¡Ándale Pues! Having Made the Tough Choices, Mexico Stands to Benefit From Reforms and Navigate Fed's Tapering With Relative Ease

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Thank you, Luis [Robles], for that kind introduction. It is my great pleasure to be here tonight as the guest of the Association of Mexican Banks and reunited with my colleagues from Banco de México. I recently returned from Europe, where I met with leaders from the European Central Bank and the National Bank of Switzerland.

I am very grateful to Governor Agustín Carstens for his hospitality. The Federal Reserve Bank of Dallas has enjoyed a long history of cooperation and consultation with the Banco de México. I like to call Banxico our sister bank. Agustín himself spent some time at the Dallas Fed when he was a young man, and we take pride in playing this small part in his accomplished career. For many years, the Dallas Fed's El Paso Branch has held joint board meetings and informational exchanges with the Banco de México regional board of directors in Ciudad Juárez. Now our branches in Houston and San Antonio are holding similar joint meetings with their Banco de México counterparts. And Governor Carstens' predecessor, Guillermo Ortiz, is an advisory board member of the Dallas Fed's Globalization and Monetary Policy Institute. The Federal Reserve Bank of Dallas and the Banco de México enjoy a unique and mutually beneficial relationship.

As Guillermo and Agustín well know, there is also a personal dimension to the Dallas Fed's relationship with the Banco de México. I grew up in Mexico City in the 1950s, attending elementary school not far from here. Spanish was my first language in school. To this day, I have many friends in El Norte who say I speak better Spanish than I do English, although that may be due to my Texas accent. Either way, I always proudly tell them, "*¡No hablo español; hablo puro mexicano!*" This evening, I will do my level best to speak to you in *español mexicano* rather than in *inglés texano*.

Unprecedented U.S. Monetary Policy

As you surely know, and as I am happy to report, the Federal Open Market Committee (the "FOMC"), charged with crafting U.S. monetary policy, is winding down its extraordinary "quantitative easing" phase. The Great Recession demanded extraordinary policy, and the FOMC responded. Led by Chairman Bernanke, the FOMC met the financial crisis head-on in September 2007 and by the end of 2008 had lowered the federal funds rate to zero from 5.25 percent.

Once the full force of the financial crisis hit, after the failure of Lehman Brothers, the federal funds tool proved insufficient. First individual companies had to be rescued, then the banking system, and eventually the whole economy. Conventional thought held that there was little that policymakers could do after reaching the zero bound—when the central bank's policy rate hit zero. But the FOMC thought otherwise.

By mid-2009, the gross domestic product (GDP) in the U.S. began to recover after contracting 4.3 percent. Progress was painfully slow. GDP eked out 1.3 percent growth in the third quarter and put the U.S. back on a growth path. Meanwhile, the labor market lagged. The unemployment rate was 9.6 percent, employment growth was still out of reach, and real wages were falling. The labor market is central to FOMC deliberations. While most other central banks, including Banco de México, are legally bound to only ensure price stability, U.S. policymakers are charged with a dual mandate: ensuring price stability *and* maximum employment. By the middle of 2009, the jobs deficit (jobs lost since the prerecession peak in employment) was 8 million and rising.

Thus, we embarked on an aggressive path of quantitative easing (QE), launching large-scale purchases of U.S. Treasuries and mortgage-backed securities and U.S. housing agency debt. The first round of QE ran until March 2010, when the labor market had finally started recovering. By the conclusion of QE1, the Fed had infused the economy with $1.25 trillion in liquidity. Second and third rounds of quantitative easing were announced in November 2010 and September 2012, respectively.

By the time the Fed began tapering the pace of these asset purchases in December of 2013, the Fed's balance sheet had ballooned from below $1 trillion to more than $4 trillion in just four years. Today, the Federal Reserve has an unprecedented volume and diversity of assets. Correspondingly, banks hold an unprecedented amount of reserves. Total reserves at depository institutions have skyrocketed from $45 billion before the crisis to $2.5 trillion today. The stock of bank reserves awaiting discharge into the economy through our banking system is vast and, troublingly, mostly unused.

