As prepared for delivery

Michel Camdessus Central Banking Lecture

Mr. Alejandro Díaz de León
Governor of the Bank of Mexico

Emerging Markets' Long and Slippery Road to Development and the Challenges of the Pandemic

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1. Introduction

It is an honor to speak at the Michel Camdessus Central Banking Lecture. He is remembered around the world for his leadership, particularly in Mexico. In 1995, following his convictions, and putting his reputation on the line, he pushed forward a historic support program for Mexico that helped us deal with a black-swan event.

This episode shows us that even though great institutions such as the Fund should be faceless, when immense tradeoffs and historical decisions are on the line, personal leadership is essential to maintain the commitment to best serve the institution's mandate. We are fortunate that this long-term oriented strong leadership tradition continues with Kristalina Georgieva, who has successfully faced a once-in-a-generation human catastrophe and a global recession with strong resolution.

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2. Emerging Markets' Long and Slippery Road to Development

Let me start with a very long-term emerging market perspective, looking into some of the key challenges we have faced in what I will refer to as "*the* *long and slippery road to development*". This will be a useful background to address some of the most pressing challenges we currently face, and an illustration of our quest for long-term development.

The year 2021 is special for my country, as it marks the 200th anniversary of the consummation of Mexico's independence. When a new country comes into being, it can have a shared vision of the future and of the type of institutions it needs. For instance, in the United States (US), the Constitution signed in 1787 remains the cornerstone of the US as a nation.

Mexico's debut as an independent country was characterized by a strongly divided nation, with two polar views on how the State and society should interact, between a centralized empire and a federal republic. This launched the country into a tailspin of civil wars, opened the door to foreign interventions and all kinds of instability, all of which hindered the development of the country and the wellbeing of the population.

Almost 100 years after gaining independence, a broadly shared Constitution was enacted in Mexico in 1917, providing the foundations for social and political interaction and economic development. The Constitution also envisioned the first central bank as an entity of the State. This goal materialized in 1925, when Banco de México was created.

We cannot underestimate the importance of stability and clarity in the legal foundation of the institutional pyramid, the Constitution, which is the cornerstone for sound and sustainable social and economic progress. I am convinced that when a country lacks a broadly shared vision of the future, it cannot enjoy a stable present, as it is continuously pulled into zero-sum quarrels and attempts to backpedal policies.

The first dimension of the foundational principles in a national debate includes: the form of government, the transfer of power, and recognizing essential human and civil rights.

The second dimension relates to the institutional design needed for social, political and economic development. This has been highly elusive for several emerging market countries, especially in Latin America, trapping the region in a "*highly persistent slow development equilibrium*", making it unable to reach the "*underdevelopment escape velocity*".

Many factors share the blame in this unfortunate outcome. This shows how difficult it is to endogenously change the incentives and the institutional setup in a rent-driven economy, making it hard to attain an efficient and highly productive incentive-based economy.

This mainly occurs because the low hanging fruit for both politicians and economic interest groups is to maintain the status quo, where outcomes are tilted towards favoring incumbents' rent extraction, at the expense of the wellbeing of broad sectors of society. This creates societies where effective social mobility ladders are scarce, inequality is perpetuated, and polarization becomes endemic.

In this context, politics tends to fall into the short-term trap of exploiting the "*oppressor-oppressed*" debate, exacerbating contrasts and deepening polarization, making a shared vision of the future a more elusive goal. We should not forget that constructive politics is the art of finding common ground between different individual interests and the common good. When these objectives are reconciled, societies get closer to their true potential in terms of economic, political, and social outcomes.

To attain progress and development, history and experience provide ample evidence in favor of market economies with strong and stable forms of government that provide critical public goods, mainly:

i) The rule of law, ensuring personal security, contract certainty and well-defined property rights.

ii) A level-playing field for all, including equal opportunities to access high quality education and health services for all social groups. iii) Strong incentives for the most efficient allocation of scarce resources, leading to profitable long-term investments and higher growth.

iv) Economic stability, which includes price stability, financial stability, and low volatility of output around potential.

To overcome *"the long and slippery road to development"* we need a shared vision of the future, with a comprehensive set of principles and policies that considers the idiosyncratic characteristics of our complex economic and social ecosystems.

Moving to better outcomes sometimes requires self-adopted multilateral commitments. This explains why some arrangements like trade agreements and economic unions have been useful as means to commit to long-term strategies and reduce adverse short-term political struggles.

Emerging markets' road to development requires an economic and financial integration to the global economy, along with domestic regulation and incentives aligned with best practices, and proven approaches and strategies. Multilateral and international financial institutions have a historic opportunity to increase their catalytic role in emerging markets' development, fostering the adoption of these comprehensive approaches.

