Martín Redrado: Monetary policy autonomy in small open economies – fact or myth?

Speech by Mr Martín Redrado, Governor of the Central Bank of Argentina, at the Central Bank of Malaysia's High Level Conference 2009 "Central Banking in the 21st Century: Implications of Economic and Financial Globalisation", Kuala Lumpur, 10 February 2009.

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Let me first congratulate the Bank Negara Malaysia (and in particular to Governor Zeti, who is always a source of inspiration for us central bankers in the emerging world) for this 50th anniversary. It is a pleasure for me to be here sharing our thoughts in such a challenging period.

For the first time in recent decades, the emerging world is not at the epicentre of a financial crisis.

However, not all developing countries are being hit in the same magnitude. Since the beginning of 2008, there is a growing differentiation of credit default swaps (CDS) premiums. Emerging markets with current account and fiscal deficits were hit the most as they became more vulnerable to foreign capital outflows. Investors perceive as riskier countries those which have external financing as an important source of funding, requiring a greater risk mark-up on their investments. In terms of CDS spreads, regions more susceptible to external shocks (those with large current account deficit) have increased 15 times their spread in the last 18 months, compared to a smaller but still important increase in spreads for countries with current account surplus and those with relatively low deficit (less than 5% of GDP).

Meanwhile, uncoordinated policies in developed countries, including asset purchases, capital injections, and extension of deposit guarantees together with increasing political pressures over banks to lend domestically is accelerating flows out of emerging markets. In this context, the understanding of this phenomenon by local investors in developing countries creates additional risks as they do not fully acknowledge that those capital outflows from global banks were just the response of calls from "the headquarters".

However, we have learnt our lesson. Mainly due to a history of financial instability a great number of central banks in the developing world have patiently build countercyclical measures to absorb external shocks. This is allowing us to weather this crisis without the usual stop-go process which created discontinuity and lack of confidence. Persistence will give our countries an unprecedented value in return: overcoming major disruptions providing our population with an unprecedented public good: monetary and financial stability. In this crisis of the system we witness significant threats to stability and the evaporation of bank lending we, central bankers around the globe, are revalidating our credentials as crisis managers.

No single country is immune to this epidemic. Everything revealed short when mature financial markets are under stress. Economic activity is shrinking all around the world and at astonishing pace in some cases, which is accompanied by massive layoffs. Financial markets keeps on the brink and world trade is almost frozen by the lack of banking institutions willing to provide the needed funding. The only positive readings on indicators are more an expression of hope than good economic analysis.

Given our experience in managing financial crisis, I believe that going forward the roadmap should have as minimum the following elements:

First: the package put forward should over react. Action should be forceful in order to curb expectations and rebuild confidence – it should reflect that authorities are persuaded that the path to follow is the correct one.

Second: simplicity. The instruments used should be transparent and straight in order to be more effective. Action can be technically flawless but, if agents have trouble interpreting it, it can cause uncertainty and become ineffective.

Third: execute. Show delivery capacity. Effectiveness to overcome complexities related to the implementation of any action is an important condition allowing, at the same time, to gain credibility.

After overcoming several turbulent episodes in our history, policymakers in the developing world have learnt that there is no single regime that is "right" for all countries at all times. In the 1990s, the so-called "bipolar view" argued that, over time, we would end up having only hard pegs (recognizing, in a way, the inability to pursue a domestic monetary policy) or purely floating arrangements. However, we have seen no "vanishing middle" at all, but the persistence of intermediate regimes during the 2000s. Even countries that have adopted inflation targeting approach show no unique foreign exchange regime: some 50% of inflation-targeting countries are not pure floaters. Rather than an "optimal" monetary policy, one that is robust under alternative scenarios is what we are all trying to pursue.

The current environment proved that there is no "one-size fits all" exchange rate arrangement. The managed floating exchange rate regime has been the most adequate at a certain time in history for many countries, particularly in Asia. Specially, for countries such as mine with decades of macroeconomic volatility and dollarization which during the past 25 years has spent more than a third of its time outside its dynamic stability path. In general, Latin American economies have shown lower rates of growth on average (less than a half) combined with higher GDP volatility as compared to Asia. This trait has been particularly marked in the case of Argentina. As an example, in the last 25 years, the country showed a standard deviation of GDP growth about three times higher than emerging Asia. At the same time GDP annual growth rate was about fifteen times lower. Just to stress this point: if we take either growth or consumption, their distribution over time looks much more like a random walk and, thus, difficult to predict.

These contexts of high volatility are associated with high uncertainty which constraints the effectiveness of monetary policy. These phenomena have severely harmed long-term performance, and were not cost-free in terms of welfare: excessive volatility in Latin America is probably the main reason behind its economic underperformance vis-à-vis Asian countries in the last three decades.

