October 28, 29 and 30, 2020

XXV (Digital) Meeting of the Central Bank Researchers Network

Opening Remarks

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Good morning everyone. It is a pleasure to welcome you to the **XXV (this time Digital) Meeting of the Central Bank Research Network**. A quarter of a century is a milestone to celebrate and reflect upon.

First, I would like to thank Professor Raghuram Rajan, who will be our keynote speaker. I am glad that he accepted our invitation to share his views on a timely topic: Covid-19 in Emerging Market Economies (EMEs). In my opinion, he is one but of a handful of economists in the world who is equally able as a policy maker, as he is as a scholar. His keynote lecture will be a fitting aperture to our three days meeting.

Next, I would like to convey our gratitude to the Central Bank of Uruguay for co-hosting this event. In particular, to Governor Diego Labat and to Jorge Ponce, for their support. Last, but certainly not least, I would like to thank all participants that have contributed to this meeting. We have a total of over 150 registered participants.

For this meeting, there are 24 papers, divided into six sessions, two of which will be parallel sessions on Friday. In addition, we have two invited papers. Tomorrow, we will have the winners of the Rodrigo Gómez 2019 Central Bank Award presenting. On Friday, a paper will be presented that is the product of a joint CEMLA-Central Bank of Uruguay effort.

On my remarks today, I would like to focus on three broad themes.

- ✓ First, I would like to emphasize the importance we give to research at CEMLA.
- ✓ Second, on the economic policy response to the Covid-19 crisis, mainly, on some of the challenges going forward.
- ✓ Third, I will make some brief remarks on some of the papers being presented.

I. On Research

Since I was appointed CEMLA's general manager, the importance of research has changed here at CEMLA.

There are several good reasons to have a solid research program. A key one is that it provides a strong and necessary foundation for the design, preparation, and implementation of CEMLA's activities. In effect, I believe that having active researchers puts CEMLA in a vantage position in this regard.

We have new researchers at CEMLA. Three have already joined us and one will do so shortly. They are Guillermo Moloche from Perú; Matías Ossandon Busch from Chile; Carola Mueller from Germany; and Manuel Mosquera from Argentina. Each one brings much value added to our Center.

As a key vehicle for this renewed focus on research, I would like to underscore the recent digital launch of the *Latin American Journal of Central Banking* (LAJCB). There are, at least, three key pillars to making this journal a successful one.

- ✓ The first one is its leadership. The LAJCB has a top-notch editorial advisory board made of distinguished scholars, policy makers, and professional economists. The editorial advisory board meets on an annual basis to discuss the journal's long run strategy.

- ✓ The second one is the editorial team, which includes a network of associate editors who directly support the refereeing processes. The idea of having a relatively large network of associate editors serves two purposes. Our editors first task is to find a good match between each paper and its reviewers and, further, to wisely make use of each reviewer's time.

- ✓ The third pillar of this journal is you, the researchers. It is your participation that is vital for its success. In effect, you should not see the *Latin American Journal of Central Banking* as CEMLA's journal; rather, you should see it as your journal.

We see central banking as a subject encompassing a broad range of topics. This reflects our interests, those of CEMLA's membership, as well as the ongoing changes that are taking place in central banking, most conspicuously, those involving technological advances.

Notably, the journal accepts full-length papers as well as policy papers.[1]

All these elements need to work seamlessly. We have been working hard for this to happen.

II. Covid-19

I´ll now make some brief comments on the policy response to the Covid-19 pandemic.

The Covid-19 crisis struck as we were all starting to put the Global Financial Crisis (GFC) behind us. It did so regionally first, and then propagated globally. The crisis is, in its origins, an extraordinary public health emergency. For several authorities, it has taken a massive effort to respond adequately to the demand for health services, while others clearly haven´t.

[1] We count with Elsevier as the editorial house of the journal. It has backed us with its services as well as infrastructure.

From an economic perspective, the policy responses to Covid-19 have been led by fiscal authorities (Blanchard, 2020). Evidently, a global pandemic is not a monetary shock. Having said that, central banks have responded to the crisis in important ways.

First of all, they have played fundamental roles in the **provision of liquidity** to financial markets and in facilitating the **continued provision of credit** to the economy. I have spoken at length about these issues at other CEMLA events and fora. Thus, let me concentrate on some issues that I believe will be *brought forth* by the Covid-19 crisis.

For an economic recovery to take hold, the **pandemic must be brought under control**. Three elements to this are:

i) A reliable and low-cost **test** for the disease.
ii) A trustworthy and low-cost medical **treatment**; and,
iii) An effective and low-cost **vaccine**.

