Martín Redrado: Closing remarks at the conference “Monetary Policy under Uncertainty”

Closing remarks by Mr Martín Redrado, Governor of the Central Bank of Argentina, at the 2007 Money & Banking Conference "Monetary Policy Under Uncertainty", hosted by the Central Bank of Argentina, Buenos Aires, 4 June 2007.

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After two days of intense discussions among policy makers and academics we may conclude that the challenges faced by world and, particularly, Latin American central bankers are not minor, thus requiring prudence, consistency and gradualism.

Changes experienced by the global economy stemming from financial innovation in products and players that Mario Draghi, Malcolm Knight and José Viñals described so well, have substantially affected not only the capacity but also the stability of traditional monetary policy transmission channels. The credit channel is less effective due to structured products, while asset price volatility is more pronounced.

We have also heard from the various experiences shared that there is no one-size-fits-all. “God only knows what the right model is,” said my friend Vittorio Corbo this morning.

Therefore, it should not come as a surprise that demand for “flexible policies” from us, central bankers, is high. This implies endowing the models with the value of our own judgment, seeking to understand changes, threats and opportunities.

It is nothing but the risk management approach applied to monetary policy conduct described yesterday afternoon by Joe Tracy, reflecting the Fed’s view. Or the Central Bank’s need to assess the source, magnitude and nature of the shocks stressed this morning by Otmar Issing, echoing the ECB stance. That is, to maximize the probability of achieving the goals we set, understanding the implicit risks and the consequences associated with each risk, and focusing on the distribution of possible outcomes.

Under this approach, robustness may be preferable to optimality – taking optimality as the most efficient policy given the most likely scenario, and robustness as the less harmful when the likely scenario fails to materialize.

In Latin America, and particularly in Argentina, economic policymaking becomes especially hard due to the discredit caused by successive failures, which in many cases turned into independent sources of instability.

In our region, the range of cyclical fluctuations and the recurrent macroeconomic volatility have severely harmed the various economies’ long-term performance. This, in turn, resulted in poor welfare levels for the population at large.

While in the developed economies cyclical fluctuations tend to be mild, in our region they have been generally characterized by their intensity and frequency.

More importantly, in my view: not all countries in the region are in the same situation. There are countries with economies approaching their long-term cruising speed. Others are heading that way. In others, however, the convergence process is still incipient.

In our case, 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. Given the unprecedented size of the past crisis, many fundamental variables “overreacted” and are presumably converging towards new long-term values, we must admit, largely unknown to us. This results, for example, in nominal dynamics which are difficult to characterize *ex ante* as temporary or permanent, but which in certain circumstances might lead to diverging paths.

In addition, despite its intensity, the recovery of financial intermediation is still incipient and term structure duration is short.

And this is crucial, since, as pointed out by Yaga Reddy from the Reserve Bank of India, these transition processes take time and raise enormous challenges. Thus, hasty diagnosis and simplistic comparisons among the various countries’ situations may lead to wrong recommendations.

Corbo's presentation stressed the sequential process that the Chilean economy underwent to arrive to a situation of macroeconomic stability. Vittorio was very precise when describing the gradual phases followed by Chile to develop the current monetary regime. Three elements have been of utmost importance in this process: consolidating fiscal solvency as a countercyclical tool, reestablishing external sustainability, restructuring liabilities, and rebuilding the financial system. 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. Once all these issues were addressed, progress was made in the consolidation of an inflation targeting regime that is nowadays highly credible and has proven successful. That is, the transition to a full-fledged inflation targeting regime was achieved in coexistence with high inflation. It was a gradual and flexible regime in terms of the use of traditional policy instruments what allowed the economy to adjust to both domestic and external shocks.

Russia is another good example of monetary policy conduct in a transition process. Ignatiev highlighted the fact that their Central Bank aims to prevent a sharp appreciation of the ruble, while slowly moving to an inflation targeting regime, which is not easy to achieve considering Russia's strong dependency on oil prices. Meanwhile, the financial system is being developed and the economy dedollarized, but very cautiously and "trying to avoid radical changes".

Sharp foreign capital inflows have an impact on the economy that, in transitional situations such as this one, may be costly rather than beneficial.

Dealing with the current trend towards exchange rate appreciation appears as an one of the most critical challenges for emerging market policy makers. One of the lessons learned from the convertibility era in Argentina is that there is nothing more procyclical that an appreciated domestic currency, in terms of both public and private consumption. Currency appreciation fosters current consumption at the expense of savings and, hence, investment and long-term economic growth. The paper presented by Rajan yesterday is quite clear in this regard: overvaluation caused by foreign capital leads to lower returns on investment and lower growth rates.

