Martín Redrado: Overview of monetary and financial policy in Argentina

Speech by Mr Martín Redrado, President of the Central Bank of Argentina, before the Committee on Treasury and Budget of the National Senate, Buenos Aires, 20 December 2006.

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1. Monetary and financial policy guidelines

In our third year in office, we are laying the foundations and starting points for the monetary and financial system of the coming decades. This strategy is based on four main pillars - a consistent, articulate and gradual monetary policy; a foreign reserve accumulation and management policy that provides a long-term horizon; a system that is independent from public sector needs; and a policy framework that boosts corporate and household credit.

The economic literature has shown that there is no optimal one-size-fits-all scheme. Worldwide, there are success stories both of fixed and floating exchange rate regimes, with or without explicit inflation targets, that use the money supply or the interest rate as an instrumental variable. The important thing here is not the label of the regime, but the monetary policy internal consistency, designed to ensure a balanced money market. At this stage in national history, there are no adequate substitutes for a monetary policy that allows the system to develop while keeping the growth of monetary aggregates in check and fosters savings without affecting investment. In fact, we carry out a sterilization program that is unprecedented for Argentina - because of its depth as well as its quality - on the basis of a public sector that saves, a sound financial system, and a Central Bank with a strengthened balance sheet.

While we are enjoying a favorable international scenario, believing that this scenario will last forever would be misleading. In fact, the world today is highly volatile and, as we all know, the challenges we face are magnified in emerging countries such as Argentina, where transmission mechanisms are still vague and instruments have a limited power. As a consequence, our risk management approach entails that monetary and financial policy should help prevent crises and weather uncertain scenarios. This leads to the development of countercyclical mechanisms to cushion the effects of external disruptions on the economy. One of them is the prudential policy of international reserve accumulation, which enables us to hold a stock of over USD 31 billion, an unforeseen level not long ago.

Besides, after decades of financing public spending through various monetary arrangements, we are designing an independent monetary and financial system. This structural change sets out a substantial difference from the past: neither the Central Bank nor the financial system are used to finance fiscal imbalances.

In this sense, the Central Bank has developed market instruments to encourage the revival of private credit. A series of specific measures from the asset as well as the liability side has led to a new regulatory framework that widens the base of potential borrowers, eases reporting requirements, extends the use of collateral and encourages the extension of maturities.

These policies lay the foundations for the Argentine monetary and financial system of the coming decades as true State policies - independently from any predetermined ideological scheme and assimilating the opportunities and challenges of today’s world - thus contributing to sustained economic growth.

2. The international scenario

The international scenario still shows sound economic growth, with commodity prices at a record high and substantial liquidity. Expansion is nowadays more balanced due to lower US growth, that was offset by a more favorable trend in the euro area, Japan and the emerging countries. In fact, the world is expected to grow nearly 5 percent by 2007 in a context of subdued inflation. Latin America benefits from a favorable global framework and is expected to increase 4 percent by next year.

The region shows a sounder expansion than in previous recovery episodes since, in the past years, macroeconomic discipline has been strengthened. The region is therefore better prepared to face adverse shocks. Latin American countries are implementing prudent monetary policies, showing sounder fiscal positions, reducing currency mismatches, holding positive external balances, applying more flexible exchange regimes, building up reserves as a preventive mechanism, and paying back debt with international organizations in an effort to improve their liability management.

An example of this enhanced soundness is that the higher financial volatility evidenced worldwide in May and June had a relatively mild impact on the region's economies as compared with other emerging economies with a more vulnerable macroeconomic situation. This was mainly reflected in stocks and foreign exchange rates and, to a lesser extent, in fixed income instruments.

However, the global scenario is not risk-free for Latin America and Argentina. Both the trend of (financial and real) asset prices and the way in which global imbalances (and, in particular, the effects of an eventual significant deceleration in the US economy) are gradually corrected, are two factors that may trigger sudden disruptions in the international economic scenario.

As to the former, today much is debated over the permanent or temporary nature of current commodity prices.

In my opinion, here the analysis can be split in three:

For metals, the long-term price has risen and current prices seem to exceed such long-term values. These new long-term prices are due to higher energy costs, while the relatively high current price is due to rather long production cycles, with significant fixed costs and low marginal costs.

