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# XIV (Digital) Meeting on International Reserves Management

## Opening Remarks

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Welcome to the **XIV Meeting on International Reserves Management**. The last time we met was in Lima in 2019, and had the *Banco Central de Reserva del Perú* as co-organizer. This time we meet digitally and have as co-organizer *Banco de México*. I would like to candidly thank *Banxico* for its support.

Let me make an announcement. We have decided to organize this **Meeting on International Reserves Management** on an annual basis. Furthermore, we will also organize the **Meeting on Central Bank Operations** annually. Prior to this edition, these meetings alternated biennially. These changes reflect our conviction on the relevance of these topics.

I would like to sincerely thank all participants that have found the time in their hectic schedules to share their expertise and knowledge with our community; particularly, central bank senior officials. I am convinced that the informative presentations and dialogue that will ensue during this meeting will be beneficial to all.

There has been a pronounced increase in the balance sheets of various central banks, both in AEs and EMEs, in the past decade and a half, although for different reasons. For many in EMEs, the component that has taken the most prominent role is that of **International Reserves (IR).** Managing and accumulating IR have become increasingly challenging tasks. They involve much work, analysis, and a good understanding of the macroeconomic environment.

As is well known, central banks accumulate and hold IR for a plethora of reasons. For instance, 1) as self-insurance, 2) to signal confidence to investors, and 3) as precautionary funds, among others. They have become a key option in the policy toolkit of central banks.[1]

I will organize my remarks today into the following two broad topics.

- The Macro environment
- Will there be market tantrums redux?

**<u>Macro Environment</u>**

World GDP registered 2.8% growth in 2019, contrasting with a contraction, mostly due to COVID, of 3.3% in 2020. Of course, this took place against a backdrop of an important set of economic

[1] One classical issue is whether the level of international reserves is appropriate. Many analytical criteria have been proposed, but there are other considerations in its determination, some of which I discuss further below.

policies being emplaced, led by the fiscal authorities in most cases, as a response to the pandemic.[2]

Central banks, while not at the policy center stage this time around, have played key roles in terms of liquidity and credit provision, as well as in financial stability. Indeed, the use of IR to provide adequate liquidity in FX and other financial markets under conditions of systemic stress has been key in stabilizing those markets, once again showing that there are important benefits to IR accumulation. **A topic of keen interest, then, is understanding the macroeconomic environment or conditions under which IR accumulation takes place**. Evidently, capital flows are of key interest.

The economic implications of the COVID pandemic have been harsh for most, if not all, economies. AEs economic activity fell by 4.7% in 2020, after having registered 1.6% growth in 2019. Specifically, U.S. GDP fell 3.5% in 2020, after having grown 2.2% in 2019. Growth in EMEs saw a similar pattern, falling 2.2% in 2020, after posting 3.6% growth in 2019.[3]

Going forward, however, it is worth underscoring that the impact on the expected economic recoveries is heterogenous, or divergent, as the IMF has called it. AEs´ GDP is expected (as of April 2021) to be 0.2% above its 2019 level by the end of 2021. What is remarkable about the US economy is that it is expected to reach in 2021 a GDP level 2.7% higher than its 2019 level. EMEs´ GDP is expected to be 4.3% above its 2019 level by 2021.[4] However, recoveries *in our region* are anything but promising, as I will later mention.

Although inflation has not been much of a concern for many years, some elements might play out differently this time around. There were several factors that contributed to persistently low, stable inflation. Let me next highlight some of them.

During the 1990s, **globalization** took full force, complemented with the incorporation of more women to the global labor force. This led to an unprecedented shift in the labor supply for the production of tradeable goods (Wolf, 2020 and 2021).

**More recently**, however, globalization has been in partial retreat for some years now. An event akin to China's entrance into the global scene will not be repeated. What is more, populations are ageing, adding to fiscal pressures in many economies.

The **secular stagnation** hypothesis**,** advocated by Lawrence Summers, is relevant in this context. It was brought to the fore by the Global Financial Crisis. It can be explained as the economy having a savings absorption problem, in effect, insufficient aggregate demand. Such conditions are reflected in low natural interest rates and also have implied low levels of inflation. As for the current conditions in the US labor market of a 6 per cent unemployment rate, some think that it could be understating slack conditions in the job market as, given the pandemic, there are possibly many discouraged workers and others that currently have a part-time position, but would like to have full-time job (see Powell, 2021).

[2] Calculations based on the IMFs' WEOs April 2021.
[3] Calculations based on the IMFs' WEOs April 2021.
[4] Calculations based on the IMFs' WEOs April 2021.

However, it is now argued by some that the stimulus already passed by the US Congress by far surpasses the currently estimated output gap, which could lead to inflationary pressures. These same people argue that, in terms of *effective* labor, slack in the labor market is much less than perceived.

For its part, the **Federal Reserve** just changed its operational framework. It now sees its inflation target as the average inflation along the business cycle and could, thus, tolerate a higher level of inflation than the target for some periods.

Recently, there has been much talk about the possibility of **reflation.**[5] This refers to deliberate inflation in the context of an economic recovery. It is justified on the grounds that it takes place after a period during which the price level has been below its trend. The crux of the matter is whether such change will be permanent or temporary and, if it is temporary, how persistent it will be.

