Martín Redrado: The challenges for emerging markets

Remarks by Mr Martín Redrado, Governor of the Central Bank of Argentina, at «Le cercle des economistes» – Aix-en-Provence Economic Forum, Aix-en-Provence, 6 July 2008.

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As the world grows in complexity, it poses major challenges to policy makers. And, definitely, the ability and flexibility to coordinate the different branches of economic policy (fiscal, monetary, wage, competition) to face the various social and economic tensions lay, today, as one of the most significant. As a central banker and former financial market regulator in an emerging country, i deal first hand and on a daily basis with regulation aiming to foster economic growth while preserving monetary and financial stability. So, let me share my thoughts by providing you with, sort of, a view on the trade-offs behind this complex task from the emerging world.

First, let me stress that today's outlook for developing economies is quite different from other turbulent times. For the first time, we are not at the epicenter of a financial crisis. Also, conditions for contagion are less evident. While there are currently evident signs of a slowdown in industrial economies, emerging ones have continued to grow at the rates close to the ones seen in recent years.

Latin America in particular is, for the first time in decades, managed under stronger macroeconomic principles. Most of the economies are experiencing robust growth, underpinned by a buoyant domestic demand. They show prudent fiscal and monetary policies and sounder financial systems. The region is finally leaving behind the well-known "original sin" as the form of currency mismatches that characterized the recent past, significantly reducing our exposure to foreign currency debt.

However, despite this rosy scenario, we definitely face several issues in the pipeline and we therefore have a tough reforming agenda ahead. Emerging economies, on top of dealing with a potential adjustment in global economic conditions, have to confront their own uncertainties both at the micro and macro levels as financial markets are being developed.

There is a widespread debate regarding the amounts of regulation needed. In my view, this is a misleading discussion as there is nothing like too much or too low regulation. Every single economy has its own idiosyncrasy that calls for a particular regulatory framework. In the case of emerging ones, more prone to have incomplete markets, government action should be directed through regulation to complete them and to foster its development.

Let me focus on one aspect, which I believe is essential to achieve sustained economic growth: to development of a long-term market in local currency.

Particularly in the case of economies in transition towards its long-term equilibrium, central banks include on their agenda other specific tasks that their policy actions cannot ignore: the need to increase the depth of the financial system, develop new financial instruments and complete existing markets in local currency becomes a priority.

There is a strong consensus about how important this is for the emerging countries. Different kinds of factors, at both the macroeconomic and microeconomic levels are noteworthy. Among the macro factors, progress in the de-dollarization of the economy and the reduction of vulnerabilities associated with the possibility of sudden stops stand out.

This is of special significance because the presence of currency mismatches has been at the root of the most important financial crises (or has at least contributed to amplify them). A significant dependence on debt in strong currencies means that countries are more

vulnerable to depreciations of their currencies (which are severely contractive). Also, the development of markets for debt in domestic currency tends to be associated with a better liability management. In fact, the development of a yield curve that serves as the base to develop new products (like derivatives), makes it easier to mitigate risks.

Of the micro factors, it is fundamental to develop a yield curve in domestic currency that reflects the opportunity costs of funding at different maturities, collaborating to achieve more efficient resource allocation. The development of these markets is a more stable source of funding for the financial system. In addition, the countries with deeper domestic markets face a broader variety of policy instrument choices. Therefore, the lender of last resort role avoids the limitations observed in a highly dollarized context, for example. Likewise, less reliance on external capital flows (usually at short terms) allows for more control over the monetary policy.

Despite the achievements observed during this decade, there is still significant progress to be attained, which is even clearer for Latin America. Especially as regards the terms of the issues (so that the change from issuance in hard currencies to soft currencies does not imply excessive currency risk for interest rate risk) and a larger share for the nominal fixed rate issues (with the aim of reducing the interest rate risk). In addition, although the liquidity of the secondary markets for debt has increased in recent years, it remains limited and unbalanced (with less liquidity in the longer term issues).

Central banks also have a specific interest in the improvement of domestic bond markets, in particular for public sector debt. One reason for this is that more complete markets reflect the relationship between borrowing costs and terms. Making an explicit yield curve reveals information about the expectations that the economic agents have, which is essential for business decisions. Recent experience has shown that the development of bond markets must be based on placing funds in domestic currency, which is not only relevant for the transmission of the monetary policy but also as a mechanism to reduce external vulnerability.

I would say that financial integration in general plays and important role enhancing the power of monetary policy instruments. In particular, when assessing the effectiveness, credibility and commitment of monetary policy in emerging markets to deal with inflation and inflation expectations. The depth of the financial system and its integration with capital markets has a powerful disciplinary effect on monetary policy as it reduces incentives to expand as foreign capital would flow out to other markets with more predictable returns.