In turn, the prices of agricultural products are relatively high, but long-term prices have not increased. That is to say, the average is stable and so a reversal to the mean kind of process is expected.

Finally, the price of oil depends on extra-economic factors that are difficult to grasp through a model. In addition, the oil market is not very competitive, leading the price dynamics to be mainly perceived as a random walk. In this sense, the recent drop in crude oil prices allowed inflation to decrease and core inflation indices to relatively stabilize worldwide. Second-round effects seem to be limited, as was the case when the oil price exceeded USD 75 per barrel.

The end of the housing boom in the US is having a limited impact despite lower prices and sales. Indicators such as employment growth, high corporate profits and liquidity, and the growth of activity in the residential segment are quite strong to support consumption. However, the correction of real estate inflation continues to be a source of uncertainty for the global economy, given the size and scope of its effects on aggregate spending.

As to the second risk factor - i.e. the correction of global imbalances - the trend in the US external sector seems to signal a certain degree of stabilization. Anyway, these data do not seem to indicate that the exchange adjustment has come to an end. Both the current account deficit - around 7 percent of the Gross Domestic Product (GDP) - and US financial assets held by the rest of the world are high. This has already resulted in a readjustment of the main currencies that, in my view, is not over yet. While the euro has significantly appreciated against the dollar, the adjustment has been less pronounced for the currencies in different Asian countries with a surplus current account.

The pattern of global growth in recent years led to a significantly reduced share of the US in global output and trade, which may limit the impact of a deceleration in the US economy. Also, the economic growth of Japan and the euro area is mainly supported by domestic demand, reducing contagion through trade flows.

Nevertheless, the possibility of the adjustment resulting in financial turbulences, such as the ones in May and June, should not be ruled out. In those months, there was a strong belief that interest rates would soar, and this led to a sell-off of emerging market assets with the resulting effects on asset prices and on most currencies in the world. The Federal Reserve monetary policy - which is today explicitly data-dependent - has shifted part of the uncertainty within its own monetary policy committee to the markets, and we, emerging countries, must be alert to any sudden change in global investors' expectations.

3. Monetary and financial policy in 2006

3.1. Compliance with the Monetary Program

By the end of 2006, the Central Bank has strictly complied with the Monetary Program self-imposed targets for 14 consecutive quarters, which is a signal of certainty and predictability.

The change in the monetary policy stance begun in 2005 through a strict control over monetary aggregates deepened in 2006, and was reflected in a sustained deceleration of year-over-year M2 growth (currency in circulation, private and public sector's current accounts in pesos and savings accounts in pesos), which fell around 6 percentage points.

An indicator used by central banks to measure the monetary policy prudential bias is the comparison between monetary aggregate growth and nominal GDP. Monetary aggregates in Argentina are decelerating nowadays, converging to the GDP nominal change, which represents a significant reduction from the excessive monetization in 2003 and 2004, whose effects are still felt today, given the lags with which monetary policy works.

The effect of the change in the monetary policy stance was not limited to the M2: the change in currency in circulation also slowed down markedly, falling nearly 8 percentage points in 2006.

In turn, we continue pursuing our prudential international reserve accumulation policy, which enabled us to hold a stock of over USD 31 billion in the past few days. This entailed that in only nine months we have managed to recover the levels reached before the full payment of the debt owed to the International Monetary Fund. As many emerging market central banks, we are generating an effective insurance mechanism against crises, which acts as a collateral for the macroeconomic program. This policy reduces external vulnerability and exchange volatility, fosters the development of domestic financial markets in local currency and the reduction of the economy’s financial cost, and improves our relative position when competing for investment in the global economy.

The impact of the reserve accumulation strategy on the money supply has been offset by a deep sterilization policy that allowed us to absorb the excess money supply in the economy. The joint action of the various absorption factors has led to a monetary contraction of around ARS 27 billion in 2006. Both the financial system and the public sector have contributed to the absorption of surplus pesos. Due to the scheme set forth by the BCRA, the early repayment of rediscounts led to a monetary contraction of around ARS 6.6 billion in 2006, and the number of institutions that are still indebted to the BCRA was reduced to two. The minimum requirement policy contributed with ARS 4.4 billion, while the main tool used was the placement of Central Bank securities, which contributed with ARS 10 billion.