In order to deepen our analysis of the subject we must evaluate the dominance factor because it poses complex problems to the conduct of our task. Moreover, in certain circumstances, it can be perceived as a source of stand-alone uncertainty on macroeconomic dynamics. On the fiscal side, not long ago in my country we used to have not only the central bank but the financial system financing the treasury with no limits whatsoever. This is a key reform made during my tenure, which is bearing fruit under this time of turbulence. Similarly, doubts as to the financial system's solvency or external sustainability can also limit monetary policy room for manoeuvre. Failure to consider this in the design of policies could eventually lead to severe disruption in macroeconomic performance, thus enhancing uncertainty.

A prominent case of "financial" dominance in emerging economies has been dollarization or euroization of the system as we are seeing in Central Europe today. Indeed, this feature can affect the full utilization of monetary policy (and the choice of the exchange rate regime) due to weaknesses in balance sheets of lenders and borrowers. In this case, dominance becomes clear in the face of the negative impact that exchange rate depreciation has on the net worth of financial systems. In contexts of financial frictions, and currency substitution, constraints for monetary policy are non-trivial. The monetary authority could therefore show some preference for avoiding fluctuations in the currency rate if the latter could seemingly originate "balance-sheet" effects that might end up affecting the solvency of the financial system. In fact, the presence of currency mismatches has been at the root of the most important crises, or has contributed to amplify them.

So, in our economies, where society has developed a high risk aversion and the need to prevent a new crisis becomes a priority objective, it is important to take the fiscal, financial and external conditions into account when conducting monetary policy. Furthermore, in such scenario, monetary policy should be conceived under a general equilibrium approach, where fiscal solvency, the monetary stance and external sustainability are mutually determined.

During this phase, both price and financial stability goals should be better tackled using all the tools of economic policy, involving joint and coordinated fiscal, wage, competition, and monetary policy actions, among others.

Several studies outline the theoretical basis and macroeconomic implications of this kind of regimes. There are many reasons to mitigate excessive exchange rate volatility, particularly in developing countries with a limited capacity to absorb external resources through their capital markets. By mitigating fluctuations without disregarding the fundamentals, this approach combines the needs of the various segments of the economy while preserving consistency with the whole of economic policy. Recent literature factors into the analysis segmentation and restricted access to markets. The most relevant conclusions suggest that the narrower the local markets and the fewer the instruments to hedge out currency risk, the better a managed floating exchange rate regime is to maximize social welfare. In a context of imperfect functioning of foreign exchange markets and incomplete capital markets, the adverse effects of a significant depreciation either on inflation or wealth is not negligible. As an example, in Argentina exchange rate volatility is positively correlated with volatility in retail deposits since depositors perceive the increase in volatility as a growing risk of vanishing of its saving's purchasing power.

Empirical work of several academics, which expanded and fine-tuned the analysis, showed that several developed and emerging countries can be considered "managed floaters." Less than a half of inflation targeting countries effectively apply a pure float. In this sense, the literature states that reaction functions of central banks in inflation targeting emerging countries have a significant coefficient for the nominal exchange rate. This means that the exchange rate is an important variable for monetary policy conduct. These arguments become more convincing in the absence of an international monetary system and a recession in the main reserve currencies of the world.

Challenges for monetary policy are also reflected on a shift in central banks´ goals and instruments. The ongoing crisis is making somewhat obvious that financial stability is relevant for central banks. Mostly ignored (or left as a "by-product"), today financial stability is a goal as important as price stability. Furthermore, in my view, how to handle the links and trade-offs between these two goals is what would make us succeed as central bankers.

Financial stability as an explicit goal has been for years very common throughout the emerging world. It actually, became a must given our history of macroeconomic instability. During past decades, crises in our countries have helped clarify the connection between monetary and financial stability. On the other hand, in developed countries, where the real side is usually highly affected by disruptions in capital markets, financial stability was traditionally viewed more as an instrument rather than a goal per se. But now, when capital markets are at stake, monetary and financial authorities in industrial countries have taken every needed step to grant stability, even in a context where traditional central bank instruments proved to be unable to deliver.

We still confront the challenging task of defining and measuring financial stability. There is no unique or generally accepted definition. As well, when it comes to making financial stability an operational factor, disagreement among relevant actors arise, something that is somehow different with price stability goals. On top of that, there is also a lack of available instruments to achieve financial stability, whether it is a developed or emerging market economy. Those missing tools may have its part on explaining the under pricing of risk during recent times, leading to a short-sighted vision on potential longer-term consequences of a reversion on the business cycle. In this regard, one of the key tools is to have a proper financial regulation and to use the information provided by monetary aggregates. This should also be consistent and well-integrated with the monetary policy framework. This means, for instance, developing a macro-prudential framework that could help to link both approaches.

