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Introduction to the IV High Level Seminar of the Eurosystem and Latin American Central Banks

Banco de México, Banco Central Europeo and Banco de España

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Good morning,

First of all, I would like to thank you, Governor Ortiz, for your warm hospitality today (and for the delicious dinner yesterday), and the staff of Banco de Mexico and the ECB for such fluid collaboration in organising this important event. It is a source of great satisfaction to introduce **the fourth edition of the Eurosystem and Latin American High-Level Seminar**, an initiative that started in Madrid, in 2002, and was repeated in Brazil (2004) and again in Madrid (2006). I also want to join Governor Ortiz and President Trichet in welcoming you all, and in thanking you for making the effort to attend this meeting in such difficult circumstances.

In introducing the Seminar, I will try to share with you some reflections along the lines of the topics envisaged in the programme. In fact, the changes in the planning of this Seminar mirror the radical transformation that the world economy has undergone in less than a year. When the letters of invitation were sent out, last July, one of the main concerns for central bankers was the **impact of high increases in commodity prices on inflation** and on general economic performance –and indeed, this was intended to be the main topic for our discussions today-. At present, however, commodity prices have retreated by more than one-third from their record highs last summer, and the overriding concerns are now the rapid spread of the financial crisis, the deep economic recession and the policy response to both of them. I should stress that the sharp correction in commodity prices is a challenging development for a large number of Latin American economies, which are net exporters of primary products. As a matter of fact, this sudden change of scenario could lead to the reversal of some of the improvements achieved in the region in recent years in terms of reduced vulnerabilities, an issue that we will discuss in the second session of the Seminar. Let me focus now on the **financial crisis and its implications**. The world economy is in the middle of a profound and generalised adjustment in financial and real terms. Downward revisions to growth forecasts are becoming bolder as the crisis unravels and negative feedback effects between real and financial sectors intensify. Since October, the IMF has cut the forecast for world growth in 2009 by almost 5 p.p. (to a global recession), and revisions for both the euro area and Latin America are of the order of -3 p.p.. After more than a year of dire economic and financial difficulties the end of the current troubles is not yet in sight –rather the recovery is being continuously postponed-.

The factors that are at the origin of this situation have to be traced back to the protracted period of expansion that started in the aftermath of the ICT revolution, underpinned by a process of rapid

financial innovation and increasing economic and financial integration. Economic policies, in general, were excessively supportive of this process in many parts of the world and were not able - to a large extent- to take into account the accumulation of internal and global imbalances. Regulatory frameworks, in turn, were not sufficiently alert to indentify the problems building up in the financial sector and did not address them in time.

Consequently, the major financial technology shock that supported innovation and financial globalisation had weak foundations. Now we are witnessing the reversal of this process which is equivalent to a negative supply shock to the real economy. In the medium to long run, as the severe adjustment of the financial sector is factored in, potential output growth, which was probably overestimated in the boom years, will be lower for a certain period of time.
In the short run, the consequence of this negative financial shock has been the shrinking of the financial systems of many advanced economies. Furthermore, the serious trouble of the financial system is having two major consequences. On the one hand, it is damaging financing flows worldwide and, on the other, it is fuelling a negative feedback between the financial and real sectors. I will tackle these two issues briefly.

The financial market freeze is a direct consequence of the dramatic shift from the search for yield process that characterised the global situation before August 2007, to the flight to safety induced by unprecedented uncertainty and lack of confidence prevailing after that date.

From an external perspective, crises usually prompt a retrenchment of capital flows towards the domestic base in advanced countries. Indeed, the change in market sentiment has led in these countries to significant amounts of capital being repatriated. In contrast, in emerging markets –including some Latin American countries- capitals have flown out in spite of the progress made in recent years in developing local financial markets.

Indeed, despite the reduction of financial vulnerabilities Latin America and other emerging markets are facing difficulties in achieving a sustained flow of external financing. We may wonder whether the countries in the region could have taken greater advantage of the good times to strengthen their economic and financial position even further. In any case, if we compare Latin America with other emerging regions we see that the efforts to reduce financial and economic vulnerabilities are paying off. For instance, some Eastern European countries are facing now some of the problems that affected Latin America in the past: large foreign currency financing needs, large current-account deficits, excessive credit growth and major currency mismatches.

Turning to the feedback effects between the financial and real sectors, the prevailing direction is changing at the global level. During the initial stages of the crisis, the direction of the impact was

from the financial to the real sector as the process of deleveraging unfolded, and liquidity preference and counterparty risk contributed to the contraction in credit markets. The deterioration of the financial situation was channelled to the real sector through the tightening of financing conditions, a sharp contraction of financial wealth and the erosion of confidence, all of which constrained consumption and investment decisions. The collapse of Lehman Brothers came as another huge financial shock, which hit the economy with unprecedented severity. As a result, global growth plunged dramatically to negative rates of -6% in 4Q08 and very few countries were spared from this sharp overturn.

At present, while the financial sector is still undergoing a severe adjustment the reverse feedback is gaining strength and the worsening economic situation is having an increasingly negative impact on the financial system. The intensified adjustment in the housing sector, growing difficulties in the corporate sector and the rise in unemployment are damaging previously healthy, traditional bank assets and non-performing loans are thus increasing.

