Overview Panel: The Case for Emerging Market Economies

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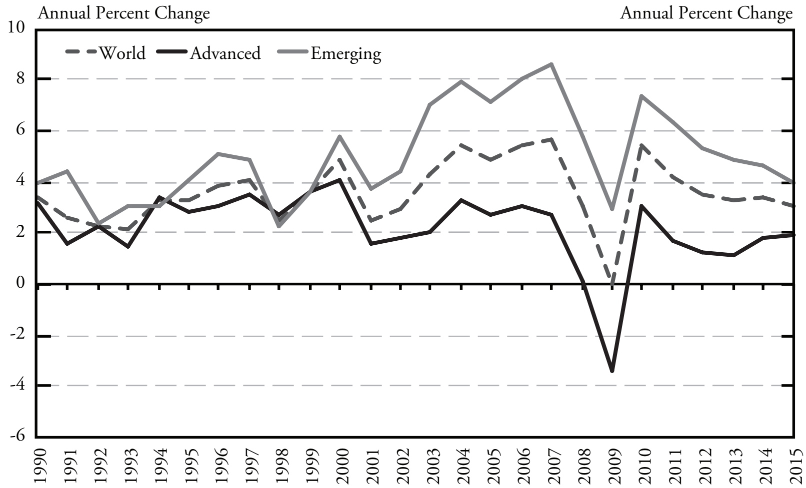
Given that my other fellow panelists will very likely address issues related to advanced economies (AEs), and discussions in other sessions have focused on AEs, I will fill the gap and concentrate on emerging markets economies (EMEs). As in the case for AEs, in EMEs we also face important challenges in guaranteeing resilient monetary policy frameworks for the future, but those might not be as obvious as for the case of AEs. To motivate my argument, let me review briefly recent developments in EMEs.

In Chart 1, I present the performance of global GDP growth, distinguishing between AEs and EMEs. If we focus on the performance of growth among EMEs, we can broadly identify three periods:

- First, from 1990 to 2000, where growth in EMEs was very similar to the one in AEs, but with more volatility. In this decade, EMEs experienced several crises, such as the Tequila Crisis, the Asian Crisis and the one in Russia, but at the same time more solid macrofoundations were established, among them the transition from fixed to floating exchange rates, adoption of inflation targeting regimes and in most cases the elimination of fiscal dominance.

Chart 1
Global GDP Growth

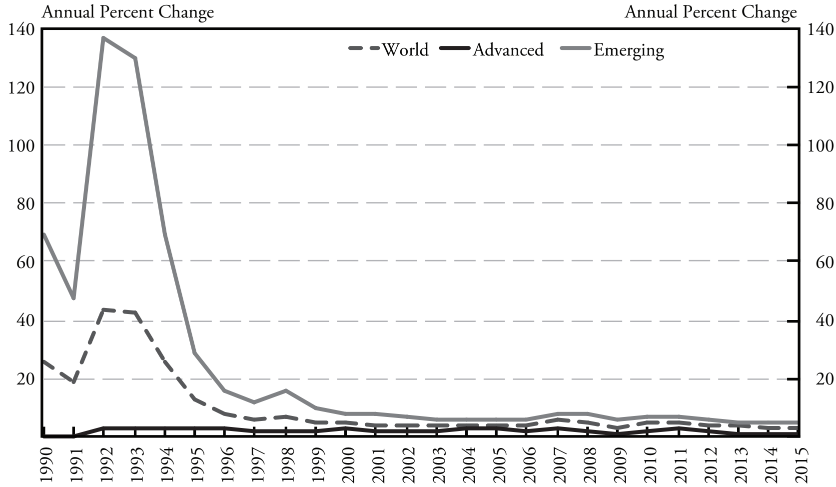


Source: FMI, WEO Abril 2016.

- The second period would go from 2000 to 2007, which I would describe as the golden years for EMEs, in which growth accelerated rapidly, helped no doubt by China, but also by the benefits of the achieved macro stability, the commodity super cycle and a steady supply of foreign capital.[1]
- The third period would be 2008 to 2016, which is the time of the global financial crisis (GFC) and its aftermath, in which the growth of EMEs outperformed AEs, but at a decreasing rate.