Consequently, in early December the stock of Central Bank bills and notes amounted to ARS 41.2 billion (29 percent of LEBACs and 71 percent of NOBACs). Throughout the year, the NOBACs’ share at a floating interest rate has increased (64 percent of the stock in early December), vis-à-vis CER-indexed instruments (5 percent in that period) and LEBACs in pesos (31 percent). As a result of this strategy, the Central Bank’s debt average term was extended from 260 (at the beginning of the year) to 360 days (in early December).

Throughout the year, the Central Bank introduced changes to the minimum requirement policy, raising minimum cash requirements for demand deposits. In particular, in April we eliminated interest paid on demand deposits and raised the minimum cash requirements from 15 to 17 percent. We also reduced the maximum interest rate paid on funds held at the Central Bank without full minimum requirements from 75 to 50 percent of the BADLAR rate for private banks; and reduced the interest rate paid on the liquidity requirements on money market funds from a nominal year-over-year 2.55 percent rate to a nominal year-over-year 0.5 percent rate. In August, additional measures were adopted, raising the minimum requirements for demand deposits in pesos to 19 percent, eliminating the requirements for time deposits of over 180-day residual maturity, and establishing that only 67 percent of cash held by banks could be used for minimum requirements purposes. These measures aimed at recovering prudential liquidity, acting, in turn, indirectly on the means of payment, promoting the extension of the funding structure, and thus facilitating an increase in credit.

Our aggressive sterilization policy is feasible due to the Central Bank’s strengthened balance sheet and positive quasifiscal result. At present, income from the high level of reserves and from the payment of illiquidity assistance more than offsets outlays, which are mainly related to payments of interest on securities issued by the Central Bank and the premia paid on its repo transactions.

In addition, the behavior of the reference interest rate (interest rate on reverse repurchase operations) in 2006 also reflected the change in the stance of monetary policy, with a 125 bp hike. Market interest rates followed the reference rate dynamics. Hence, in early December, the BADLAR rate for private banks rose 240 bp up to a 9.5 percent year-over-year, and the interest rates for 30-to-59-day time deposits grew 210 bp up to a 7.2 percent year-over-year, thus leading real interest rates to neutral levels.

In turn, there was a sustained decrease in the inflation rate throughout the year. During the first eleven months of the year, the consumer price index (CPI) rose 8.8 percent, 2.3 percentage points below year-over-year. This trend is explained by stabilization of core inflation since May (around 0.7 percent per month, equivalent to 8.7 percent per annum), which was also accompanied by smaller increases (the median price rise for the products making up the core inflation index went from 0.9 percent in the second quarter to 0.5 percent in the last few months), a lesser spreading of rises (from around 85 percent in the first half of the year down to 76 percent), and a lesser persistence of price adjustments within the various time horizons. The trend was reflected in inflation expectations: according to the latest measurement, the retail inflation forecast for the next 12 months resulting from the BCRA´s Market Expectation Survey (REM) was nearly 3 percentage points down from the beginning of the year.

Despite these advances, lower inflation for 2006 is concentrated in certain specific sectors, and the magnitude as well as the spreading and persistence of price rises remain high, reflecting the need to keep on following this path.

To sum up, in 2006 we have complied with the Monetary Program targets strictly controlling the means of payment growth, without affecting the Central Bank's balance sheet and actively pursuing our prudential policy of international reserve accumulation.

3.2. Credit growth

In 2006, the process of rebuilding financial intermediation, which was begun last year, was consolidated. This year we are able to show not only a deepening of this process, but also an incipient improvement in terms of its quality as well as of general access conditions.

Our proactive policy, together with the favorable macroeconomic scenario, boosted private credit, which is growing at rates of over 40 percent year-over-year. All lines have grown, with credit to small and medium enterprises reaching above-average levels.

Mortgage credit lines began to grow significantly together with their average maturity, boosting medium- and long-term financing. This positive behavior is being driven by public as well as private banks, with prudent risk management evidenced by the improved quality of both public and private sector portfolio. Today, nonperforming loans are hitting record lows and are below the Latin American average.

