CEMLA
CENTER FOR LATIN AMERICAN MONETARY STUDIES

CEMLA/DALLAS FED FINANCIAL STABILITY WORKSHOP

Tackling the headwinds of inflation and higher interest rates

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Welcome and acknowledgements

Good morning, everyone. It is a great pleasure to welcome you to this Workshop on Financial Stability, jointly organized by the Federal Reserve Bank of Dallas and CEMLA. This workshop follows-up a series of research conferences on financial stability that CEMLA has organized over the last years, including last year's conference jointly organized with the Journal of Financial Stability.

As some of you may know, CEMLA operates since its creation in 1952 as the association of central banks of Latin America and the Caribbean, being therefore the oldest regional association of central banks worldwide. We are primarily a capacity building and research institution, providing through our activities, research and otherwise, policy advice and a coordination mechanism to our more than 50 member and collaborating institutions.

Therefore, we see this workshop as a key initiative to achieve our objective of fostering research activity within our community of central banks and financial supervisors, providing guidance on current benchmarks and advances in frontier financial stability research. We are excited and most honored with your presence here today. I hope you will find in CEMLA a comfortable space to discuss your research work and obtain valuable feedback during the next two days.

Before highlighting a few remarks, I wanted to thank the co-organizers for setting up this excellent agenda. In particular, I wanted to thank Scott Frame, Vice President in the Dallas Fed's Research Department and his staff for the excellent joint work in defining this year's agenda. I am aware of the effort that Scott and his team have put in this workshop, being directly involved in all stages of the organization. This fruitful cooperation with the Dallas Fed is allowing us to connect research activities between our members and leading research institutions both across the Federal Reserve System, as well as in universities in the US.

We are also honored to host Prof. Victoria Ivashina, Lovett-Learned Professor of Finance and

Head of the Finance Unit at Harvard Business School, who will be the keynote speaker today. In recent years, Victoria has achieved key contributions in the areas of international finance, corporate credit markets, and the real effects of financial markets' dynamics. As you are aware, her research has shaped academic and policy discussions, providing central insights to understand the drivers and consequences of financial crises.

I am convinced that we will benefit extensively from Victoria's experience to enrich the exchange of ideas between the more than 80 representatives from 30 central banks from across the Americas and the Caribbean, Asia and Europe who are joining us today, both in person and virtually.

Last, but not least, let me give a special shout-out to our staff at CEMLA for organizing the meeting. Particularly, Matías Ossandon Busch and Carola Müller from CEMLA's Financial Stability Directorate have been the driving force behind the organization of this workshop.

Sailing into headwinds of rate hikes and geopolitical risk

This workshop takes place in a challenging time for finance researchers. Some of the cornerstones that defined economic conditions over the last decades appear to be crumbling away. The era of "Great Moderation", only briefly disrupted by the Great Financial Crisis, where inflation and overall financial market volatility were low and markets seemed to be ever rising, is now coming to an end. A whole generation of young investors and policymakers had, until very recently, known nothing but bull markets. They are also unfamiliar with inflation. In the past 20 years, inflation in Advanced Economies was often below target, and even most Emerging Economies successfully kept inflation in check by putting their public finances in order and increasingly making use of inflation targeting and forward guidance.

Following the strong post-COVID rebound in the global economy observed during the second and third quarters of 2021, the recovery started fading out, reflecting formidable and unprecedent headwinds. Geopolitical tensions and uneven recovery paths also highlight that a new world is presenting itself to us. We see a regime-switch towards more volatile global financial markets and instead of prospering emerging markets eager to catch-up with industrialized countries, we see inequality on the rise and mounting debt sustainability concerns spreading across countries.