The crisis highlights the importance of the risk management approach in the design of precautionary strategies for the conduct of an effective monetary policy in small open economies. It is necessary to consider not only the most likely future path of economic development, but also the distribution of feasible outcomes around that path. An informed judgment of the costs and benefits of these possible outcomes under alternative choices should be made.

As usual, and regardless of undeniable costs, crises are a breeding ground for creativity, but also for the inevitable revision of previously accepted principles. In times of turmoil, theoretical consensus on “what to do” and “how to do it” tends to vanish. In other words, while the relationship between economic theory and policy recommendations is reasonably well defined during “normal” times, in periods of turmoil, this relationship becomes much weaker. We have reached a point in which economic theory is having a hard time keeping up with praxis.

My reading is clear: there is no single policy or one optimal approach that could be defined in a vacuum. Every policy option has its costs and benefits. The key is to choose whether we want to avoid “going long” or “falling short”. Naturally, beyond any attempt to mitigate this trade-off, the strategy and policy choice will crucially depend on the attitudes of the government and its people towards risk. It will also depend on their intertemporal considerations, because the profit and loss profile of alternative regimes will not always coincide. Furthermore, past trends in the relevant economy and the starting conditions will naturally affect our policy choice.

Also, current turmoil and policy reaction in developed countries is an opportunity to understand how monetary policy is performed in emerging economies where financial markets are shallow, the power of monetary policy to affect aggregate demand is limited. One interesting conclusion from the ongoing crisis is that the way of doing monetary policy in such an extreme framework is not much different in emerging or developed countries. It could be framed as a matter of effectiveness of the available tool-kit.

However, this is not a negligible point. Monetary authorities in emerging countries, are much more used to employ diverse tools. Even the emerging countries with inflation targeting regimes were forced to make their systems more flexible to face the new environment. In the end, we all operate under similar principles, but are surrounded by different realities, circumstances and idiosyncrasies.

In the case of small open economies the job becomes even more comprehensive from a monetary policy perspective. Emerging economies need to achieve macroeconomic and financial stability, develop capital markets, deal with fewer and less developed policy instruments, with fiscal, external and financial dominance, and build credibility, all at the same time.

We often lack developed economies’ room to implement counter-cyclical fiscal and monetary policies. It is hard to think of an Asian country doubling its monetary base in four months or reducing its reference interest rate to almost zero percent, as the U.S. did, without adversely affecting economic agents’ expectations regarding future inflation or the sustainability of the foreign exchange regime. It is also hard to imagine an emerging economy announcing a fiscal package of 7 percent of GDP to bail out financial institutions, without creating doubts as to the sustainability of their public accounts. At the same time, emerging countries are more likely to experience joint crises. A drop in deposits may lead to FX pressures with an impact on the external position and may affect fiscal accounts (due to the impact on sustainability of the potential fiscal cost of a financial system bailout or domestic currency depreciation in the face of a currency mismatch).

These limitations together with second round effects make a strong case for more coordinated efforts with a greater voice from the emerging world. Otherwise, countries might be tempted to further address the shocks in an uncoordinated way probably by taking measures to isolate themselves. The backfire could be seen either on financial integration (by controlling capital outflows), or on trade policy (rising barriers on imports).

We have to avoid that the positive aspects of integration are overcome by the flaws of the system. It is also worth noting that self-insurance via international reserve accumulation or fiscal funds seems not to be enough when confronted to the magnitude of the de-leveraging process taking place at a global level.

We are seeing many welcome developments, particularly the surge in bilateral currency swaps agreements such as the recent one between the Hungary National Bank and the Swiss National Bank as well as the one between the People's Bank of China and the Monetary Authority of Hong Kong to facilitate a smoother trade. This adds to those seen during last year between central banks in developed economies and with emerging ones: the Fed with Mexico, Brazil, Korea, and Singapore; the Bank of Japan with India and the Scandinavian central banks with Iceland. All of these bilateral agreements just prove the need for international cooperation in a context of an absence of a multilateral organization in a position to perform as a kind of "central bank of the central banks". This is the next step we need to go for.

While challenges for policy makers around the globe are significant, now we seem to understand that policy recipes vary from one country 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 the standards of living of our population and, most importantly, build institutions and credibility at the same time. In fact, it is more a synchronic than a sequential two-fold challenge: advancing towards the development of our economies and building institutions simultaneously. And, specially a fundamental institution: a deep local currency market able to channel domestic savings to the most productive investments in order to minimize macroeconomic volatility. To implement these policies effectively, the only possible way is to keep a consistent approach (I mean consistent with the history and idiosyncrasies of each economy). This approach seems to be the rule rather than the exception not only in the emerging world but also all across developed countries.