Martín Redrado: The Central Bank of Argentina passed the test

Article by Mr Martín Redrado, Governor of the Central Bank of Argentina, published in Clarin newspaper on 5 August 2007.

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This time, the epicenter was not Latin America, Southeast Asia or Southern Africa. The financial turbulence of the past few days comes from the developed world – more specifically, the United States. Real estate prices, which have been falling for more than twelve months now, have begun to affect the quality of the assets in the mortgage market. In particular, banks and mutual funds trading mortgages in the subprime market have passed on increased risk to the system. This has led to a massive sale off in most of the higher-yield asset classes, including emerging market securities, to cover losses in the markets of origin. Against this turbulent backdrop, which leads to a new risk assessment and tighter credit, Argentina has shown that it has the necessary exchange rate and monetary tools to provide its population with a horizon of solvency and predictability.

In this context, the Central Bank of Argentina is like a chess player playing simultaneous games, since monetary policy cannot have an erratic or spasmodic behavior. Instead, each "move" must be in line with the global strategy applied in multiple chessboards, that is, preserving the value of currency, the stability and depth of the financial system, and the equilibrium in the monetary market. From this perspective, special attention should be given to the downstream effect of each "move," since often, "sacrificing a pawn" may seem costly in the short-term, but healthy and consistent with the main goals of the framework in place from a strategic point of view.

Action taken – encompassing a set of financial and banking regulations and direct intervention in the monetary, foreign exchange and financial asset markets – should not be interpreted in isolation. **Instead, it responds to a preventive and consistent strategy developed in the past few years to ensure the necessary "artillery" to prevent frights in times of international financial turbulence.** Prudential foreign reserve accumulation is an example that speaks for itself. As with every insurance policy, it represents an "abstract" benefit while it is not used, but a "concrete" one in financial stress situations: the $44 billion in the Central Bank's coffers were enough to discourage speculation that might have increased uncertainty. If this is coupled with the positive inflow of dollars coming from the external surplus, the potential supply of foreign exchange is clearly higher than the demand.

The current managed float scheme aims at preventing excessive volatility of the dollar in the long-term so as not to affect consumers and investors´ spending and saving decisions. At the same time, the current framework avoids providing a "foreign exchange insurance" that would favor short-term inflows of "hot money".

Unlike what happened in the past, avoiding a hysterical reaction by the monetary authority in the first two days of turbulences was key to prove the adequacy of the current exchange rate regime: **the "fear of floating" so much discussed in the economic literature is still alive in the Argentine collective memory, even among sophisticated analysts and the specialized press. Therefore, an early migration to a fully floating exchange rate regime might be a reckless action and a point of no return.**

Afterward, and in order to reduce uncertainty, action taken by the monetary authority combined direct intervention in the foreign exchange market – in coordination with the state-owned banks – to avoid inflationary pressures and the provision of liquidity in the money market so that the natural increase in interest rates would not become persistent and thus threaten credit dynamics. To that end, monetary policy instruments were used such as the absorption of Central Bank securities (Lebacs and Nobacs) which, far from being conventional debt – they are backed by reserves – make up liquidity "cushions" that may be used in a situation of financial stress. Besides, regulatory measures were adopted – bimonthly calculation of banks' reserve requirements – to "decompress" monetary stress situations.

Another eloquent example of the strategy developed in the past few years to face contingencies is the recovery of banking liquidity. **Just as reserves play the role of liquidity insurance for the monetary authority, banks' *cash* is the first defense line against unexpected events.** For this reason, banking regulations fostered the recovery of liquidity, equivalent to almost 40 percent of total deposits, among the soundest in the region.

Moreover, other financial solvency indicators are robust: partly driven by a regulation limiting bank financing to the public sector, the exposure of the financial system to the government was dramatically reduced since the crisis (18 percent of public sector-related assets, a record low in years, which also makes resources available to finance the private sector), the nonperforming portfolio is record low, the system has already shown profits for a couple of fiscal years now, and the process of capitalization and extension of maturities for liabilities (negotiable instruments) has gathered momentum in the past few years, leading to a mature financial system for the future.

All things considered, currently there are no symptoms of a weakened demand for domestic money. Deposits and credit do not seem to have been impacted by the international change of mood, and continue on their upward trend. Demand for dollar bills diligently rose and then fell to preexisting levels.

All in all, the new international scenario creates new opportunities and challenges for the monetary strategy, but without risking the continuity of the ongoing program nor disrupting the rules of the game. On the contrary, international volatility can provide greater room for maneuver in terms of use of available instruments, that is, the foreign exchange and interest rates to achieve the intermediate targets (monetary program) and final targets (intertemporal inflation rate) of the Central Bank's monetary policy, the greatest contribution of it to stability being the transparency and predictability of its guidelines.

These days' greater uncertainty can also be a good exercise to understand that it is possible to live with international volatility, without fearing for the future of our savings or the stability of our jobs.