The Central Bank went on building a plan of adequate incentives to generate the revival of private credit in its three basic dimensions: quantity, quality, and access. A set of specific measures on the asset as well as the liability side has led to a new regulatory framework that widens the base of potential borrowers. According to the underlying philosophy, adequate conditions need to be created for financial institutions to assess projects requiring financing with a forward-looking perspective - that is, favoring prospects over past experience.

On the liabilities' side, we have broadened the range of instruments included in financial institutions' equity that make it easier to attract resources in the long run. The so-called "hybrid bonds" or "perpetuities" have become eligible as basic capital. What distinguishes these instruments is their extended maturity, which we have determined to be no less than 30 years. The possibility of accessing this type of funding, particularly considering the current context of marked liquidity in the financial markets, favors long-term financing and fosters productive investment and housing financing and, simultaneously, the development of the domestic capital market.

One of the features that has historically characterized our system is the low use of banking services. Although the most economically productive regions in the country enjoy relatively adequate levels of banking coverage, the distribution nationwide should be improved. That is why in the past year we authorized the opening of 137 new branches. Opening new branches in geographical areas where banking services are not so widespread enables these areas. Also, we are working to improve access of lower socio-economic segments of the population to such services. Our measures include a more regular payment schedule for credit to microenterprises (on a weekly, bimonthly, or monthly basis), enabling banks to grant an initial grace period for the payment of capital services. In addition, we raised the maximum payment amount from ARS 200 to ARS 300 in order to cover a larger population segment, and extended the maximum financing term from 24 to 36 months, thus increasing the financing amount available for infrastructure works from ARS 3,000 to ARS 6,000.

In addition, we offer the possibility of setting up a new type of operating house in towns with no branches already opened to perform various transactions. This enables a more efficient management of variable costs to reach areas that are farthest away from the major cities and beyond the financial system's coverage.

During 2006, several changes were introduced to deepen the reversal of the crowding-out of private credit (the maximum amount allowed for public sector asset holdings will be reduced from 40 to 35 percent of assets as from July 2007). Consequently, in the past two years the share of credit to the government in total assets decreased 17 percentage points. In fact, financing to households and firms is today the main component of financial institutions' assets and the focus of their action.

When assessing central bank practical independence both in Argentina and in other emerging countries, strict compliance with the rules regarding assistance to the Treasury and regulatory incentives for banks to absorb the public debt are crucial. This contrasts with mistakes made in our recent history when, under a supposedly independent scheme, the financial system ended up financing public spending in the framework of banking regulations that not only failed to prevent it but also fostered it, discouraging private sector financing.

In this context, earnings amounted to 1.7 percent of assets year-over-year. Improved profitability together with capitalizations (the financial system received capital contributions worth approximately ARS 2.4 billion throughout 2006) fostered the consolidation of financial system solvency.

3.3 International reserve management

Uncertainty factors worldwide trigger the need to protect ourselves against volatility and to create mechanisms to ensure liquidity and the value of our financial assets. In this sense, the international reserve management policy aims at optimizing returns on reserves, seeking the best possible combination of risk and return through investment in financial assets with high liquidity and with the lowest credit exposure.

The specific restrictions to Central Bank international reserve management, our country's structural changes and the current international economic cycle have led to flexibility in the objectives pursued for reserve management, as well as the maximization of opportunities available.

Today's international reserve management is significantly different from that of the past decade's: in the past, the monetary system prioritized the immediate availability of investment and a comprehensive program of external managers was used (supplemented by the in-house management of a part of the reserves).

The current floating exchange rate system and the policy of foreign reserve accumulation make it possible to lay less emphasis on very short-term placements.

In the past two years, apart from the "traditional" task of monitoring the international markets and economies on a daily basis as the starting point for decision-making in international reserve investment, quantitative analytic models have been developed that have succeeded in improving the strategic and tactical decision-making processes. Some of these models focus on the fundamentals; others, on technical indicators of market behavior; yet others combine both elements - but all of them use advanced financial tools to assist and supplement the traditional qualitative analysis of investment opportunities.

In turn, the floating system implies that there are no technical reasons to concentrate reserves in a single currency, which allows for portfolio diversification. Diversification gradually moved from an "opportunistic" approach (fully based on the expectations regarding exchange rate evolution) to an approach based on the economy's structure, particularly, on the currency composition of the current account and the external debt, which allows for tactical deviations to increase returns.

