REMARKS BY MR. JAVIER GUZMÁN CALAFELL, DEPUTY GOVERNOR AT THE BANCO DE MÉXICO, AT THE PANEL OF CENTRAL BANK GOVERNORS ON "NEW CHALLENGES FOR CENTRAL BANKS IN LATIN AMERICA". SEMINAR ON FINANCIAL VOLATILITY AND FOREIGN EXCHANGE INTERVENTION ORGANIZED BY THE CENTRAL RESERVE BANK OF PERU AND THE INTER-AMERICAN DEVELOPMENT BANK. Cusco, Peru, July 25, 2017.[1]

The central banks from emerging market economies (EMEs) have faced a challenging external environment in recent years. The monetary policies implemented by the advanced economies after the global financial crisis, combined with episodes of turbulence in highly integrated international financial markets deriving from a combination of factors, have resulted in substantial volatility of capital flows. In addition, EMEs have confronted a world economic environment characterized by lower rates of global potential growth, a decline in commodity prices, a growing anti-globalization sentiment and events of a geopolitical nature. The combination of these factors has led to a situation of acute uncertainty. If this were not enough, the global financial crisis has eroded confidence on our understanding of the economics science and of the proper way to implement monetary policy under current circumstances.

The Mexican experience of the last couple of years provides an illustrative example of the nature and magnitude of the challenges that our central banks have faced. Since mid-2014, the country has been hit by a combination of external shocks. To a significant extent, the current evolution of the economy

[1] The opinions and views 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.

has been determined by the impact of these shocks and the economic policy that has been implemented in response to them. Let me refer briefly to the most important:

1. The price of the Mexican crude oil basket fell from around 100 dollars per barrel in June 2014 to some 45 dollars per barrel at present. Although the share of oil in exports and GDP is relatively modest, it accounts for a substantial share of public revenues. Therefore, these developments have had significant implications for public finances. In fact, when the impact of the concurrent reduction in oil prices and output is taken into consideration, the result is a decline in annual public revenues from this source of approximately 5 percent of GDP since 2012.
2. After a prolonged period with near-zero interest rates, the US Federal Reserve began to increase the target for the federal funds rate in late 2015. While this shock affects EMEs in general, its implications for Mexico are particularly important, given the close economic relationship between both economies and the openness of Mexico to foreign capital flows.
3. From December 2014 until late 2016, a recession was observed in the industrial sector in the United States. In addition, in a context of weak world trade, exports and imports of this country stagnated during most of that period. This had important repercussions on the Mexican economy, since the industrial sectors in the US and Mexico are closely integrated, and exports of the US to the rest of the world make an intensive use of Mexican manufacturing goods as inputs.

4. The results of the electoral process in the United States in 2016 substantially increased uncertainty regarding the future economic relationship between this country and Mexico. In particular, concern emerged about the evolution of NAFTA negotiations, fiscal policy in the US, and the potential for actions with adverse repercussions on Mexico in the areas of migration and remittances. Although the possibility of extreme scenarios has decreased substantially, uncertainty has not dissipated.

Challenges for the implementation of monetary policy resulting from the above shocks were accentuated by other features of the Mexican economy. In particular, the sizable portion of domestic public securities in the hands of foreign investors (around 30 percent of the total stock) may have increased the sensitivity of capital flows to external and domestic developments. In addition, in view of the high international liquidity of the Mexican peso, the currency has been used to hedge risks unrelated to developments in the domestic economy, giving rise to the potential for additional volatility and pressures on the peso.

In this context, the Mexican peso has depreciated significantly in recent years. From September 2014 to late July of this year, the depreciation vis-à-vis the US dollar amounts to around 36 percent, although at some stage the cumulative decline in the value of the peso reached more than 60 percent. Mainly as a result of increased credibility of the Central Bank, the pass-through from the exchange rate to inflation has dropped significantly over the years. In fact, at present it remains relatively low compared with other EMEs. However, the depreciation of the peso has inevitably reflected in higher prices of

internationally tradable goods, thus affecting inflation, an effect that has become more evident in recent months.

Inflationary pressures in Mexico have not resulted from depreciation of the peso only. In an effort to strengthen public finances and support the process of reform of the energy sector, prices of gasoline were substantially increased in early 2017 and domestic gas prices were liberalized. This combined with other supply shocks[2] and the above mentioned peso depreciation. Thus, after remaining below the 3 percent Banco de México's target during 17 consecutive months, the inflation rate rose to 3.1 percent in October 2016 and to 6.3 percent in the first half of July 2017, i.e. well above the +/- 1 percent variability interval around the target.

GDP growth in Mexico recorded a moderate yet sustained expansion in recent years, which implied a gradual narrowing of a negative output gap. As of the first quarter of 2017, a combination of indicators suggests an output gap around zero. However, to a significant extent as a result of the shocks that the economy has faced, and especially the uncertainty resulting from the future economic relationship with the United States, the economy is showing signs of deceleration, although to a lesser extent than originally foreseen. Consequently, it is anticipated that the output gap will fall again into negative territory in coming months.

Therefore, monetary policy in Mexico has faced an environment with mixed features. On the one hand, a significant increase in inflationary pressures, in a

[2] Namely higher agricultural prices, an increase in the minimum wage and an upward adjustment to public transport fares.

context of an upward trend of the federal funds rate and a situation of high uncertainty to a large degree originating from potential policy actions in several fronts in the United States. On the other hand, absence of significant demand pressures on prices and the perspective of a weakening of economic activity.

What has been the monetary policy response?