A first and paramount challenge is represented by inflation and the associated necessary hikes in interest rates. Illustrating the magnitude of this phenomenon, only in the US annual inflation went from an average of around 2% in the decade between 2009 and 2019, to an average of 8.2% since December 2021. In Latin America, the inflationary trend has followed a similar path, with the largest economies in the region finishing 2022 with an average inflation above 9%.[1]

In this environment of high global inflation, we have observed strong and decisive actions from monetary authorities worldwide, aiming at restoring price stability. The increase in the Effective Federal Reserve Funds rate from around 0.08% in March this year to the current levels of around 3.8% is the fastest pace of interest rates increases in recent history. The magnitude of this changing pattern is reflected in the fact that we have not seen such high levels of interest rates since before the Great Financial Crisis. Keeping up and in most cases ahead of this changing environment, central banks in Latin America led the way by reacting quickly and forcefully, with monetary policy rates in the largest economies in the region increasing on average by 9 percentage points since 2021. [2]

A new world of high inflation and tighter monetary conditions has material implications for the operation of financial markets, the more so given the uncertain macroeconomic and geopolitical environment that we observe worldwide.

Inflation surprises have been historically linked to increased market volatility and a disorderly repricing of assets (Mosk and Welz, 2022). This time around, this could become quite acute, as interest rates in most AEs have remained at historically low levels for a very prolonged period of time. Simultaneously, high inflation may lead equities to become more attractive than fixed income assets, particularly considering that bonds' nominal cash flows do not offer protection against inflation. These factors, among others, are likely to put further upward pressure on bonds' yields, as some recent numbers have been showing in different countries.

A clear example of this trend is the benchmark figure for the US 10-year Treasury Bond, whose yield has increased from 1.3% in January 2021, to a peak of 4.1% observed last November[3]. Similarly, the Bloomberg U.S. Aggregate Bond Index is, as of December 2022, down 16% from

[1] Own calculation using CPI data for Brazil (10%), Chile (11%), Colombia (9.5%), Mexico (7.8%), and Peru (7.7%). Based on monthly data from December 2021 to November 2022 from Haver Analytics.
[2] Own calculations based on data from Haver Analytics. The peak-to-trough change in the monetary policy rates between 2021 and 2022 is computed for Brazil (11.75 p.p.), Chile (10.75 p.p.), Colombia (9.25 p.p.), Mexico (5.75 p.p.), and Peru (7 p.p.).
[3] Data from the St. Louis Fed, see https://fred.stlouisfed.org/series/DGS10.

its peak in 2020. Notably, this number is more than double than any other peak-to-trough decline observed in this index historically, illustrating the extend of the deterioration in bond markets as investors have become increasingly risk averse.

Conflicting objectives? Price vs financial stability

As researchers interested in financial stability, you all understand that restoring price stability is of paramount importance as the basis for financial stability. These two objectives have, however, intricate double causal relationships, while well-functioning financial markets are also a necessary condition for monetary policy to be effective. Needless to say, with disrupted credit and treasury markets there is little that monetary policymakers can do to influence the real economy.

These trade-offs and policy interactions are certainly not new and reflect longstanding debates about potential conflicting objectives when considering central banks' mandates of price and financial stability. In the current inflationary context, a main concern derives from private and public debt sustainability, considering the massive increase in debt throughout the pandemic and the difficulties to raise, repay, and refinance credit with raising interest rates (FSB, 2022). This is an example of situations in which the stance of monetary policy can affect the sustainability of credit and the build-up of systemic risk, factors that macroprudential policies seek to offset.

The other side of the coin is that monetary and macroprudential policies can also reinforce each other when being aligned, as a stocktake of recent research suggests (see Laeven et al., 2020). The increase in bank lending following an accommodative phase of monetary policy has been found to be larger, particularly to riskier borrowers, in the presence of a looser macroprudential environment.

These findings are in line with the notion that monetary policy transmission is influenced by financial intermediaries' balance sheet characteristics. In effect, the response of banks to monetary policy, both in terms of credit volumes and risk-appetite, is directly affected by macroprudential policy actions. The corollary is that monetary policy can have a material impact on the stance of financial stability, whereas actions tackling financial stability risks directly affect well-understood channels of monetary policy transmission (see Acharya et al., 2022).