The debt with the IMF was paid with practically all foreign currencies in the portfolio other than the US dollar. Since then, euros and pounds were gradually purchased, until investment in currencies other than the US dollar (including gold) reached around 18 percent of reserves. As part of this diversification policy, the euro and pound positions were set above the neutral levels (resulting from the current account and public debt currency structure), while the yen position was set below those levels.

Despite the redefinition of the currency composition after the payment to the IMF, the share of euros is at its highest (except for the considerable euro purchases in late 2005 to make the payment), while the share of pounds and yens has been reduced. As to the gold position, derivative instruments started to be used in order to reduce the impact of market rate volatility, as necessary.

In particular, the great increase in the price of gold during the past two years entailed an additional source of return for international reserves.

While the rise in the price of gold was mainly due to the strong demand from India and China, this year in particular there was a very significant increase in speculative positions. In consequence, and in line with the higher price, there was a significant increase in price volatility. Against that backdrop, we decided to use a partial hedge strategy, made up of financial derivatives. This has protected us from an eventual decrease in prices and, in turn, considerably reduced the volatility of reserves resulting from fluctuating gold prices.

Investment in callable bonds involved the need to resort to “effective duration” (instead of the usual duration) to measure the average term of placements and the portfolio’s exposure to interest rate changes.

As from this year, a policy of gradual increase in portfolio duration was adopted. This policy is not only the result of expectations on the US rate cycle, but also a gradual process towards the reintegration of benchmarks for reserve management. In fact, as has been empirically proven, the discipline derived from the use of benchmarks, with specific restrictions to deviation, offers tangible results in the medium-long term and is the policy regularly adopted by most central banks.

As the element agglutinating all of the innovations mentioned above, a full change in investment policies is being introduced so as to include the basis for investment policies and update the range of instruments available. At the same time, updating investment policies entails, besides the traditional restrictions in terms of liquidity and credit risk, precise limits to market risks, such as value at risk measures, among others.

Despite context-imposed limitations, the outcome has been very positive. It is estimated that, without taking into account fluctuations in the peso exchange rate, the investment of international reserves in 2006 would yield over USD 1.2 billion (5.6 percent yield per year over the average stock during that period). This means that there was a 2 percentage point increase during our term in office.

Regardless of the very important benefits for the economy in general (less country risk, less crisis risk) as a tangible result of a prudential reserve accumulation policy, as our stock grows, its management becomes increasingly relevant. Therefore, maximizing investment efficiency and effectiveness through the optimization of the decision-making process impacts on financial performance and is a fundamental basis for monetary policy.

4. The 2007 Monetary Program

4.1. The macroeconomic scenario

The optimistic scenario for the global and regional economy, together with the pillars of the domestic economic policy, anticipate a good performance of the Argentine economy for the coming year, with significant output growth, continuing fiscal and external surplus, favorable financial conditions, and improved social conditions.

Nevertheless, when designing the Monetary Program, some domestic economic determinants should be taken into account which in the transition towards the steady state path, influence the behavior of some variables and restrict the use of certain traditional economic policy tools, available in contexts of sufficient financial depth.

Firstly, the adjustment of relative prices after the devaluation is not yet over and, therefore, preventing some goods and factor prices from adjusting, far from being a healthy practice, may threaten the economic path towards long-term stable equilibrium.

Secondly, although post-crisis financial recovery has been extraordinary, monetary policy transmission channels are not yet adequately consolidated. In fact, credit barely exceeds 10 percent of GDP, so its channel is still inadequate to influence the aggregate demand level through monetary policy.

Thirdly, even though uncertainty is external, domestic economic policy and, in particular, domestic monetary policy should be ready to face unexpected changes in the international scenario. It would be a mistake to think that the favorable conjuncture for emerging countries will last forever.

In that case, the lack of definition of the new global financial architecture and the absence of a lender of last resort force us to enhance prudential policies which, for the monetary authority, result in international reserve accumulation to face external contingencies.

Apart from that, expected 8.5 percent GDP growth for 2006 brings to the coming year a statistical carry-over of over 3 percent. Thus, output is projected to grow to over 7.4 percent next year, bearing in mind a quarterly increase that will remain high, though somewhat lower than this year's, leaning toward levels that are more consistent with long-term sustained growth. Domestic absorption would continue to lead this process, mainly due to a new expansion of consumption and investment. Investment is expected to grow again above average, expanding its share in terms of output.