If we turn to Chart 2, we can appreciate one of the most successful events in macro stability, namely the very sharp decline in inflation among EMEs in the 1990s, and its gradual convergence to the one of AEs, a convergence that has not yet been fully completed. I attribute this performance to the wide adoption as monetary policy framework in most EMEs of flexible inflation targeting regimes, for which important preconditions needed to be fulfilled (Svensson 2010), among them the most important being:

Chart 2
Headline Annual Inflation



Source: FMI, WEO Abril 2016.

a) Granting autonomy to the central banks;

b) The institutional commitment to price stability as the central banks' primary goal;

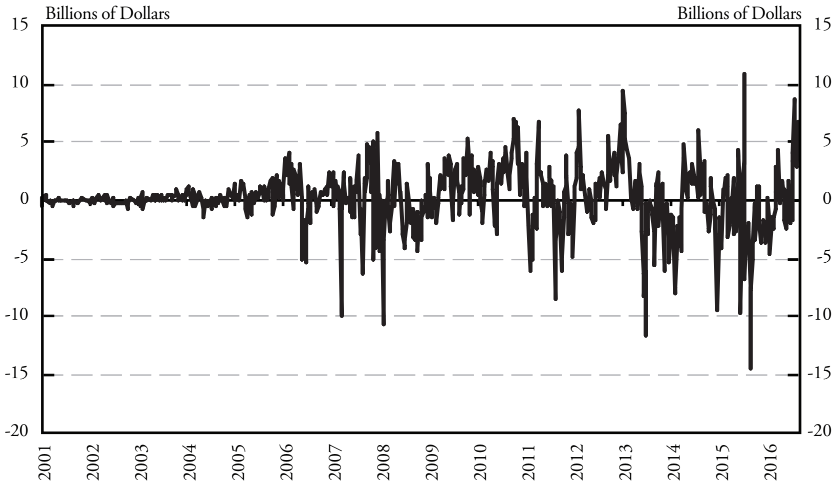
c) Exchange rate flexibility, in order to absorb external shocks without posing considerable pressures on inflation;

d) A healthy financial system, with sound banks and well developed capital markets; and lastly,

e) The absence of fiscal dominance, which otherwise would put pressure on central banks to monetize government debt, thereby producing higher inflation.[2]

In addition, benign external conditions that prevailed before the GFC contributed to the success of inflation targeting regimes in EMEs.[3] An environment in which external shocks were small and financial markets worked smoothly prevented the external environment from becoming the source of particularly large shocks to domestic inflation. This allowed EMEs' central banks to focus on domestic cyclical conditions as the main drivers of inflation, to

Chart 3
Capital Flows to Emerging Economies (Debt and Equity)



Note: The sample covers funds used for the buying-selling of stocks and bonds from emerging countries, recorded in advanced countries. Flows exclude portfolio performance and changes in the exchange rate.
Source: Emerging Portfolio Fund Research.

establish credible reaction functions, primarily of short-term interest rates, which permitted the anchoring of inflationary expectations, and inflation itself.

The task for central banks in EMEs became substantially more difficult after the onset of the GFC and its resolution:

- As you can see in Chart 3, capital flows to and from EMEs became massive and extremely volatile; and
- The commodity-price supercycle came ended. The effect has been particularly pernicious for oil producing and exporting countries, as the price of crude not only collapsed, but its volatility was exacerbated.

All these factors called for depreciation in the real exchange rate (RER) of currencies in EMEs against the strong currencies in the world, in particular, after the 2013 episode in the United States now better known as the "taper tantrum."[4] For such an adjustment in the RER to happen, a nominal depreciation of the domestic currency has been necessary, but with a limited pass-through to inflation, an issue that represents a challenge to the traditional inflation targeting regimes.[5]

In addition, the collapse of commodity prices has affected GDP growth, weakened public finances and induced higher current account deficits, which also has put pressure on the nominal exchange rate and inflation.[6]

I have to say that, so far, most affected EMEs have shown remarkable resilience to these very considerable external shocks, a performance that would have been unthinkable just two decades ago (IMF 2015). But substantial challenges persist, mostly to preserve stability and engineer faster growth, in an unusually uncertain external environment for EMEs. Needless to say, this makes it imperative for authorities to have a contingency plan, which should encompass not only monetary policy actions, but also fiscal policy adjustments and structural reforms. In what follows, I would like to delineate what a contingency plan would look like for a country such as Mexico.