Certainly, the sizable and rapid shifts in interest rates we observe can be seen as a source of stress that lays bare vulnerabilities related to the build-up of debt of the last years, a dynamic further exacerbated by geopolitical risks and raising market uncertainty and volatility. While policy trade-offs are difficult in nature, one way that can guide us out of the gridlock is thinking about financial stability policies as actions that should enhance the structural resilience of financial institutions against shocks. While central banks in the short run always seem to take actions that reflect possible unfavorable trade-offs, monetary policy choices become easier when operating based on sounder macro-financial fundamentals. Evidently, when considering the appropriate time-horizon.

Furthermore, the importance of fostering market resilience through a comprehensive set of macroprudential policies is probably one of the main lessons from the post-Great Financial Crisis reforms. We all learned that individual policy decisions targeting specific objectives become more effective when being coordinated in a mutual-support scheme. This lesson certainly applies to the relationship between monetary and financial-stability objectives (Williams, 2022).

In the end, the timely and effective response of central banks at the onset of the COVID crisis benefited from operating on the basis of sound macro-financial conditions, with financial institutions having faced major reforms in their regulatory architecture in the decade before the pandemic, proving the effectiveness of global coordination efforts to strengthen financial resilience.

Despite the presence of conflicting objectives in certain scenarios, the COVID crisis has shown that a close coordination of monetary policy and prudential actions can amplify the effectiveness of monetary policy on credit supply, highlighting the importance of central banks' macroprudential toolboxes in providing a wider range of alternatives when action is needed in a timely manner. Exploiting these complementarities means also understanding how macroprudential policies can contain episodes of excessive leverage and maturity transformation in periods of monetary accommodation (Angelini et al., 2014).

Finally, we should not forget the importance of financial stability conditions for central banks' forward guidance strategies and communications. Weak and volatile market conditions make it harder to fully commit to policy responses ex-ante, which is crucial for anchoring inflation expectations. It is therefore of the highest importance to coordinate macroprudential and conventional central bank policies and communicate them clearly to the public. After all, credibility is the most valuable asset for central banks in the times ahead.

Making research relevant to policymaking

In today's grim economic scenario, the importance of economic research in contributing to guide policy discussions becomes evident. The topics and the papers selected for this workshop are good examples of how to link rigorous economic research with the possibility of informing key policy discussions, in topics ranging from financial digitalization to the increasing importance of climate-related risks. While boundary-crossing collaborations between academia and policy institutions are always challenging, I would like to highlight that fostering our understanding of financial stability challenges in areas such as finance, banking or macroeconomics will require an increasing dialogue between these fields.

Policy institutions face increasing pressures to justify their decisions vis-à-vis the public and other stakeholders, for which an honest and balanced evaluation of policy interventions is required. While many evaluation exercises are straightforward and can be done by policy experts, economic research can contribute to conceptualize evaluation methodologies, identifying data and methodological gaps, and assessing the validity of evaluation schemes.

Most importantly, research can assist to identify unintended consequences and spillovers of policy interventions that were not foreseen by policymakers in the first place. While randomized control trials and other forms of quasi-experimental designs are difficult to implement in the field of financial stability, the use of granular micro-data has improved researchers' capacity to evaluate the effectiveness of policies. Several papers included in this conference are good examples of how research can make us aware of the complexity of policy decisions by inspiring a critical view on policy evaluation.

From the researcher's perspective, sticking closely to evidence in the real world can help to adjust theories, critically revise previously documented evidence, and narrow down those narratives that best explain facts. The dialogue with policymakers also matters to reconcile seemingly opposing theories, which may turn to be valid under different institutional contexts or economic circumstances.

Final remarks

Before concluding, I would like to welcome you again and emphasize that this workshop is key to foster the dialogue between central banks and academia on key challenges for financial stability. At CEMLA we are grateful to host you and we are looking forward to promoting further collaboration and research initiatives among central banks that can improve our common understanding of relevant challenges, especially in these uncertain times.

I wish you a fruitful discussion during the workshop. Thank you for your attention.

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