There will also be a significant logistical challenge in inoculating a large portion of the world population.

All in all, the main point here is that countries need to bring the pandemic under control for there to be a full recovery of consumption and investment. Otherwise, a situation somewhat akin to the peso problem comes to mind. Indeed, even if the chance of someone getting infected and severely affected, or even dying, is small, so long as it is not zero, it will distort consumer and investor attitudes, inhibiting them. This is probably already the case in many services sectors, for example, in the hospitality, recreation and transport industries.

On top of the above, for a variety of reasons, it is doubtful that economic activity will recover to pre-pandemic levels anytime soon. It is well known that after sharp drops in economic activity, hysteresis sets in, perhaps because of different frictions that persist in input markets. Let me underline two relevant aspects about this concerning the labor market.

i) A job involves, in many cases, human capital that is sector specific. Under a separation, there will probably be a loss.
ii) When the unemployment rate is high and the vacancy one is low, someone who is unemployed is likely to take the next available offer she has, albeit it might not be her best match.

A more macro element that is related to both human and physical capital, is that major changes in relative prices are and probably will continue to take place, both at the intra-national and the international levels. This will imply that some individuals´ skills and/or sectors will become more profitable, while others less so. *Indeed, a considerable reallocation of resources is likely to take place*.

Three relevant implications are.

1) **Bankruptcy laws** need to be efficient to not unnecessarily prolong asset freezing. Bankruptcy proceedings should be an important element of a "creative destruction" process.
2) There will be a need for **banking sector resilience** to absorb losses and for the **reallocation of credit** to profitable sectors. Here we can see the necessity to recalibrate and possibly, at some point, even revert the support that has been given to banks through **regulatory forbearance**.
3) For such a reallocation to be efficient, beyond macroeconomic support, many EMEs need structural reforms conducive to more competition, and to labor and social security laws. Both would need to address the presence of the informal sector.

Something similar is likely to happen with **fiscal policy**: the need for a redesign of the tax system and a reallocation of public spending (e.g., more spending in health). Moreover this, unfortunately, would need to be done in a context where most economies in the region have *limited fiscal space*.

From a **monetary perspective**, a balance will have to be struck between the risk of allowing monetary accommodation to remain in place for too long and, thus, generate unwarranted inflation, and that of withdrawing it too early, a situation where we could observe "cliff effects" or, at the very least, a slowing down of the recovery.

The possibility of the pandemic **raising unemployment structurally** would require the redesign of social security, unemployment insurance, as well as considerable efforts to retrain many workers and reduce job search frictions. In EMEs, where the informal sector has such a prominent role, social security will be patently insufficient, for which the need for a redesign will become ever more urgent.

A key word here is *redesign*: as Santiago Levy has argued, it is not enough to direct more public resources to social security in the presence of a segmented system, as is the case in many countries in the region. *Beyond* this, for example, it would be highly desirable to go in the direction of universal health financed by general taxes such as VATs or firm income taxes. There already have been and will continue to be sharp increases in **poverty levels**. This represents possibly the greatest challenge.

In sum, it is quite probable that governments' roles in EMEs will increase. How this is implemented will define whether our economies will be able to regain sustainable economic growth for years to come.

I am afraid, however, that perhaps there aren´t that many reasons to be optimistic. Many of the reforms that will be urgently needed *have already been so* for many years in many of our economies. To reduce the gap between insufficient skills and the difficulties of using ever more sophisticated technologies, to better incentivize our economies, for example, through more competition, and to level the playing field for new entrants in various sectors, has been a very difficult task in many EMEs. Add to this the need to transition to greener technologies. It´s quite a package with a mostly very gloomy record.

Some of the common denominators that need to be present are competition, labor market flexibility, universal social insurance, effective bankruptcy laws and a reduction of the wedge between skills and technology.

Indeed, there need to be conditions for there to be “creative destruction”. However, paraphrasing Santiago Levy, in many of our economies, which have large informal sectors, there are incentives for “*destructive creation*”: that is, as unprofitable firms die, incentives are there to create new ones in the informal sector, with outdated physical capital and no incentives for the accumulation of human capital. *The resulting poor performance of productivity is well known*.

Relatedly, let me just briefly mention a (2009) paper by Rajan.[2] There, he models an economy with the characteristics of many EMEs in which three agents, the oligopolists, educated and uneducated, interact in a game. He shows that, under the conditions that characterize many of our economies, there won´t be an equilibrium where there is integral structural reform. Indeed, there will always be a coalition of two agents that blocks the third´s desires for reform, as they all want other agents’ rents to disappear, but not at the cost of losing theirs. These are stable and perverse equilibria.

