Commencement Address

by

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Thank you, Executive Vice Chancellor Peter Cowhey, Acting Dean Gordon Hanson, faculty, parents, spouses, partners, children, friends, and members of the Class of 2017. It is an honor to celebrate with you today. To you, Class of 2017, my warmest congratulations and heartfelt good wishes. As we say in Mexico, *Muchísimas felicidades.*

Not only have you earned your degree from this distinguished program in a world-class university; you have been living and studying in a very beautiful, unique place in North America and indeed, the world: this dynamic, vibrant, multicultural and international metropolitan area on the Pacific Rim, at the western extreme of the nearly 2,000 mile-long U.S.-Mexico border.

May you have long and successful careers as policymakers.

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You just finished your degree, and you have a state-of-the-art toolkit to go into the real world and contribute towards making it a better one. So you are in top shape, ready to go.

Since the day I last wore a cap and gown, I been in some way involved in making or influencing economic, fiscal, and, above all, financial and monetary policies, both at the national and international levels. And if there is one thing I have learned about policymaking, it is respecting the life-cycle of policies.

We can think of a policy life-cycle as a sequence of stages: conceptualization and design; formalization, for example through a legislative process; implementation; evaluation and maintenance; and finally, adjustment. Usually the first three stages are the most exciting and the ones that garner the most attention. But the last two stages, evaluation and maintenance and adjustment, are the most critical to long-term success.

In other words, once a policy has been formulated and implemented, over time, responsible policymakers must remain both vigilant and flexible—to be willing to take a wrench to it. We must be more than just the makers of policy; we must also supervise policies and, as needed, adjust them. Without an appreciation for the life-cycle of a policy, it becomes easy to take its early successes for granted.

And this is a typical and very serious mistake.

Public policy can and should help people live better lives. What are the best policies? That is not so much the question I want to address today, although I will say something about it, but rather, that as policymakers we must recognize the reality that time changes many things. Unintended consequences of policies may become apparent. Over time, there may be new priorities, new perceptions, new paradigms. New constraints. A new generation with new concerns.

We might think of any given policy as a house. The roof might leak. The electrical wiring may need updating. Maybe the family grows and needs more rooms—maybe there needs to be a whole new floor.

In the real world, this one that has given me so many grey hairs, there is no perfect policy. But there are many policies that are good, and that can be made better. Much better.

I would like to share with you three examples.

First: Globalization and the North American Free Trade Agreement

In the many decades after World War II, in what is often called the *Pax Americana*, the world's economies experienced a wave of globalization. This was largely because the victors in that war, the United States and its allies, rather than further weaken their already defeated enemies, as might have been expected, they sought something better, something of a higher, more noble spirit. In concrete terms, they decided to seek greater free trade and greater financial integration through international cooperation, following a rules-based approach.

In 1944, with the end of that terrible war in sight, the United States and forty-three other countries including Mexico sent delegates to the resort town of Bretton Woods, New Hampshire to iron out the founding agreements for what are known as the Bretton Woods Institutions. These multinational institutions include the World Bank, the International Monetary Fund, and the World Trade Organization (previously known as GATT).

This goal of shared prosperity through peaceful cooperation was also the impetus for the European Union, which began as a plan to avoid another European bloodbath by intertwining the economies of France and Germany.

In the broad scheme of things, this post-World War II decades-long wave of globalization has led to large cross-country capital and foreign direct investment flows. Many countries have reaped the gains from trade through the more efficient allocation of resources that results when they can exploit their respective comparative advantages.

For developing countries this wave of globalization has also meant greater access to skills and technology, and this has prompted the modernization of many regions, including much of South East Asia and Latin America.

Recent decades have also seen the fall of the Berlin Wall and the breakup of the Soviet Union, bringing much of Eastern Europe into global economic networks.

We have witnessed the spectacular rise of China as an economic superpower. Most of the clothing most of us are wearing today is probably made in China. Perhaps your shoes, your wallet, your watch, and your smartphone. That so many things would have been made in and imported from the Peoples Republic of China would have been unthinkable as late as the early 1980s, when I was in graduate school.

From a global perspective, in this period of the *Pax Americana* we have seen a dramatic decline in extreme poverty.