Since late 2015, within the framework of an inflation targeting regime, the target for the overnight interbank rate has been raised by 400 basis points, to a level of 7.0 percent. This response is explained by a combination of factors:

1. The increase in interest rates in the United States. Under conditions of close economic links with that country, substantial openness to external capital flows, bulky investments by foreigners in the domestic bond market, and an environment of high uncertainty, decoupling from actions taken by the Federal Reserve would have implied high risks for the exchange rate and inflation in Mexico.
2. The potential impact of depreciation of the peso on prices. In view of the lags with which monetary policy operates and the openness of the Mexican economy to foreign trade, most of the monetary policy actions undertaken during 2016 were of a preventive nature and aimed at containing the pass-through of the exchange rate to prices.
3. The inflationary implications of a number of simultaneous supply shocks. The latter would, under normal conditions, imply a change in relative prices without a permanent effect on inflation. The risk in this case derives from the potential for second-round effects, given the

magnitude and simultaneous impact of the shocks, in the context of a large depreciation of the exchange rate.

The overall objective of this prudent monetary policy approach was to achieve a gradual convergence of inflation to the target, at the lowest possible cost for economic activity.

It is important to stress that monetary policy has been supported by actions in other fronts. To ensure an orderly functioning of the foreign exchange market, pre-announced or sporadic interventions in this market have been carried out and, most recently, a mechanism for the hedging of foreign exchange risk of up to US$20 billion was introduced, which does not imply the use of international reserves. This strategy is consistent with a flexible exchange rate regime that plays a key role as a shock absorber, and allows market forces to determine the equilibrium real exchange rate. It is also worth noting that against the background of an increase in public debt as a share of GDP, a major fiscal adjustment has been announced for 2017 and subsequent years. The implementation of these measures should widen the margins of maneuver for monetary policy. Moreover, the banking system is well capitalized and profitable, and in general the financial sector does not appear to face risks of a systemic nature.

Thus far, the strategy adopted has yielded satisfactory results. Inflation expectations for the end of 2017 have increased sharply, to figures above the upper end of the variability interval around the target. However, a sharp decline is expected for 2018, and by the end of that year inflation is anticipated to show figures falling within the interval. Furthermore, there is no evidence

of second-round effects from the shocks that have affected the evolution of prices. It is also worth noting that even though a deceleration of economic activity is projected for 2017, this is expected to be gradual and, as noted before, heavily influenced by external developments. In addition, higher short-term interest rates in Mexico have discouraged use of the peso for the hedging of risks in other EMEs.

I wish to note that notwithstanding the results observed up to date, inflationary risks remain. Long-term inflation expectations based on surveys are relatively stable, but above the target. Similarly, the differential between nominal and real yields on government bonds remains at levels above those observed in 2016, pointing to concern about the medium- and long-term evolution of inflation in Mexico.

Furthermore, an environment of high uncertainty is likely to persist, especially in view of ongoing NAFTA negotiations and other potential actions by the US government, the normalization of monetary policy in that country, and the electoral process in Mexico in 2018. Therefore, the possibility of additional pressures on the peso stemming from these or other factors remains. Also, the risk of second-round effects from the recent supply shocks, though contained thus far, has not disappeared. Under these circumstances, a cautious implementation of monetary policy is warranted.

What lessons can be learned from the recent Mexican experience?

First of all let me say that any comments in this regard should be considered as preliminary, since the process of adjustment to the challenges faced has not concluded. It should also be kept in mind that the experience of one country

cannot automatically be considered as suitable for other economies. With these caveats in mind, I would underline the following:

1. Inflation targeting has been an efficient framework for the implementation of monetary policy in Mexico under the present conditions of the world economy.
2. A timely and well measured response of monetary policy to inflationary pressures is essential to minimize the policy effort. In other words, the cumulative increase in interest rates required to contain upward pressures on inflation will be larger if the initial response is tardy or insufficient.
3. Central banks will frequently need to deal with inflationary pressures in the face of a weak GDP growth. The costs for economic activity of monetary policy actions have to be seen against the counterfactual. Indeed, such costs will be higher in a scenario where second-round effects on prices arise. On the other hand, the definition of the time span over which convergence to the inflation target will be sought is a crucial element.
4. The exchange rate may have a significant effect on domestic prices in economies with large foreign trade sectors. It is not possible to say *a priori* if this justifies a monetary policy action. However, it will always be important to keep in mind that the size of the pass-through coefficient can be closely linked to the monetary policy reaction, and that after a certain stage depreciation of the currency may have non-linear effects.
5. A change in relative prices does not normally justify a monetary policy response. However, depending on their magnitude, the simultaneous

impact of several shocks of this nature can increase the risk of second-round effects.

6. Monetary policy must not bear an excessive burden in the adjustment to external shocks. The adequate support of other policy instruments is fundamental to minimize costs for the economy.
7. A flexible exchange rate mechanism can play a crucial role to achieve a smoother adjustment to external shocks. However, a floating exchange rate may also be accompanied by substantial volatility and other costs, and therefore it will frequently be necessary to find appropriate means to foster an orderly functioning of the foreign exchange market.
8. Fiscal policy will often need to respond to shocks of an external nature and in many occasions will in fact be the key policy tool. With an adequate implementation of fiscal policy, the degrees of freedom for monetary policy management are increased. Naturally, financial stability is another crucial piece in this regard.
9. Communication, a key instrument for the implementation of monetary policy, must be handled carefully, to avoid potential misunderstandings and the possibility of market overreaction.
10. Under a situation of higher-than-usual uncertainty, it will generally be better to err on the side of caution.