If we could go as far as reaching a new, comprehensive, and detailed *"shared vision for emerging markets' development",* with clear incentives and opportunity costs for key decision makers, it could have the potential of improving the fortunes of hundreds of millions of people.

3. The Role of Central Banks in Emerging Markets during the Pandemic and Beyond

Central banks play an instrumental role in all economies: price and financial stability are key public goods needed for sustainable growth and development, even more so in the challenging context of the pandemic. This is why independent central banks are a crucial element of the institutional framework, and their actions must be insulated from political pressures to focus on long-term stability, creating an environment conducive to economic growth and social development.

The pandemic caused a synchronized global economic recession with large shocks in the financial and real sectors. First, we faced a sharp increase of risk aversion in global financial markets, with a strong impact on emerging markets in terms of capital outflows, foreign exchange depreciation, and higher risk premia. What was expected to be a transitory shock has become longer lasting and with significant heterogeneous effects across countries, sectors, and groups in society. This had major consequences for face-toface services and for the informal sector – which are very important in emerging markets.

The pandemic also accelerated ongoing trends, posing worrisome challenges, widening the technological divide among individuals and firms, and increasing inequality in education and development opportunities.

While advanced economies implemented historic stimulus programs, emerging markets faced policy tradeoffs and a more limited policy space. The pandemic significantly affected economic activity, external financing, and public revenues. The policy space has been more constrained than in advanced economies due to a dependence on external sources of finance, less resilient fiscal accounts, and weak and pro-cyclical fiscal revenues.

Taking into consideration the unprecedented nature of the shock, and the deep social scars it has caused, emerging markets have faced the challenge of supporting the economic recovery without compromising macroeconomic and financial stability. As capital-importer economies, emerging markets need to keep ample sources of financing and continuously attract foreign investment. This requires a strong and resilient macro mix, being conscious of the policy space available under additional adverse scenarios, and following a risk management approach as part of policy making.

Being mindful of the policy space does not justify inaction. Comprehensive packages of near-term support should be implemented jointly with credible medium-term strategies, anchoring macroeconomic sustainability, and promoting pro-growth structural reforms.

Despite facing a more complex and heterogeneous set of tradeoffs, central banks in emerging markets loosened monetary policy considerably and provided liquidity when needed. In the first months of the pandemic, global risk aversion and domestic financial markets' volatility called for a broad set of measures to supply liquidity and credit. In April 2020, Banco de México announced up to 3.3% of GDP in several financing facilities. For Mexico, the IMF's Flexible Credit Line was a highly valued complement for our external liquidity buffers at a time of acute stress.

In addition to avoiding a risk aversion spiral, supporting the recovery through an orderly and sustained reduction of interest rates along the yield curve is needed. This implies being mindful not only of short-term interest rates, but also of medium- and long-term rates, which in emerging markets are largely determined by risk premia. Thus, to attain lower financing costs along the yield curve, a solid macroeconomic framework is required, with fiscal sustainability, price stability, and a resilient financial sector.

Regarding monetary policy instruments, asset purchase programs should not be considered "*over-the-counter*" measures in emerging markets. Policy makers need to be mindful that central bank financing to governments can fall into a situation of fiscal dominance. Stress tests of fiscal sustainability and availability of sources of finance are needed to avoid situations that could lead to financial repression or monetization of fiscal deficits. Unfortunately, in the past, Latin America had many of these painful episodes that caused incommensurable long-lasting damage. Also, if asset-purchase programs in emerging markets were perceived as central bank financing of governments, it would exert pressure on risk premia, the exchange rate and capital outflows, contrary to the original objective of easing financial conditions.

Emerging markets have different degrees of integration and exposures to global downturns and episodes of risk aversion, but they are all subject to larger monetary policy tradeoffs that need to be considered in the central bank's reaction-function.

In small and open emerging market economies, the traditional monetary policy role of keeping inflation around the target and reducing output volatility around potential faces additional challenges. External and idiosyncratic shocks rarely work exclusively on the demand side, and they tend to include a supply side and a financial dimension that increases policy tradeoffs. For example, shocks to the terms of trade, global risk appetite, and sovereign credit risk put additional pressure on the exchange rate, capital flows and on the financial system, and these factors rarely coincide with output gap pressures on prices, often exerting opposing forces on inflation. This results in more complex monetary policy tradeoffs.

This was precisely the case during the pandemic, as we faced an unprecedented aggregate demand and supply-related contraction, together with a financial shock. Thus, policy making in emerging markets faced acute tradeoffs with limited space. In Mexico we experienced a significant foreign exchange adjustment and a record contraction of non-residents' holdings of government securities. Also, in spite of a sharp economic contraction, since June 2020 inflation has remained clearly above target.

