Recent financial and economic developments from an emerging market perspective

CVI Meeting of Central Bank Governors, CEMLA, October 11, 2018

Juan José Echavarría
Governor
Global economic and financial developments and prospects

1. Real sector issues
   • Economic activity
   • Trade tensions
   • Commodity prices
   • Policy perspectives

2. Financial factors and amplifiers
   • Tightening of financial conditions
   • The role of foreign investors in EMEs’ local markets

3. Some questions and policy issues
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Global economic expansion remains solid but has become less synchronized. Activity moderated more than expected in some advanced economies such as the Euro area. Asia continued to register strong growth while Latin America and the Caribbean region is lagging behind from the rest of the world.

**Growth projections (%)**

<table>
<thead>
<tr>
<th></th>
<th>2017</th>
<th>April projections</th>
<th>October projections</th>
<th>Change</th>
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</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>World</td>
<td>3.8</td>
<td>3.9</td>
<td>3.9</td>
<td>3.7</td>
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<tr>
<td>Advanced Economies</td>
<td>2.3</td>
<td>2.5</td>
<td>2.2</td>
<td>2.4</td>
</tr>
<tr>
<td>Euro area</td>
<td>2.3</td>
<td>2.4</td>
<td>2.0</td>
<td>2.0</td>
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<tr>
<td>Emerging markets</td>
<td>4.8</td>
<td>4.9</td>
<td>5.1</td>
<td>4.7</td>
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<tr>
<td>Latin America and the Caribbean</td>
<td>1.3</td>
<td>2.0</td>
<td>2.8</td>
<td>1.2</td>
</tr>
<tr>
<td>United States</td>
<td>2.3</td>
<td>2.9</td>
<td>2.7</td>
<td>2.9</td>
</tr>
</tbody>
</table>

Source: IMF

Latin America and the Caribbean includes Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Paraguay, Peru, Uruguay and Venezuela.
World industrial production has lost momentum, in some AEs and EMEs.
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Trade tensions may have started to affect activity. Emerging-market assets may have been affected by the escalation of trade tensions between the United States and China....

... the trade wars could hinder global financial conditions and investment, although the effects on individual countries would depend on possible trade deviation.
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Divergent commodity prices dynamics might explain part of the de-synchronization of economic activity in EMEs.

Rising oil prices due to supply factors (e.g. issues in Venezuela and Iran) may affect global economic activity going forward.
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Policy space to deal with a slowdown in economic activity is limited in some AEs and EMEs.

Fiscal space is specially reduced. Public debt-to-GDP ratios remain on an upward trajectory for advanced and emerging market economies. Vulnerabilities continue to rise as financial conditions tighten, especially for EMEs.
Limited room of manoeuvre for monetary policy. In AEs, central bank balance sheets reached high historical levels accompanied by low interest rates. In some EMEs the real interest rates are at historical lows.

Emerging markets: Argentina, Brazil, Chile, China, Czech Republic, Hungary, India, Korea, Malaysia, Philippines, Poland, Mexico, South Africa, Russia, Thailand, Saudi Arabia, Turkey

Advanced economies: Australia, Canada, Switzerland, Denmark, United Kingdom, Norway, Sweden, United States

Source: BIS
The accumulation of private debt may also limit the space for monetary policy expansion in some economies.

Source: BIS
In some EMEs, international reserves ratios are lower than prior to the GFC. **Lower ability to absorb external shocks.**
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Long term interest rates have increased significantly in some advanced economies. A compression in term premium suggests that long-term interest rates are linked with increased expected short-term interest rates.

Also, there is a potential increase in the term premium which would add to the tighter financial conditions.
However, the recent decrease in corporate spreads suggests that financial conditions remain easy in the US.

Aggregate financial conditions indexes indicate tighter conditions, though still expansionary.
Likewise, during 2018 capital inflows to EME have fallen with higher sovereign spreads suggesting tighter financial conditions.

**Portfolio Flows to Emerging Markets**

- **USD Billions**
  - Sep-14, Mar-15, Sep-15, Mar-16, Sep-16, Mar-17, Sep-17, Mar-18, Sep-18

**EMBI (%)**

- Colombia
- Peru
- Brazil
- Chile
- China
- South Africa
- Malaysia
- Mexico

Source: IIF

Source: Bloomberg
Higher external interest rates and risk premia have contributed to a tightening of financial conditions in EMEs. Already this tightening has been reflected in some EME local bond markets.

Source: Bloomberg
Apparently investors have been differentiating between emerging markets, so far. Lower rated emerging economies have seen larger currency depreciations and greater CDS changes.

Source: Bloomberg, Calculations Banco de la República
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EME’s have benefited from a higher presence of foreign portfolio investors in their local markets (reduced “original sin”).

Nevertheless a larger participation of offshore investors can pose some risks (e.g. procyclical behavior). In some countries, their presence has generated high volatility.
In the long term, the investor’s base matters and can suffer some changes.

**Colombia:**
In 2012 international banks were the main investors. But since then, mutual funds, pension funds and monetary authorities have increased their investments considerably.
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Some questions remain ...

1. Since financial conditions have tightened in emerging markets, most countries with external weaknesses have experienced mostly a depreciation of their currency, as investors have begun to differentiate among markets.
   Two alternate explanations:
   • **Overshooting hypothesis**. We were scared by volatility but we will come back to previous scenario.
   • **Benign markets hypothesis**. Markets were undervaluing the risk. We entered to a new equilibrium.

2. What should be expected from the trade tensions?

3. What will be the effects of these trade tensions on the terms of trade of the emerging markets?
Policy implications

It is necessary to implement reforms that enable the economy to withstand external shocks:

- **First line of defense:** Exchange rate flexibility but with some preconditions
  - Limited currency mismatches
  - A credible monetary regime
  - Sound and robust financial sector
  - Sound fiscal policy
- **Second line of defense:** External buffers
Thank you