Martín Redrado: An economy in transition

Article by Mr Martín Redrado, Governor of the Central Bank of Argentina, published in La Nación newspaper on 25 June 2007.

*   *   *

Severe economic crises make countries significantly stray from the path of long-term growth. In post-crisis periods, the macroeconomic fundamentals usually overreact to then gradually readjust themselves and converge towards a lasting scenario. Therefore, for some time there remains uncertainty as to the "real" equilibrium value of the main aggregates, with many of the nominal and real variables showing distortions while returning to their usual levels. Factors such as the dimension of the crisis, the condition of fiscal, monetary and financial institutions, and the sustainability of the external equilibrium achieved determine the duration of this normalization phase.

Judging by the crises that shook the region over the past decades, not all countries are in the same stage of evolution. Thus, there are economies approaching their long-term cruising speed; in others, however, the convergence process is still incipient. Therefore, simplistic comparisons among various countries' situations may lead to wrong recommendations.

In Argentina, despite a notable recovery, several features of the current macroeconomic performance enable us to infer that the economy is still heading towards a new long-term equilibrium. Neither in Argentine history nor in the international experience do we find precedents for the deep, large impact of the 2001-02 crisis. Unlike the case of Brazil, Mexico or southeast Asia, the abandonment of convertibility in Argentina included an institutional breakdown, a huge devaluation, the destruction of the financial system and the default on the public debt, all at the same time.

These transition stages take time and raise enormous challenges. Our neighboring countries' experience teaches us that flexibility and gradualism in both policy design and implementation are the adequate way of treading them. During the Money and Banking Conference organized by the BCRA, Vittorio Corbo, Governor of the Central Bank of Chile, stressed the *sequential* process undergone by the Chilean economy following the crisis of the early 1980s. Four elements have been of utmost importance in this long process: consolidating fiscal solvency as a countercyclical tool, reestablishing external sustainability, restructuring liabilities, and rebuilding the financial system. Once all these aspects were addressed, progress was made in the consolidation of a fullfledged inflation targeting regime that is nowadays highly credible. Thus, in 15 years, Chile managed to lead inflation from around 30 percent to the current annual 2.9 percent, after patiently building credibility and institutions. The transition was characterized by a flexible regime in the use of instruments, including foreign exchange market intervention first through the Central Bank and nowadays through operations with the government-owned exporting companies and the Treasury, which allowed the economy to adjust to both domestic and external shocks.

In Argentina, the monetary policy transmission channels are only just being rebuilt, since credit to the private sector accounts for 10 percent of the domestic product, still far below the Latin American average. Moreover, consumer credit reacts weakly to interest rate fluctuations. This means that 90 percent of the economy operates in cash; therefore, the hasty adoption of certain instruments would not only be useless but also hamper their future use. We cannot "take short cuts"; rather, we must patiently rebuild the power of monetary policy tools.

Furthermore, in certain macroeconomic scenarios with still persistent features of fiscal dominance and external determinants, monetary policy should be conceived under a general equilibrium approach, where fiscal solvency, the monetary balance and external sustainability are mutually determined.

In consequence, when devising the transitional monetary regime, the classical dilemma of rules versus discretion cannot be solved with an extreme option. Far from "buying" credibility, a "rigid" monetary policy rule might become unsustainable if the people anticipate inconsistencies with the rest of the macroeconomic policies. On the opposite extreme, "unrestricted discretion" would also lead nowhere and could contribute to a frustrating process.

Our approach to financial and monetary policy rests upon this theoretical framework and is built on four pillars – (i) a gradual and consistent monetary policy that ensures money market equilibrium; (ii) a countercyclical prudential reserve accumulation approach; (iii) a system that is independent from public sector financial needs; and (iv) a policy framework that boosts corporate and household credit.

The current regime of control over the money supply and the demand for money combines the necessary doses of monetary prudence and flexibility. Simple rules on the growth of money supply provide the adequate tool for the people to make monetary policymakers accountable. Thus, the credibility lost in the crisis is gradually rebuilt without sacrificing the necessary discretion to address the contingencies inherent to an economy that is in transition towards its long-term equilibrium. To preserve the money market equilibrium, we apply a deep monetary absorption strategy coupled with reserve accumulation for prudential purposes. Such a strategy has been implemented – without neglecting the Central Bank's balance, which is now showing positive results – through various mechanisms that comprise the issuance of bills and notes, swap operations, the collection of liquidity assistance provided to banks during the crisis, and the minimum requirement policy. In this way, we are able to control the growth of the means of payment which is, for the first time since the end of the crisis, below nominal GDP growth, reflecting the prudential bias in our approach.

In turn, credit should focus on facilitating consumption and investment decisions by the community. On the one hand, we have set strict guidelines to reduce financial system exposure to the national, provincial and municipal public sectors and, on the other, we have created market incentives for the recovery of credit to the private sector from a set of specific measures. Therefore, in the past two years, the share of credit to the government in the system's total assets was significantly reduced, and bank actions are focused today on credit to households and businesses. There is a widespread expansion in all credit lines to the private sector and arrears hit a historical low that is currently below the average for the region.

All this must be articulated through policy coordination as a sine qua non during the transitional phase. The most successful stories are those of countries that understood how important it was to reconcile aims with instruments in a stage such as this one, where it is the combination of fundamental economic policy tools that will allow us to achieve a gradual and lasting decrease of the inflation rate against a backdrop of sound growth and social inclusion.