Another trend in the post-war decades that is easy to miss, for we can always find flaws—certainly they have them—these multinational Bretton Woods institutions have played an important role in promoting better governance throughout the world by emphasizing the need to foster strong and legitimate institutions, to hold policymakers accountable, and to make the policymaking process more transparent.

For example, one of the three main roles of the International Monetary Fund is surveillance of the economic, financial, fiscal, and external situations of its member countries. This is done periodically through peer review exercises, each one concluding with recommendations that it continues to monitor.

This grand arc of the post-World War II period, this *Pax Americana*, has also seen the astonishing growth of international trade. On the one hand, with greater trade consumers and workers have benefitted all over the world.

I share the strongly held view that free trade among countries contributes to faster economic growth and greater aggregate well-being. However, it is evident that in any given country not all members of society benefit from freer trade. In an ideal world, through appropriate policymaking, there would be schemes of compensation so that everyone might be satisfied. But the honest truth is that there are no examples of a seamless compensation processes. Therefore, we periodically hear the voices of those who have been left behind.

As I said, once a policy has been formulated and implemented, over time, responsible policymakers must remain both vigilant and flexible. We must evaluate policies and, as needed, adjust them.

The North American Free Trade Agreement, or NAFTA, which includes Canada, the United States, and Mexico, and was signed in 1994, is a case in point. All three nations have enjoyed substantial gains as a result of NAFTA. It is more than a trade agreement; NAFTA should also be understood as a production sharing agreement, helping North America remain competitive against fierce global competition.

But for all of NAFTA's benefits, greater economic integration has also brought about uneasiness.

It has meant rapid change.

It has also meant an uneven distribution of the gains. This transition to a more efficient allocation of resources has not come without costs, and the burden of adjustment has fallen on certain sectors and types of employment in all three countries.

Also, in this same period new technology has made many jobs obsolete.

Moreover, the complementary policies that were intended to cushion the effects on workers have not always worked as they were intended.

NAFTA is a good policy. But it is subject to improvement.

It is fair to say that, to some extent, policymakers have neglected its downsides for too many years. We took its early successes for granted. We have also neglected to extoll, explain, and communicate, its very real and very substantial net benefits.

This has led to a growing resentment against NAFTA in some pockets of the population and the idea that reversing the integration of the region could somehow improve things for those who have found their world changed for the worse—whether by NAFTA or by other factors, such as technological change.

The truth is, to turn our backs on the economic integration of North America—of Canada, the United States, and Mexico—would be extremely costly for all concerned. In NAFTA what we have is a framework for mutual cooperation.

What I want to say is, it is important not to forget the need to work with other countries, to improve the value of our relationships with each other.

And in NAFTA, this framework for mutual cooperation that we have, can be made better.

It is my hope that in all three countries policymakers can modify, can modernize our North American Free Trade Agreement so that its benefits are preserved and enhanced, and more people in the region can benefit. North America can be converted into the most resilient and prosperous region in the world. We have what is needed to achieve that, but we need to work together to accomplish it. Many of you will be, or will influence, the policymakers attending to these issues. Remember, the house has a good foundation. Let’s give it the maintenance and adjustment it deserves.

Second: The Global Financial Crisis

In the 1980s the United States and advanced economies in general entered into a period we economists call the Great Moderation. Macroeconomic conditions and prices were characterized by historically low volatility. It was commonly assumed that in such relative tranquility and with other favorable economic conditions any buildup of financial risks would not be a concern. Many policymakers began to take macrofinancial stability for granted. They overlooked the accumulation of serious vulnerabilities in the financial system, both nationally and internationally.

These vulnerabilities included the accumulation of excessive private sector debt; inadequate monitoring and managing of banks' risks; heavy reliance on very short-term debt funding; and the increasing use of new and exotic financial instruments, traded mostly in what we refer to as the "shadow banking" system, that is, financial intermediation that takes place outside the traditional regulatory and supervisory framework.

Many of these financial instruments were exotic indeed— futures, options, elaborate combinations of puts and calls and asset-backed securities of every size and shape and stripe, most especially mortgage-backed securities. Issuing and trading in these exotic instruments generated bonanzas, yet it seemed too many of even the most experienced financiers that these instruments could only be fathomed by triple PhDs in rocket science. Bank owners and bank regulators oftentimes simply did not fully understand what these instruments were, how they were traded, and the jaw-dropping risks that were piling up for the system as a whole.