There is plenty of money available for American businesses to work with. Consider this: In fourth quarter 2007, U.S. GDP was $14.7 trillion; at year-end 2013 it was an estimated $17.1 trillion. Had we continued on the path we were on before the crisis, real GDP would currently be roughly $20 trillion in size. That's a third larger than it was in 2007. Yet the amount of money going unused in the banking system is 60 times greater now than at year-end 2007. It isn't a lack of liquidity that is keeping businesses from putting people back to work.

Money's Cheap and Abundant, Yet the Recovery Disappoints

The Federal Reserve has created an opportunity for others to act. Money is cheap and plentiful. The objective now is for banks to lend, consumers to borrow, and businesses to invest so jobs are created and economic activity expands. With such aggressive monetary policy, it is surprising that the economic recovery has languished. Notwithstanding recent data that show consumers are borrowing again, four and a half years into the economic recovery, employment still has not reached its prerecession level, making this by far the slowest of the 12 post-World War II U.S. recoveries.

One problem has been the sluggish pace of the recovery in the other advanced economies. The financial crisis was a global phenomenon, affecting advanced and emerging market economies alike. Yet the emerging market economies bounced back and in almost all cases have long since surpassed their precrisis levels of output. This has not been the case in the advanced economies.

Europe and the euro zone, which have been hobbled by a series of sovereign debt crises in the wake of the financial crisis and the adoption of a single currency, remain important to the global economy, and problems there cannot help but have international repercussions. The good news is that European Central Bank (ECB) President Mario Draghi's pledge in 2012 to "do whatever it takes" to stabilize the situation there seems to have worked and to have bought time for much-needed reforms. In conversations with President Draghi and the ECB governors last Friday, it was clear that recent data suggest the worst may be over.

Meanwhile, in Japan, "Abenomics" seems to be succeeding in ending the decades-long deflation, though progress on structural reforms—crucial to restoring long-term growth—has been disappointing. There is an important lesson here, one to which I will return later: Monetary policy can only do so much. In the case of Japan, monetary policy can end the deflation that has characterized the economy since the late 1990s, but can do little to infuse long-run expansion unless it is accompanied by fiscal policy that implements structural change.

But the biggest problem the U.S. confronts is homegrown: political failure in Washington to act on the key issues holding the recovery hostage. Fiscal and regulatory uncertainty is a powerful deterrent to business investment. Going back to the earliest days of the current recovery, my business contacts have regularly complained of the fog of uncertainty emanating from Washington. They have consistently cited fiscal and regulatory uncertainty as major impediments to capital investment and expanding payrolls.

Uncertainty comes in many forms. In some cases it is major legislation such as the health care reform or financial regulation as in the Dodd Frank [Wall Street Reform and Consumer Protection] Act. Fiscal issues have regularly constrained the recovery—the debt ceiling debacle in summer 2011, the last-minute resolution of the fiscal cliff in December 2012, the brute force sequester of 2013 and so on. Most vexing is not knowing how businesses will be taxed or how the federal government will shape future spending. This makes budgeting and planning capital outlays and payrolls into the future an uncertain process.

It is my personal opinion that the Fed has bought time for fiscal authorities to get their house in order, but four years later I am not sure we are much closer to that goal. It is true that Washington politicians stopped bickering long enough in December to pass a budget, the first budget in four years. And the projected budget deficit is just 3 percent of GDP this fiscal year, down from 4.1 percent in 2013 and 7 percent in 2012. After five years of outsized deficits, the U.S. is finally on par with Mexico, whose deficit throughout the recovery never exceeded 2.8 percent of GDP.

You might think that agreeing on a budget means the U.S. government can go about its business, taxing and spending and keeping the monuments open to tourists. But in the U.S. we have another obstacle, the debt ceiling. This ritual battle, which we have fought at least 87 times since the end of World War II, does not address the underlying imbalances at the root of our fiscal situation. Nevertheless, we revisit it regularly and did so in February when Congress actually approved raising the debt ceiling without a big fight. Last time, you may recall, things did not go so smoothly. The stock markets wobbled, the International Monetary Fund (IMF) issued warnings, and one of the credit rating agencies downgraded U.S. government debt.