III. The Meeting

Let me now make some comments on the stimulating papers that will be presented in the following days, associating them with some of the remarks I have just made.

Some policies implemented by central banks have involved **regulatory forbearance**. On this regard, Mourad, Schiozer and dos Santos (2019) explore bank loan forbearance, providing evidence from millions of restructured loans in Brazil. They explore when and how bad bank loans are renegotiated. While their study is based on a specific form of forbearance, it can be informative for public policy design, particularly, on how such a policy might be effective or not.

Labor markets have been subject to notable shocks. As I mentioned, job separation involves efficiency losses and, in the process, new job matches can be suboptimal. In this context:

- ✓ **Morales et al.** examine the effects of the Covid-19 pandemic on the Colombian labor market. They document that sector-specific restrictions have affected employment, and account for one quarter of the losses. The remaining three quarters are explained by the epidemiologic and economic factors evenly affecting the country. Thus, we should expect significant employment losses even under the absence of the referred restrictions. This suggests that labor market negative outcomes could be quite persistent.

- ✓ **Haas Ornelas and Fajardo** explore how negative personal experiences in the labor market can affect household credit behavior adversely. As a corollary, long job separations could make it harder for policy makers to reactivate economic activity based on the enabling of credit channels.

I mentioned that we should be concerned about the **banking sector’s resilience.**

- ✓ **Landaberry et al.** explore credit risk and its systemic effects. They do so in an interbank network in Uruguay. This is one of the first papers in which the intrafirm exposures are

[2] Rajan (2009) Rent Preservation and the Persistence of Underdevelopment, AEJ: Macroeconomics, Vol. 1, No. 1, January.

estimated and used for the computation of a systemic risk measure. If we want to understand how resilient a banking sector is, we need to measure systemic risk as precisely as possible.

- ✓ If the financial condition of some banks deteriorates, we might face insolvencies. In turn, the level of competition in the banking sector could be affected and, with it, its risk-taking. Understanding the relationship between bank competition and risk-taking could become more relevant and, thus, **Pozo and Rojas**' paper on this topic.[3]

I mentioned the need of using fiscal policy in a setting where there is little fiscal space. Such space has to be used prudently, which implies, among other things, that its interaction with other policies should be thought thoroughly. On this matter, we have **André et al.'s** paper, which analyzes the interaction between monetary and fiscal policy for the case of a small open economy.[4]

I also mentioned that from a monetary perspective there must be a balance, a part of which depends on price and inflation expectations' formation.

- ✓ Three papers, by **D'Acunto et al., Frache et al. and Pedersen** shed some light on such processes. Their research suggests that, perhaps, agents pay more attention to everyday pricing experiences than we thought; firms are very concerned about their costs when determining their prices; and agents differ in the way in which they conceive inflation expectations.

On monetary policy related work, we have the following papers:

- ✓ **Eguren-Martin et al.'s** characterizes the distribution of capital flows for a group of EMEs as a function of financial indicators. They find the strongest reactions are in its left tail. This is compatible with the presence of herd-like type behavior among exiting investors.

- ✓ Relatedly, **Carrasco and Florian's** paper on FX interventions, a policy measure that has been an important part of the policy toolkit of EMEs during this crisis.

As **poverty levels** rise, many governments will respond. Having the right positive analysis is relevant. In this regard,

- ✓ **Fernández-Bujanda's** findings suggest that good deeds might not be enough. He finds that minimum wage increases in Mexico seemed to have affected formal employment adversely. It could be argued that if the agents that were previously employed in the formal sector transit to the informal one, such policies might have a negative bearing on productivity.

[3] The Covid-19 crisis has changed many of our habits. An important one is the use of cash. Elosegui and Pinto explore some of the constraints that EMEs face in moving towards a cashless economy. They use a model of payment methods that includes determinants of the adoption of electronic ones. In addition, they examine the underlying factors of the decisions to adopt and use a credit card in Argentina, underscoring the role of the network effects and informality in driving such decisions.
[4] For their part, Lankester et al. study the interdependence between monetary and fiscal policy in Costa Rica through different lenses.

- ✓ **Cantore and Freund,** based on a two-agent New Keynesian model in which one agent faces limited asset market participation and the other one concentrates firm ownership, argue that changes in fiscal policy could have adverse distributional implications.

As the role of governments rise, active fiscal policies might bring about doubts on government finances, which could in turn put pressure on monetary policy. **Ramos-Francia et al.** explore the historical interaction between the fiscal deficits and inflation dynamics for the case of Mexico. Particularly, how seigniorage financed deficits have led to high and unstable inflation expectations episodes. Such episodes have been confronted with reforms.

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