Trade with the rest of the world will continue on the upswing, anticipating additional exports growth (exports would hit record levels of around USD 50 billion). Exports levels would practically double the ones recorded before the devaluation and allow the trade surplus to hit high levels again - of around USD 10 billion, in FOB-CIF terms - in spite of a slight correction. In addition, based on the aforementioned goods trade balance, which would still be the major foreign exchange earner for the country, the positive current account balance in 2006 is projected to remain so in 2007, allowing for the external gap to be slowly bridged. By the end 2007, international reserves are expected to hit a new record high in the institution's 71 years.

In turn, following budgetary guidelines, fiscal discipline would continue as in recent years, which would contribute to stabilizing inflationary expectations. More specifically, and according to expectations, the 3.1 percent of GDP primary surplus will be accomplished. It is worth highlighting that in building a financial system permanently independent from public sector needs, the 2007 Monetary Program allows for a reduction in public sector assets in the financial system during 2007.

Finally, core inflation forecasts point at a deceleration of end-to-end measurements as compared to this years' to fall within an 7-11 percent range.

4.2. Monetary guidelines

In 2007, the Central Bank will follow monetary policy guidelines based on the prudential accumulation of foreign reserves and a strict control of monetary aggregate expansion, through the sterilization of money supply in excess of demand.

As in 2006, M2 will continue to be targeted because it is the monetary aggregate that better reflects the demand for means of payment, given its closer long-term relationship with price dynamics.

Thus, we consolidated monetary policy conduct based on the control of M2 growth, while the institutional and financial infrastructure is being developed, to enable the transition towards an inflation targeting regime but without completely departing from the quantitative analysis, via the adoption of a two-pillar approach that draws on the European Central Bank's successful experience.

Among the prerequisites to implement this regime, we have already complied with the following:

(1) institutional commitment with long-term price stability, regardless of the natural and necessary relative price adjustments related to the transition phase;

(2) fiscal, financial and external stability, evidenced by the consolidation of a positive public sector balance, a recovered banking sector, and a stable external surplus;

(3) a comprehensive and transparent communication strategy, including a clear explanation by the monetary authority of its plans, intermediate objectives, and decisions;

(4) autonomy for the monetary authority to manage its instruments and meet the targets set;

(5) the monetary authority's accountability for compliance with disclosed plans.

As I have already mentioned in several opportunities, the main obstacle to implementing inflation targeting is the small size of the financial system: this does not ensure the adequate functioning of monetary policy transmission mechanisms and results from the deep shrinkage experienced by our banking system after the crisis. Based on the current scenario, in an economy that still makes intensive use of relatively liquid means of payment, with reduced credit and financial depth, it makes sense to directly control the money supply vis-à-vis the control of aggregate demand through interest rates. However, the remarkable financial system's recovery points at the prospects for advancing towards a more sophisticated monetary system in the future.

Consistently with expected macroeconomic and fiscal performance for 2007, means of payment were estimated on a quarterly basis, both for M2 and for the other monetary aggregates. The need for monetizing the economy in keeping with the expected trend in output, interest rate and inflation was calculated with the best econometric techniques available. In addition, intervals were determined around specific estimates, so as to define a M2 floor and ceiling and consider the probability of occurrence of alternative scenarios.

The 2007 Monetary Program anticipates a deceleration in monetary aggregate growth. It thus establishes an year-over-year growth for M2 within the 18.7-11.7 percent range for December 2007. Moreover, M2 is projected to grow below the expansion of nominal GDP. A deceleration in the growth of other monetary variables, such as private sector M2 and currency in circulation, is also expected.

Together with the deceleration of transactional money, an expansion savings in the financial system is projected.

The Monetary Program seeks to mitigate fluctuations of the most liquid forms of money in terms of output, while the broader monetary aggregates grow. Thus conceived, the Monetary Program is, according to the Central Bank's best information available, fully consistent both with the aim of serving the economy's liquidity needs and that of providing an environment of price stability. It is also flexible enough so as to include various scenarios other than the most likely. This methodology is an improved way of contributing to normalizing economic and financial variables and thus aiming at sustained economic growth that includes all the Argentine people.