First, in the context of an inflation targeting regime, it could be convenient to adjust the reaction function of the central bank to incorporate exchange rate considerations. As I already mentioned, given the external shocks that have been observed and that are likely to continue, a real exchange rate depreciation is required, but without generating substantial deviations from the inflation target. In plain language, for the central bank this implies that it might be necessary under certain conditions to adjust the policy interest rate as a response to exchange rate developments, as these might affect the achievement of the inflation objective established by the central bank. It takes time for markets to identify changes in the central banks' reaction function. Here an adequate communications strategy is of the essence: forward guidance could be used, describing the potential adjustment of the monetary policy stance as a response to specific exchange rate developments. Let me underline that I am not proposing to transform the inflation targeting regime into an exchange rate targeting regime. I limit the proposal for EMEs' central banks, under the foreseeable environment, for them to be more mindful about the impact of exchange rate dynamics on inflation.

Second, a stronger fiscal stance is required to assure the sustainability of public debt, in particular given the very large holdings of foreign investors of internal debt instruments, and to keep the current account under control after the commodities' prices shocks.[7] This would reduce the pressure on the exchange rate, and thus on inflation.

Third, macroprudential policies should be used if required and if possible, to preserve degrees of freedom for monetary policy, and make more efficient the convergence to the inflation target. The main macroprudential policy implemented by many EMEs since 2010 has been the accumulation of international reserves, under the premise that an important portion of capital inflows was the result of the search for yield impulse by asset managers given AEs' unconventional monetary policies, and that at some point such capitals could flow out again unexpectedly (BIS 2015).

Fourth, and as a corollary of the third item, EMEs' central banks should have a well-thought contingency plan to face a sudden stock adjustment that could imply massive capital outflows and/or portfolio duration adjustments by asset managers. These stock adjustments could result from external shocks or surprises that could trigger a response like a run by such investors. Under these circumstances, the traditional response through short-term interest rates might not be sufficient. Then, the central bank could use its balance sheet to substitute foreign assets by domestic assets, and/or change the duration of its domestic assets portfolio. These types of unconventional policies should be a very last resort, but that does not mean that at least a contingency plan shouldn't be ready. By the way, these strategies could also be accomplished through the use of derivatives.

Fifth, it does not hurt to arrange a contingency emergency financing in foreign currency, such as Mexico, Colombia and Poland have done though the IMF's Flexible Credit Line (FCL) (IMF 2016b). Not only are the resources made available on a contingent basis helpful, but the FCL is also a good signaling devise (that the country has a strong macro framework), since countries need to pre-qualify to get it.

Sixth, and finally, higher sustainable growth should be pursued primarily through structural reforms. A strong macro framework is a necessary, but not a sufficient condition for high, sustainable growth. In particular, at least in the case for EMEs, monetary policy cannot remove distortions in markets for goods and services, nor can it improve the functioning of the labor market, nor directly increase productivity.

Author's note: The views presented in this document are solely the responsibility of the author, and not necessarily the ones of Bank of Mexico. I appreciate the support of Ana María Aguilar and her team.

Endnotes

[1]The commodity supercycle refers to the period between 2000 and 2014, characterized by a boom of commodity prices.

[2]IMF (2005), Batini and Laxton (2007), Mishkin (2000) and Mishkin (2008) describe most of these preconditions.

[3]Mishkin (2000) states that stable external conditions helped the process of implementing inflation targeting in EMEs. Moreover, there are several empirical works that describe the benefits of implementing the inflation-targeting framework in EMEs. Vega and Winkelried (2005), Batini and Laxton (2007), Choudhri and Hakura (2006), Edwards (2006) and Nogueira (2007) study different mechanisms through which this framework succeeded before the GFC.

[4]On May 22, 2013, the Federal Reserve announced it would start to gradually reduce the pace of bond purchases as part of the unconventional monetary policy measures. As a consequence, U.S. Treasury yields surged and capital flows flew out of EMEs.

[5]Bank of Mexico (2015) and IMF (2015) document the low levels of pass-through from the exchange rate to inflation after the financial crisis for EMEs.

[6]In July 2016, the IMF revised down its baseline global growth forecast (IMF 2016a).

[7]Serkan and Tsuda (2014) point out the sharp increase of the foreign share in EMEs' government debt. However, this tendency has decreased for some EMEs in the last two years.

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