The debt ceiling may be well-intentioned and put in place to protect our children from our own and prior generations' excesses, but it has been completely ineffectual in stopping rising debt and may be contributing to the uncertainty that is holding up the recovery. U.S. debt held by the public has ballooned to 76 percent of GDP, up from 36 percent in 2007. The U.S. is nearing debt-to-GDP ratios not seen since the aftermath of World War II. In contrast, Mexico's debt is relatively small, about 30 percent of GDP, although it too has increased, and is up from 20 percent in 2007.

Here in Mexico as in the U.S., the recession worsened the fiscal situation by depressing tax revenues while spending rose. That said, the nations' trajectories are quite different. While the growth of U.S. government debt has temporarily slowed, longer-term factors are expected to push the debt-to-GDP ratio to 100 percent by 2038 from where it will likely continue rising. Mexico's debt-to-GDP ratio is projected to fall once the recently passed fiscal reform is fully implemented.

This era of unprecedented liquidity and low interest rates has presented the U.S. with at least three great opportunities:

One was to address the long-term fiscal outlook by reforming entitlement programs such as Social Security and Medicare. We must create a balanced system that will prevent future liabilities from spiraling out of control.

A second was to pass regulatory reforms to lessen the risk of future financial-market crises and ensure too-big-to-fail entities never again place the U.S. in a position where taxpayer funds must be used to bail out bad private-sector actors.

A third was to restructure government debt while long-term rates are at historic lows. Within the next four years, 58 percent of U.S. government debt will mature. And though short-term rates are low now, they won't be low forever. When the existing debt matures, rates are sure to be higher and servicing the debt will take a bigger share out of the budget, leaving less to spend on everything else. One sobering statistic is that net interest payments on the debt are scheduled to nearly triple by the end of the decade, rising from $221 billion in fiscal year 2013 (1.3 percent of GDP) to $635 billion in fiscal year 2020 (2.8 percent of GDP).

I would say that this era of cheap money is one of missed opportunities on all three of these fronts. To add insult to injury, there are increasing signs quantitative easing has overstayed its welcome: Market distortions and acting on bad incentives are becoming more pervasive.

Stock market metrics such as price to projected forward earnings, price-to-sales ratios and market capitalization as a percentage of GDP are at eye-popping levels not seen since the dot-com boom of the late 1990s. In the words of James Mackintosh, writer of the *Financial Times* column "The Short View," a not insignificant number of stocks in the S&P 500 have valuations "that rely on belief in a financial fairy." Margin debt is pushing up against all-time records. And, in the bond market, narrow spreads between corporate and Treasury debt reflect lower risk premia on top of already abnormally low nominal yields. We must monitor these indicators very carefully so as to ensure that the ghost of "irrational exuberance" does not haunt us again.

QE Spillovers

As you well know, the effects of unprecedented monetary easing in the U.S. and other advanced economies do not stop at international borders. They spill over onto the rest of the world. Record-low interest rates engineered by central bankers have led investors to seek higher returns elsewhere, generating massive inflows of capital into emerging market economies (EME), including Mexico. Let's not forget that capital flows to EMEs were large even before the crisis. That said, they rose further as quantitative easing gained momentum in the U.S. and other nations adopted similar policies. For example, U.S. capital stock as a share of home-country GDP rose from 11 percent to 17 percent in Brazil and from 18 percent to 25 percent in Mexico between 2008 and 2012. Capital flows were increasingly made up of portfolio investment rather than direct investment during this time.

News of Fed tapering in late spring last year reversed the flow of capital into EME-dedicated equity and bond funds, and emerging market currencies depreciated against the dollar. Sovereign debt yields rose sharply in vulnerable emerging market nations such as Brazil and Turkey. Sovereign debt spreads edged up in Mexico also, but significantly less so than in other EMEs. Much like in the morning after a party the night before, investors woke up sober and more discriminating.

Why Mexico Stands Apart

There are concerns that the outsized capital flows to EMEs during the QE era pushed down interest rates and led consumers and businesses to take on too much debt. Mexico seems better positioned than many other countries in terms of this risk exposure. While according to the Banco de Mexico, private lending is up 38 percent since its recession low in 2010, international comparisons based on World Bank figures show the rate of credit expansion in Mexico pales in comparison to other emerging market nations. Between 2009 and 2012, private lending as a share of GDP grew 5 percentage points in Mexico while jumping 20 percentage points in Brazil. The level of debt exposure is also lower in Mexico than in many other emerging market nations. Private lending as a share of GDP was 28 percent in Mexico in 2012, compared with 35 percent in Indonesia, 54 percent in Turkey and 68 percent in Brazil.