Furthermore, for a country that has undergone three financial crises in the past twelve years, where macroeconomic volatility is perhaps the main factor for the low dynamism of the previous decades, preventing another crisis must be a priority economic policy objective. Within that framework, the role of the exchange rate as a trigger of a crisis should be considered: currency overvaluation typically ends in a sharp devaluation with high costs for the economy.

Besides, it is essential not to adjust policy to temporary trends: part of the current pressure for the appreciation of emerging currencies relates to commodity prices (through the current account) and the investors' risk appetite (through the capital account), which may clearly be temporary instead of permanent forces.

Against this backdrop, it would be wrong to adjust monetary policy to these forces. On the contrary, it is prudent to try and prevent euphoria, taking these changes as temporary in nature. These factors may lead to nominal exchange rate overshooting, which, far from adjusting towards long-term equilibrium, may cause excessive volatility and hence distort relative price signals for savings, consumption and investment.

Finally, we central bankers should never forget about the general equilibrium analysis, especially when assessing the impact of exchange rate volatility on the set of macroeconomic variables in a normalization phase. In my opinion, monetary policy should be conceived under a general equilibrium approach, where fiscal solvency, the monetary balance and external sustainability are mutually determined. In this sense, the need for policy coordination is stronger in a post-crisis period, and sine qua non for long-term stability.

Therefore in our case, the current context of transition towards a steady state, the classical economic policy dilemma of rules versus discretion cannot be solved with an extreme option. Both "unrestricted discretion" and a rigid "lock-in" rule lead us nowhere.

In contrast, an intermediate scheme – the monetary aggregate approach, combining a dose of flexibility (such as indicative inflation targets), with simple rules on the growth of money supply providing the adequate accountability by the policymakers – may gradually rebuild the credibility lost in the crisis without loosing the necessary discretion to address the contingencies inherent to this stage.

We definitely cannot "take shortcuts": we need to develop and calibrate the instruments with capacity to stabilize cyclical fluctuations and, in turn, reduce macroeconomic risks.

One of these tools is a deep domestic financial system and the capital market. We are working to rebuild credit to the private sector as a monetary policy transmission channel as our financial markets are not deep enough to channel large capital inflows. Local currency debt markets are still in their infancy, and secondary markets are not liquid enough. Yesterday afternoon, Rajan himself pointed out the financial systems’ inability to efficiently intermediate foreign savings as an obstacle for economic growth in emerging economies.

The development of the market in domestic currency, as Malcolm Knight pointed out, allows a reduced dependence on capital flows, diminished currency mismatches, and a lesser concentration of risks in banking systems. But here we should also be cautious, all the more so at a stage when monetary stability and confidence in the local currency are gradually recovering, so as to avoid reducing currency mismatches at the expense of assuming an excessive maturity mismatch risk, or to avoid flooding local investors with instruments that restrict the possibility of risk diversification.

We applied strict guidelines to reduce financial system exposure to the public sector. Consequently, in the past years the share of credit to the government in total assets decreased by 20 percentage points, fast reversing the crowding-out process of credit to households and firms. In fact, these kinds of financing are today the main component of financial institutions’ assets and the focus of their business.

Anyhow, we see that every country in the region is taking precautions. In our case, for an economy in transition towards its long-term cruising speed, foreign reserve accumulation is an extremely useful countercyclical policy.

I have referred to monetary policy and uncertainty, but it is also worth noting the introduction of our central banks to the wider institutional system comprised by the national governance structure.

This morning, Ron McKinnon and Willem Buiter spoke of the changing doctrinal perspectives on central banks. I believe that there clearly emerges a positive development of the past decades, that is, granting autonomy to monetary authorities to decide on the best instruments to carry out our task. This development has been coupled with a higher transparency and accountability by central banks, something that only a decade ago was not as widespread. This teaches us a valuable lesson: the notions that we consider today as the most firmly established are the result of a specific institutional development rather than unchanging practices.

We, as monetary authorities, must contribute to deepening the positive aspects of such development. Here, it does not seem adequate either to think of a single “universal institutional framework,” but of useful principles such as autonomy and accountability that should be adapted to the institutional reality of each individual country.

In the past years, macroeconomic discipline has been strengthened and thus the region is better prepared to face adverse scenarios than in the past decade. However, there is still much work to do in order to reduce potential sources of vulnerability in our economies. This entails a hard duty. Agreement among public policymakers and analysts is not enough —there is a need for broad and lasting economic and institutional consensus to prevent policy reversal, which only leads to stagnation and frustration.

Thank you very much and look forward to seeing you next year.