Let me next briefly review some recent data.

- Currently, the five-year break-even inflation is 2.5%, while ten and thirty-year break-even inflations are 2.3% and 2.2%, respectively, although climbing rapidly.[6] They have increased around 50 bps, 30 and 15 bps, respectively, during this year (January 2-April 9). This suggests a certain inflation hump in the medium-term.

- For its part, the U.S. term premium has increased more than 50 bps in the last two months (140 bps from august 2020). This is indicative that average expected short-term interest rates in the U.S. are not the main factor explaining the recent rise in U.S. long-term interest rates, suggesting that the Federal Funds Rate will stay at very low levels for some time.

- In any case, long-term interest rates are still at historically low levels. For example, the ten-year U.S. yield is around 1.7% and the thirty-year, 2.3 %. (Their means since 1990s are about 4.8% and 4.9%, respectively).[7]

As can be appreciated, currently, the US business cycle is difficult to gauge. There is no consensus on how the different elements listed above will impact inflation and for how long, and thus, on the expected path of interest rates in the medium term. Nevertheless, the prevailing view seems to be that there could be a moderate, transitory increase in inflation to perhaps 3-3.5 per cent, and then gradually fade away consistent with usual business cycle dynamics. In effect, this view would mean reflation taking place, with the Fed accommodating the temporary spike in price increases. This would substantially reduce slack in the labor market, as the supply of labor is considered at present to be highly elastic. Under this view, long term inflation expectations do not become unanchored.

But, again, some people do not concur with this way of looking at things, and have been outspoken about their reservations, in particular, with respect to the size of the stimulus given in recent

[5] This term makes reference to a paper written by Irving Fisher in 1934
[6] Source: With data from Bloomberg. Inflation swaps tell a somewhat similar story, their levels of inflation are: 2.5%, 2.4%, and 2.3%, respectively (5-year, 10-year and 30-year horizons).
[7] Source: U.S. Treasury.

months (2.8 USD trillion) in the context of the FED stepping on the pedal in an unprecedented way.

For Latin America this discussion is key, particularly, the repercussions on expected US interest rates, especially in the long term. Low natural interest rates have undoubtedly been crucial for a very benign environment for capital inflows to the region and, thus, for IR accumulation. These conditions have triggered an unprecedented search for yield process and considerable risk taking. Evidently, in several countries, IR accumulation also depends on certain commodity prices, but it is clear that persistent low inflation and interest rates, i.e., low for long, have proven to be very favorable for most EMEs.

***The Latin American Economic Macro Environment***

If we consider 2019 GDP standardized levels against the expected GDP level for 2021 in April 2021, Brazil, Mexico, Colombia, and Peru are not expected to recover by end of this year. An exception is Chile, which is expected to reach such level by end 2021. This is taking place against a backdrop where the world is expected to reach in 2021 a level of GDP 2.6% above its 2019 level.[8]

The data above highlights a very important point. Not only has growth lagged in Latin American countries with respect to other EM regions, it is expected to continue doing so in the next few years. The lack of fiscal and monetary space certainly contributed to a lackluster response in all aspects to the pandemic when compared to AEs, and will mean a much slower recovery. This, in turn, adds to the urgent need of structural changes to make these economies more productive. **All in all, these elements do not forbode well for growth in the region**.

**Market Tantrum Redux**

For the past few years and for various reasons, conditions for capital flows to the Latin American region have been mostly very benign.

There have been mostly very favorable push factors, mainly very low natural rates and extraordinarily accommodative monetary policies in AEs, which have supported a very active search for yield process and risk taking.

Additionally, there have been, for the most part, and in many cases, favorable pull factors.

Both of these, push and pull factors, are now shifting in the opposite direction. Indeed, the share of foreign resident holdings of domestic currency government bonds in Latin America has decreased. (Term premia for Brazil, Chile, Colombia, Mexico and Peru have increased between 70 and 160 bps since their last minimum in the latter part of the second half of last year, and most are climbing.)

[8] Calculations based on the IMFs' WEOs April 2021. Brazil, Colombia, Mexico and Peru, are expected to reach 99.4%, 98.0%, 96.4% and 96.4%, respectively, of their 2019 GDP level.

How much will the investment setting change? Will there be a sustained spike in US inflation? How much more will ten-year TB yields increase? These are difficult questions to answer, but a lot is riding on them.

A big related question is whether US inflation and financial conditions can give rise to renewed market tantrum episodes. All the elements seem to be there: rising inflation expectations, term premia and long-term interest rates, in combination with poor growth perspectives for most of the region´s countries, compounded by the known fact (for various reasons) that liquidity conditions in most of the region´s financial market dry up very quickly in times of stress (the so-called pipes factors).

So far, the shift in investment settings has been moderate, gradual and not too painful, on top of the FED acting and communicating actively to keep financial markets functioning properly. But there is no doubt that in the foreseeable future, conditions for IR accumulation will not be as benign as in the last few years. We hope that adjustments such as portfolio re-balancing will continue to take place in a mostly orderly way, but have to prepare for more challenging times ahead.

Thank you

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