The economic recovery will be heterogeneous, as a result of differentiated advances in the vaccination process and in policy support across countries. The unprecedented fiscal stimulus in the US will support the world economy, but it could also exert pressure on medium- and long-term interest rates in the US and on global financial conditions. Thus, the outlook for the world economy and financial markets will be strongly influenced by the US recovery and its inflation dynamics.

In advanced economies, several structural factors and demographic trends have induced lower potential GDP growth, lower levels of inflation, and a lower real neutral interest rate. They have experienced inflation below target for long periods of time. These conditions will allow their central banks to be very patient in the wake of higher inflation. Emerging markets are not in the same position. We have less policy space, as price formation faces higher risks and inflation and its expectations have not been persistently below target.

Even if the central scenario is of transitory increases in inflation in the US, a smooth path is unlikely, and financial markets will be subject to volatility episodes, exerting pressure on emerging markets' financial conditions. To benefit the most from the US-led recovery, emerging market economies need to promote an orderly adjustment of their domestic financial markets.

This requires a strong macroeconomic policy mix, where fiscal sustainability and price stability play a key role to contain risk premia throughout the yield curve.

The massive fiscal and monetary policy stimulus adopted by advanced and large capital-surplus economies must not create the impression that these approaches are also available for emerging market economies. We must remain conscious about our policy constraints and our susceptibility to external and idiosyncratic shocks.

4. Global Challenges and Opportunities

Finally, let me highlight three areas where International Financial Institutions (IFIs) can play a key role to promote a stronger and more sustainable recovery, a more resilient global financial architecture, and a fast-paced development of low- and middle-income countries.

First, emerging markets' development requires strong macro-policies and a consistent integration strategy to the world economy. In this regard, the valuable IMF's Integrated Policy Framework could be useful not only to expand the instrument toolkit to face international capital flows and other shocks, but also to develop a *"policy roadmap"* to stay the course towards a stronger, deeper, and long-lasting trade and financial integration. This could help us address current and future challenges without reducing our economies' resilience, and aligning national strategies towards deeper financial markets and better medium- and long-term social outcomes.

Additionally, the IMF along with other IFIs could develop a clear and detailed set of concrete policies and regulatory approaches, similar to those that have proven to be successful in some economic unions or regions to foster investments and development, and complement them with low-cost targeted funding. Emerging markets could voluntarily adhere to the observance of a broad set of standards and recommendations, like the current Reports on the Observance of Standards and Codes (ROSC) works for the financial sector, but with a broader scope.

Second, IFIs can develop new approaches to quickly mobilize capital when facing global systemic shocks. Loan-guarantee programs could be designed to leverage more resources, attract private investors, and allow countries to access financing through international capital markets for specific programs, like vaccination or much needed green and sustainable projects.

Third, the pandemic has deepened the digital divide, within and across jurisdictions, making it clear that technology adoption and financial inclusion have become an imperative for all. IFIs can play a critical catalytic role in promoting last generation financial infrastructure. New technology and payment infrastructure offer invaluable options to advance financial inclusion, and can become the cornerstones of the best forms of digital money and Central Bank Digital Currencies (CBDCs).

In this effort, we need to move fast, with the right strategies and approaches, to develop the best digital financial ecosystems, where Bigtechs and Fintechs could be included following five key principles: 1) universal access; 2) same-risk/same-regulation; 3) interoperability and network neutrality; 4) foster competition, avoiding king-maker mergers and alliances; and 5) promote strong consumer protection. We welcome and strongly support the steps the IMF is taking in this direction to help its membership address the broad set of challenges of the new era of digital money.

We hope that this line of work can attain concrete short-term recommendations and deliverables, helping all central banks to develop new forms of money and fully operable CBDCs in a very short period of time. Otherwise, private crypto-assets hungry for seigniorage returns could consolidate as acceptable barter-tokens. These alternatives, which could have partial functions as a medium of exchange, grossly fail as a store of value, unit of account, and as a fully acceptable and efficient payment instrument. This can seriously affect the public goods delivered by the central bank's provision of money, thus jeopardizing financial stability, weakening consumer protection, and deteriorating social outcomes.

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Let me conclude by highlighting that when emerging markets face either the structural or perennial challenges of the long and slippery road to development, or unforeseen and acute disruptions like the shocks derived from the pandemic, these are better addressed when broad mutual trust allows to attain a shared vision of the future and creative solutions that can improve social outcomes, both at the national and international levels.

Thank you very much for your attention.