On my flight home from Zurich, I read about a bank with compliance failures; however, I have to say that as a whole, the Mexican banking system is quite healthy. Bank profits rose in 2013 and Mexican banks are well-capitalized, with an aggregate capital ratio of 16 percent as of year-end 2013. While four small banks failed year-end stress tests by the Comision Nacional Bancaria y de Valores (CNBV) and were asked to boost capital and diversify their portfolios, it was also the first year the regulator fully implemented the stringent Basel III capital rules. The share of nonperforming loans rose slightly; among commercial loans, this was partly due to changes in the accounting methodology, so it cannot fully be attributed to deteriorating credit quality.

I am convinced that the biggest problem facing Mexico is not too much credit, but too little. That's why the recently implemented financial reform is so important; that's why its core objective is to boost credit.

Another advantage that Mexico has is plentiful foreign exchange reserves, about $180 billion, and a $73 billion standing line of credit with the IMF. Mexico has been amassing more foreign exchange reserves as other emerging market nations have seen them dwindle.

While excess liquidity from the U.S. has found its way to all emerging markets, there is a palpable investor commitment to Mexico that sets it apart from the rest. At over $35 billion, 2013 was a record year for foreign direct investment in Mexico. Foreign direct investment doubled over 2012, although a large portion of the increase was due to the acquisition of Grupo Modelo.

Mexico stands apart. As of February, Moody's boosted its rating on Mexico's government bonds to A3—joining Chile as only the second Latin American country with an "A" rating. The structural reforms Mexico has passed played a role, but so did the ability to pass them. A unified political will to work for what's in the nation's best interests is a rare find these days and something about which Washington can only dream.

Other nations, such as Brazil, may be headed in the opposite direction. Brazil's economy likely shrank in the second half of 2013 and prospects for 2014 are half of what Mexico's growth is projected to be next year. The Brazilian slowdown follows years of rapid growth and rising prices. Now, there are fears of a Brazilian house price bubble—homes in Sao Paulo are selling at three times 2008 prices. In contrast, Mexico City house prices are up 35 percent.

I am not forecasting a housing bust for the Brazilian economy, mind you. But consumers may have to deleverage, which will detract from growth. The government may have to rein in spending as well. Brazilian government debt has outpaced GDP growth in recent years and currently stands at 57 percent of GDP, nearly twice that of Mexico. Faced with poorer growth prospects and a weakening labor market, Brazilian banks will likely tighten lending after a decade of credit expansion. And at a time that the central bank would normally need to loosen policy to stimulate the economy, it needs tighter policy to ward off inflation.

I am not as concerned about cyclical adjustments as I am about structural impediments to long-run growth in Brazil. During this time of remarkable liquidity and cheap credit, and despite a decade of high commodity prices and booming exports, Brazil failed to advance further market reforms. Mexico, on the other hand, has continued to build on its earlier reforms such as its commitment to free trade through NAFTA and other trade agreements. Mexico has secured the openness of its economy and ensured the global competitiveness of its manufacturing sector. Exports plus imports as a share of Mexico GDP reached 64 percent in 2012 while Brazil's trade share of GDP was just 21 percent. Mexico is now the No. 2 exporter of auto vehicles to the U.S. after Japan and has been the top exporter of auto parts since 2001.

Mexico Reforms and the Texas Shale Oil Boom

Mexico in the last year has logged impressive structural change. Your government stands as an example for many other nations, including my own.

A dozen reform bills passed Congress and were signed into law in 2013, five requiring constitutional amendments. To put this feat in perspective, this government has accomplished more in the last year than the three preceding administrations combined.

Mexico has revamped labor laws, the education system and its telecommunications system, financial and energy sectors—including a plan to open up its oil and gas sector to private investment. The timing is good. The implementation of these new laws will coincide with a strengthening U.S. economic recovery.