One particular example of the close linkages between finance and activity is trade. The current recession has seen the sharp drop in global trade in the last quarter of 2008. While this can be explained to a large extent by the contraction in global demand, severe disruptions in trade finance, after last September, may have also played a part in the collapse of trade. These disruptions have a larger direct impact on emerging economies, where export firms may have no other source of finance.

The **policy response to the crisis** has been stepped up since October. Monetary policy easing, financial support plans and fiscal packages were implemented urgently in order to prevent financial panic and stabilise the markets, put a floor on the foreseeable fall in activity, and most of all stop the loss of confidence that had spread through the real and financial sectors.

Central banks have responded decisively to the changing outlook for price stability brought about by the escalation of the crisis by changing the monetary policy stance through substantial cuts in official interest rates and by an unprecedented increase in liquidity provision. Since October, the ECB has reduced its interest rate by 275 bp; and in Latin America large cuts have also recently been made, with a lag of some months. An additional challenge for Central Banks -one which is less pressing in Latin America for the moment- is the need to conduct policy in an environment where official interest rates have become very low. These considerations have led an increasing number of major central banks to implement unconventional measures to support the flow of credit, which have induced a substantial expansion of central banks' balance sheets. In Latin America, in addition to interest rate cuts, there was also ample liquidity support, with a strong bias

towards foreign currency provision, and foreign exchange reserves were used to limit exchange rate fluctuations.

Regarding **financial support** packages, there have been common elements –capital injections, guarantees, asset purchases- but with very different mixes and sizes from one area to another. The contrast between the committed amounts in advanced economies (almost 50% of GDP) and emerging markets (around 2%) is most significant.

Finally, **fiscal stimuli** have been widespread, amounting to an estimated 2.7% of GDP for the G-20 countries between 2008 and 2010. Here the divergence between advanced and emerging countries is less marked, due to the weight of the measures applied by Russia and China. Some Latin American countries –such as Argentina and Chile- have also announced sizeable packages.
The ammunition spent in sustaining the financial system and cushioning the decline in growth in advanced economies leads in my view to two main considerations: The first is that although the three types of policies –monetary, financial and fiscal- have been adopted, the stabilisation of the financial sector is a precondition for macro policies to work fully and effectively in pulling the economies out of the recession; from that perspective the emphasis given to the recovery of the financial sector seems to be totally justified. The second is that given the extraordinary nature of the measures introduced in all three policy dimensions, and the negative consequences that would result from maintaining them beyond what is reasonable, the design of exit strategies over the medium term that continue to ensure price stability, the sustainability of public finances and an efficient and sound financial system is necessary to sustain confidence and reduce uncertainties on how our economies and financial systems will look like in the aftermath of the crisis. Something that will condition our future potential growth rates.

In this respect, it is particularly important to take into account that public finances in a number of advanced economies are becoming dangerously overstretched. In principle, part of the funds invested or committed to supporting the financial system will be recovered. However, Treasuries and even some Central Banks are incorporating ever-greater risks into their balance sheets, and fiscal positions will worsen substantially. Likewise, debt-to-GDP ratios will increase, partly induced by the huge support to the financial sector. The cost of financing –now subdued in advanced economies as their public debt is considered a safe haven- may shoot up in the future, reflecting an increased perception of risk and the massive issuance of public debt. If we factor in subdued growth for several years, debt dynamics can turn very negative.

So even if the swift and strong policy reaction is largely warranted in the present circumstances, it should be followed by a timely and decisive withdrawal of the stimulus when the situation stabilises, as I pointed before.

A further consideration in view of the large financial and fiscal packages introduced in advanced economies regards emerging markets, which may suffer lasting financing constraints. On the one hand, sovereign spreads have widened substantially; and on the other, the increasing supply of sovereign issues by advanced economies increases the competition that emerging economies face in financing themselves in the markets.

I would like to make a last point, on **the need for international policy cooperation,** before leaving the floor.

There is a risk that national responses lead to a reversal in globalisation which, in spite of possible excesses, has been the driving force behind the increased growth potential in recent decades. The case of trade I mentioned earlier is just one aspect of the possible impact of the crisis on the globalisation process, but I should stress that the risk of financial de-globalisation is also high.
As I suggested, the natural reaction to a crisis in advanced economies is retrenchment, back to the domestic base. But on top of it, the national financial policy options –in particular, those aimed at keeping domestic credit flowing- may exacerbate this retrenchment through the segmentation of markets. Contrary to protectionism, which is an explicit policy option, financial de-globalisation may be the unintended outcome of domestic policies.

This risk and the synergies that joint coherent action may provide highlight the need for international policy cooperation. The efforts within the G-20 and the European Union go in the right direction, although they are far from complete.

At present, the outlook for the global economy remains highly uncertain. On the positive side, a fair amount of stimulus is in the pipeline and the framework for financial support is slowly settling down. On the negative side, the unfavourable effects of the perverse real-financial interactions have not been fully felt yet. These counteracting forces and their impact on confidence will determine the scope for the recovery of the global economy. But as mentioned, such recovery will not take hold until the policy efforts succeed in sorting out the deep-seated problems of the financial system.
Let me conclude. We have a very busy day ahead to discuss these topics, but to end on a positive note I just hope that in our next meeting two years from now we will have succeeded in leaving the crisis behind and our economies once again enjoy growth, but this time based on really sound economic and financial foundations.

Thank you.