On the regulatory side, dangerous vulnerabilities appeared as well: a lack of attention to systemic risks in the financial system, and an over-reliance on markets to self-discipline. In other words, complacency kicked in.

One of the most important factors triggering the global financial crisis of 2008 was that in the previous years housing prices in the United States had stopped rising. In the absence of these many vulnerabilities, this might have had only minor consequences. But with these vulnerabilities, the U.S. and other major financial centers, now complexly interconnected through the “shadow banking” system, slid to the verge of collapse. The financial system was saved, but it was badly damaged. Above all, trust in the regulators and in the system itself was damaged.

Policies cannot do what they are intended to do without adequate political support and that requires trust. Trust that policymakers will not only make good policy but that, over time, they will remain vigilant, not complacent, and they will be flexible, always willing to get in there, root around in the basement, climb up and look into the attic. Fix what needs fixing. Update what needs updating.

As Governor of the Bank of Mexico it has been my firsthand experience that the community of financial policymakers of the most relevant countries has taken the lessons learned from this crisis to heart. Many years of hard and cooperative work in many countries and among them has been done to improve the stability of both domestic and international financial systems. Of special note is the work of the Financial Stability Board created by the G-20 group of countries that encompasses over 80 percent of the world’s GDP. But this should be a permanent effort. And here too, many of you will be, or will influence, the policymakers attending to these issues.

Third and final example: Taming Inflation in Mexico.

Here a key point I want to stress is that in the real world policymaking responsibilities usually belong not exclusively to specific individuals but also to institutions.

Strong institutions ensure continuity of policy that transcends individuals and passing fashions, and they can inspire trust when their policies and actions are transparent and they are held accountable.

For decades, Mexico struggled under the painful burden of double-digit and sometimes even triple-digit inflation. In 1993 the Mexican Congress ratified an amendment to the Constitution that granted autonomy to the Central Bank, that is, to the Bank of Mexico, the nation's monetary authority. This amendment also established as its sole mandate the pursuit of a low and stable rate of inflation.

The Bank of Mexico serves and is accountable to the citizens of Mexico. Specifically, the law requires the Bank of Mexico to be accountable to the Mexican Senate. What "autonomy" means is that, by law, no longer can any governmental authority, such as the President, the Secretary of the Treasury, or the Senate, strong-arm the Bank of Mexico into providing credit, that is to say, printing money for public spending.

For Mexico, autonomy for the central bank has been a seachange.

Over the last decades Mexico's inflation has been brought down to remarkably lower and more stable levels. In the 1980s it averaged 69 percent, and 20 percent in the 1990s. Inflation then declined to 5 percent in the first decade of this century, and to only 3.8 percent so far this decade.

Not only has there been a substantial reduction in the rate of inflation; its volatility and persistence have declined as well. What this means is that, in comparison to the past, now the effects of changes in relative prices over inflation tend to be transitory and of lower magnitude.

This has contributed to the deepening of the Mexican financial system. Back in 1994, the Mexican government could borrow to a maximum term of one week. Today the Mexican government regularly issues bonds in pesos at fixed rates of interest with a maturity of 30 years.

Moreover, with lower inflation, the ratio of private sector credit to GDP has increased since the mid-2000s, contributing to higher sustainable growth. Financial inclusion has deepened, reaching the base of the pyramid. Today Mexico's financial system is well-capitalized and the Bank of Mexico's international reserves are at historic highs.

I have spoken of the importance of vigilance. The Board of Governors of the Bank of Mexico has sought to enhance confidence in the institution and improve the effectiveness of its monetary policy by adjusting it as required and becoming more open about how its decisions are taken.

This openness, this greater transparency and accountability, have helped the Bank of Mexico achieve two key goals. First, this has enhanced the legitimacy of monetary policy. Second, with greater trust in the institution, the Bank of Mexico is able to take less aggressive measures than might otherwise be required to counter any given economic shock. This means lower social costs for achieving our inflation target.

The bottomline: Creating and nurturing the right institutions is essential for good policy over time.

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Let me wrap up. Again, Class of 2017, I sincerely congratulate you. Now may you go out into the real world and make good policies, and then continue, vigilantly, to make them even better.

Thank you very much.