You know far more about these structural reforms than I do. I cannot pretend to speak with any authority on the detailed economic implications of these reforms, but I do want to offer some perspective from Texas. Last year's passage of the historic energy reform should, if carefully and deliberately implemented, increase oil and gas production and reverse the nine-year trend of declining output that is currently depressing Mexico exports, industrial production and GDP and adversely impacting government revenues.

The Eagle Ford shale oil boom in south central Texas exemplifies the regulatory differences between our two regions that the reform aspires to relinquish. The gap is very telling. As activity has accelerated dramatically north of the border, there is no corresponding drilling or production in northern Mexico despite the contiguous geology. And it's not because Eagle Ford required the deep pockets of the huge energy corporations. Rather, it is largely independent operators who have developed the vast majority of Eagle Ford projects. The result: sharply rising oil production in the Eagle Ford, from nothing four years ago to more than 1.3 million barrels per day currently.

The shale oil boom in Texas has had far-reaching effects on the state. Texas alone now produces more oil than Mexico, more gas than Canada. While oil and gas industries directly employ only 2.5 percent of Texas workers, the energy sector as a whole accounts for over 10 percent of annual output. Downstream operations—our Gulf Coast refineries—are booming, and gasoline and diesel exports have skyrocketed.

While the Texas economy is well diversified and no longer stereotypically dependent on energy, oil and gas provides a not insignificant impetus to the Texas economy and helps differentiate us from the rest of the United States, as does our state government's approach to pro-business regulation and taxation. To give you an idea of the growth differential with the rest of the nation, Texas employment has grown 2.5 percent per year during the economic recovery, which is about a percentage point faster than the nation. State GDP has averaged 4.2 percent annual average growth since 2009, compared with 2.2 percent in the U.S. Texas exports have increased 79 percent since their low in 2009, compared with 35 percent in the nation.

All this economic activity is finally spilling over into wages, which are rising in Texas as they remain flat in the rest of the nation. As you can imagine, job opportunities and rising compensation have made Texas the No. 1 destination for interstate moves in the country. Since 2006, Texas has averaged 150,000 newcomers per year who are relocating from other states. This is in addition to international migration, which is still high but has decreased from where it was before the crisis.

This is what I see for Mexico. Structural reforms—handled judiciously, especially as U.S. economic growth accelerates and Europe recovers—can pay off in spades for the Mexican people, who deserve it many times over. While Mexico has somewhat reduced its dependence on the U.S., 80 percent of exports still go to El Norte. In a strange twist of fate, it may be helpful in the near to medium term to be exporting manufactured goods to a slowly recovering U.S. and Europe rather than maintain the last decade's shipments of raw materials to China as in the case of Brazil.

Mexico Has Emerged

I began my talk tonight by running through the events, institutional backdrop and the thinking behind the Fed's quantitative easing efforts. I clearly have not been onboard with all the decisions the FOMC has taken during the economic recovery. I fear that we are feeding imbalances similar to those that played a role in the run-up to the financial crisis. With its massive asset purchases, the Fed is distorting financial markets and creating incentives for managers and market players to take increasing risk, some of which may result in tears. And all this is happening in uncharted territory. We have aided creation of massive excess bank reserves without a clear plan for how to drain them when the time comes. And there is the challenge of doing so while keeping inflation expectations stable.

Nevertheless, I believe that the FOMC will find practicable ways to normalize the Fed's balance sheet. I believe that practicable ways will be found to avoid inflationary pressures once the velocity of money returns to precrisis levels. I certainly believe that continuing to pare back on the amount of the Fed's large-scale asset purchases is a good start and should be continued at a measured pace that leads to their complete elimination as soon as is practicable.

And I believe that as the tide of easy money recedes, Mexico stands ready for the next phase. Unlike other emerging market nations, Mexico seized the opportunity to make some tough decisions and is more resilient and globally competitive as a result. Macroeconomic stability, openness to trade and a unified commitment to confront rather than run from market forces indicate that the Mexican economy is no longer an emerging economy; it has emerged. For this man who spent his childhood in Mexico and feels Mexican, this is one of the most gratifying developments of my lifetime. So that's why I say, *¡Ándale pues, México!*