic Prospects, June. This and other related indexes can be obtained from: http://www.policyuncertainty.com/.
[7] International Monetary Fund (2018): Global Financial Stability Report, April.

Naturally, a substantial degree of heterogeneity underlies these projections, as global investors can be expected to differentiate amongst individual countries depending on the strength of their economic fundamentals. Indeed, a number of EMDEs took advantage of benign conditions in international financial markets to move in this direction. However, it is also true that even for these economies the outlook may prove to be challenging in view of the following:

- A decompression of term premia in the United States may have important global ramifications, given their close correlation with those in other major advanced economies.
- A significant overvaluation of risky assets across a wide spectrum of market segments is observed.
- Recent structural changes and rapid growth in the asset management industry may be leading to an underpricing of liquidity risks, increased interconnectedness and, in general, accentuate financial stability challenges.
- Crossover investors not specialized in emerging economies have enlarged their presence in the markets for these countries' instruments, thereby increasing the potential for wide fluctuations in these assets' prices.
- For the already noted reasons, the balance of risks for the world economy is clearly tilted to the downside, especially in the medium and long terms.

One must add to the above the emergence of vulnerabilities in a number of EMDEs. One of the most important among them is the protracted rise of debt owed by these countries, which has been heavily concentrated in, and thus largely driven by, their non-financial corporate sectors. Although the situation varies considerably from one country to another, non-financial corporate debt in EMDEs as a group is at present comparable in magnitude to that of these countries' sovereigns as, by some accounts, it has risen from about 60 percent of GDP in 2006 to 86 percent in 2017, reaching an all-time maximum at levels considerably above pre-crisis levels. Although the bulk of the increase is explained by China, whose corporate sector debt rose from 107 to 163 percent of GDP during the same period, a similar trend is observed in many other EMDEs.[8]

The increased leverage of EMDE non-financial corporates acquires particular relevance as a source of concern for at least a couple of reasons. First, global factors (such as low interest rates and compressed risk premia) have been more important drivers of this development than firm- or country-specific ones.[9] Second, the contribution from foreign currency-denominated debt has been sizable, at around half of the observed growth since 2010.

Thus far, notwithstanding the generalization of financial volatility among EMDEs, the presence of severe problems has been concentrated in a few of them. Overall, international institutions remain relatively optimistic about the

[8] International Monetary Fund (2018): "The Riskiness of Credit Allocation: A Source of Financial Vulnerability?", Chapter 2 of Global Financial Stability Report, April; and World Bank (2018): "Corporate Debt: Financial Stability and Investment Implications", Special Focus 2 of Global Economic Prospects, June.
[9] Ayala, D., M. Nedeljkovic and C. Saborowski (2017): "What Slice of the Pie? The Corporate Bond Market Boom in Emerging Economies", Journal of Financial Stability 30:16-35.

prospects for the group in coming years. For instance, in its baseline scenario, the IMF is projecting growth in EMDEs in the medium term at close to the levels observed in 2018-19.[10] However, it is clear that these projections are surrounded by considerable uncertainty. Furthermore, even in the absence of a major disruption to world economic activity, average potential growth in EMDEs over the next decade is expected to be slower than during 2013-17.[11]

What should EMDEs do?

In my view, the adage "there are no easy answers but there are simple answers" seems to apply, underscoring the appropriateness of looking at what we have learnt from the past and putting into practice the lessons from episodes such as the GFC. Indeed, most of the conclusions derived from these experiences remain valid today, i.e. strong macroeconomic foundations, solid financial systems, flexible policy frameworks and a firm basis for sustained growth are the best antidote to an adverse external environment. In fact, the current episode of volatility is once again showing that rather than looking for magic formulas, countries should concentrate on meeting these requirements. Furthermore, the need to adhere to this path is far more evident at present, since the complexities of external conditions, if anything, are likely to accentuate in coming years.

Having said this, it is also clear that the responsibility for overcoming the current difficulties, and more generally for ensuring a healthy evolution of the world economy, does not lie on EMDEs only. In fact, we should bear in mind

[10] International Monetary Fund (2018): World Economic Outlook, April.
[11] World Bank (2018): Global Economic Prospects, June.

that the challenges faced by the world economy today are mostly a result of actions undertaken in AEs. Indeed, these countries have a fundamental responsibility in ensuring that their monetary policies are properly implemented and communicated; in avoiding inadequate fiscal-monetary policy mixes; in adopting any measures needed to increase productivity and the potential for growth; in properly taking into consideration the international repercussions of their policy actions in the monetary and other fronts; and in leading by example to continue with the push towards a more integrated world economy. In the face of financial turmoil resulting fundamentally from policy measures in the AEs, like the current one, it could hardly be argued that the implications of such actions should not be exaggerated.