For this purpose, a precondition is the reduction of the macroeconomic volatility so typical of our region. We need not only to sustain but also to strengthen the pillars of, what i call the new economic paradigm, with several anti-cyclical components:

- Fiscal solvency. Today fiscal responsibility in most of the emerging world is not a feature from the left or the right: it is just common sense.
- Monetary robustness and consistency.
- More flexible foreign exchange regimes.
- Reduction of net foreign debt and currency mismatches. A lesson from current turmoil is that emerging markets with current account deficits and fiscal deficits were hit the most as they became more vulnerable to foreign capital outflows.
- Trade dynamism (diversifying destinations and products). Just as an example, the share of exports to the United States, one of the major destinations of foreign sales, from 2002 to 2006 dropped from 33% to 27% of total Latin American exports and from 21% to 18% of the emerging Asia total. This is very important as the US and other developed countries face also significant challenges.
- Accumulation of international reserves (insurance against external shocks). And the later has been, i would say, the common pattern all across the emerging world. Today, with no international lender of last resort, there is no good substitute for a

sound external liquidity policy at the country level. I am afraid it is the responsibility of every country to develop its own set of countercyclical policies that would help weathering limited access to financial markets, without having a significant impact on domestic variables. Building a precautionary cushion of foreign reserves is particularly important for emerging countries, where there is a tighter connection between monetary, fiscal and financial stability.

It is also accepted that a weak corporate governance framework negatively affects the investment process. The development of a bond markets request improvements into the legislation on corporate governance. Emerging economies are making efforts aimed at helping improve standards of corporate governance, focusing on shareholder and stakeholder rights, board member duties, disclosure, and effective enforcement. Also the development of a broad debt market, regulatory tools for secondary markets and derivative markets is key: the first one for liquidity purposes and the second for hedging matters. Developing a repurchase (repo) market in securities has often proved extremely useful in fostering market liquidity. In terms of infrastructure, many countries need to adapt their clearing and settlement systems to enhance integration of international financial markets. Also public policy efforts to improve data dissemination of debt issue in domestic currency are required to allow possible investors a better monitoring.

International experience shows that, in many cases, the development of a local currency debt markets need the active participation of the government itself as a market maker. An example for the former is the Mexican case. Mexico defined a public debt strategy that included financing the public deficit in local markets, favoring the issuance of long-term fixed-rate securities, and decreasing gradually the issuance of variable-rate instruments. The strategy set annual targets for net external debt reduction, to widen and diversify the investor base for local debt. The implementation of this strategy needs a minimum level of credibility for government which relates with the previous paragraph.

International financial institutions (IFIs) have a role to play as well. They could collaborate with the acceleration of the deepening process of the local markets debt, enlarging the group of available instruments in local currencies both within emerging countries as well as in international financial markets. In addition, the issuance of IFIs has a "signaling effect", improving confidence on macroeconomic and financial conditions of that market, attracting the presence of international investors and potential issuers. One way of achieving this is that the IFIs itself issued debt in currencies of emerging countries, in line with various types of transactions carried out in recent years (usually by taking advantage of their best rating). In this sense, IFIs often operate as a catalyst agent, leading the first issuance (start ups) in currencies of emerging countries in both local and international markets. The issuing of IFIs could also help decoupling the sovereign risk of currency risk, meeting the demand for assets in local currency (for example, from domestic institutional investors, with liabilities in local currency but with fear of sovereign *defaults)*. Instruments in local currency rating to AAA would be of interest to such investors.

There are several examples that show the progress institutions such as the World Bank, the IDB and the BIS have made over the last years on this field. With regards to the BIS, as central banker of the monetary authorities, its role in the development of the local debt markets may have at least two aspects. On the one hand, the BIS can coordinate joint initiatives (and provide certain guarantees) of some groups of central banks that decide to unify part of its reserves to invest in specific purposes, such as buying bonds in local currencies. Moreover, although most of the resources administered by the BIS are invested in financial assets of top quality at international level and their exposure to the various risks are managed conservatively, a greater portion of such funds could be spend toward the direct purchase of debt denominated in local currencies of emerging countries or to the use of them as collateral of certain bond issuance of countries with limited depth of their financing markets in local currency.

In a nutshell, carrying out the reforms mentioned above does not mean blindly following certain recipes that must be applied always and under any circumstances. This acknowledges that there are different ways of putting into practice the adequate policies to achieve a stable and deep financial market. Moreover, it is not only necessary to identify the adequate economic policies for a country under specific circumstances, but correct timing is also crucial when implementing the measures. The pace at which reforms and policy measures are implemented cannot be independent from the structural characteristics, nor the economic and social environment in any particular country. Therefore, the pace chosen should maximize the likelihood of success of the process.

Depth, quality and pace of institutional reforms are at least as important as their stability in time, since otherwise, any effort shall be vain. For such purpose, they must be consistent (without generating more losers than winners in the short term, because otherwise they will not be politically sustainable) and involve consensus among the different stakeholders. They cannot be imposed in an authoritarian way or imported from other countries (transferring rules form a developed country to a developing one does not necessarily mean the latter's progress), rather, they are endogenous to each society. They are the result of collective decisions where groups with different attributions and preferences take place, whose political power hinges on political institutions (*de jure* political power) and on distribution of economic resources (*de facto* political power). Even if this collective decision-making process may take time, the fact that institutional reforms are carried out based on "conviction" rather than on "need" and with the necessary consensus, clearly improves the possibilities of success and its long-term persistence.

Now policy makers worldwide seem to understand that policy recipes vary from one case to the other in this complex scenario. This progress is, obviously, welcomed. Especially for us, emerging markets' policy makers, as we have to catch up with growth, deal with the tensions derived from buoyant economies and, most importantly, build institutions and credibility at the same time. In fact, it is more a synchronic than a sequential two-fold challenge. To implement these policies effectively, the only possible way is to keep a consistent (I mean consistent with the history and idiosyncrasies of each economy) and gradualist approach.

Thank you.