Martín Redrado: Where is global finance heading? Status of the international monetary system and the stake of emerging economies

Speech by Mr Martín Redrado, Governor of the Central Bank of Argentina, at the Session II – Emerging Economies in the international financial system – the way forward, Cusco, 13-14 July 2009.

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The experience of having to deal with recurrent crisis over the last decades finally is paying-off for us, emerging economies. For the first time in recent decades, the emerging world is not at the epicenter of a financial crisis. We, developing economies, were "learners of first resort" that financial stability is a prominent goal for central banks. And, what is most important on the way forward, we are meant to be both the engine of the world economy but also to share the driver's seat, which is a bigger role that comes with bigger responsibilities.

While the global economy seems to be bottoming out, it is still gripped in what, in my view, will be a lengthy recession. In the developed world further adjustment is in the pipeline in a context of credit squeeze, growing unemployment and a deteriorating credit quality. We have not yet seen clear steps to what is needed in terms of long-term funding; households and banks balance sheets repair; and long-run fiscal and monetary sustainability, which could be a drag today but clearly is an issue for the medium term.

In the emerging world, the correction is also taking place. And, in some cases, it is showing up the hard way. We witness Asian economies suffering from a collapse on trade but mostly region-driven. Figures reveal that U.S. imports did not fall as much as intra-Asia trade. On the positive side, inventories data in East Asia suggest that the retrenchment on industrial activity might be over. Here, again, the "green shoots" could be the effect of anti-crisis packages rather than a more lasting effect with domestic consumption on the "driver's seat".

Collapsing global demand caused a sharp drop in the international prices of raw materials since their reached their peak in mid-2008. During the first half of the year, however, prices showed some signs of stability and certain improvement. The outlook imposes a limit on a recovery, but it is expected that structural factors that are underpinning prices, will continue to prevail. We have been seeing lately a remarkable performance of quotations on both hard and soft commodities. There can be two main explanations for this development: a surge on speculative trading or a surge in physical trade.

In the former case, although there have been some improvements in financial markets, activity on non-commercial commodity trade is still bellow last year levels, and the causal relationship between speculative trading and prices is under hard scrutiny. In this regard, there is a clear concern of US authorities that are set to strengthen the regulation on commodities markets, and at the same time are going to disclose more detailed information on non commercial operations. On the fundamentals of these markets, there is much more information to justify an upswing on prices: on the supply side there is a lower harvest of some grains and oilseeds. The stagnation of productive investment (because of reduced spending in fertilizers, seeds and equipment) due to the crisis, in a context of low grain stocks, makes the markets vulnerable to any weather shocks in the 2009/10 season, something that starts to be reflected in prices. For example, my country consumed 30% less fertilizer during 2008, while in the first quarter of 2009 imports showed a decline of 90% annually. This lower investment is particularly relevant for countries in the southern cone because it would affect the productivity of the soils, which were damaged by the drought of the last season (even with favorable weather, it is likely that productivity will be lower than that of recent years). On the demand side, there were new increases on biofuels targets and a broad re-stocking process, taking advantage of lower prices. Much of this is reflected on a surge on vessels use with a clear impact on freight rates, which jumped nearly 50% last June.

In addition, with a focus on ensuring the future supply of food and commodities and on investment, countries like China and Saudi Arabia, among others are making progress in the purchase of arable land in developing regions like Africa and in our region. This factor shows a renewed investor's interest in the development of agriculture. The first reason that explains the proliferating acquisition of land is linked to food security concerns. Several countries invest in the long run to feed their people at affordable prices. The second reason is more related to financial gains. Faced with the collapse and prospects for future increases in prices of food and land, institutional investors are returning to invest in the agricultural sector.

It is crystal clear right now that the way out of this crisis for emerging markets will be critical for the future growth path of the world economy. In analyzing medium-term economic growth perspectives, a key issue is whether the dynamics of previous years will be maintained, especially when considering the disruptive effects of the crisis. In this regard, emerging economies are expected to play a key role. Our projections indicate that the BRICs, for instance, would share approximately 30% of global output in 2020, while the U.S. share would drop to 17%. Two areas where these structural changes associated with emerging economies have most clearly come true are the world production of industrial goods and in the development of global imbalances. As to imbalances, the increased importance of emerging countries became apparent in international reserves and the creation of sovereign wealth funds.

At the same time, the growing importance of emerging economies in the global economy reveals the need for their increased participation in the global policy decision-making process. In turn, the appearance of new important players in the emerging world makes this process more multi-polar and complex.

One example is the participation of emerging economies in the recently launched Financial Stability Board and the expansion of the Basel Committee on Banking Supervision, which in my view, have been the most significant reform in the international financial architecture so far. For instance, in the case of the regulatory treatment of currency mismatches, we, I mean those countries that suffered macroeconomic crisis, have something to say. The increased credit risk faced by subsidiaries, when these subsidiaries are significant for the banking group as a whole, imposes negative effects for the parent bank and home market. Central Banks could strengthen its regulation on credit risk management by requiring banks that before granting a loan, they should assure that no currency mismatches exist in debtors' balance sheets. This regulation can be imposed by host authorities to subsidiaries in their jurisdictions, and also, by home regulators to the banking group as a whole regarding each of its subsidiaries. This means for example that home regulators ask that the parent bank and each subsidiary inside the group must comply with that requirement. If not, penalties should be imposed, such as increases in capital requirements. The effect of that kind of currency mismatches could be explicitly considered in the Pillar II in Basel II. If the effects of currency mismatches are not properly attended by banks, supervisors at the banking group level, should require additional capital. Also, the potential effects of currency mismatches should be explicitly addressed in supervisory colleges.

In this context, Latin America is also playing a growing role in the world economy by being a factor of stability as opposed to what happened in other times in history. Definitely, the region has been better prepared to face this crisis both when comparing with history and with the way other emerging markets are being affected. Following the crises of the 1990s and 2000s, our countries have taken important steps to strengthen macroeconomic management, prudential regulation and oversight. Improved current account and fiscal positions, large amounts of external liquidity, better liability management and robust monetary frameworks are several features that place my region not even in the first row of the fire line at this time. I would like to stress, in particular, the strengthening of balance sheets, including the built up of liquidity buffers to face external shocks and the reduced currency mismatches – one of the key sins of the past. The development of a domestic currency capital market was a corner-stone that allow the monetary and banking system to act as a shock smoother rather than a shock amplifier, proving for financial stability.

Speaking about financial stability, in my opinion, one of the key structural changes in economic policy is that financial stability is now ranking higher on every central bank goals worldwide. Both developed and emerging countries have had to adjust monetary schemes focused on the interest rate as the single instrument to maintain stability. In fact, financial stability objectives were implicitly and explicitly added, and instruments were adjusted to new priorities. Within this framework, many central banks have had to revisit their usual regulation, operation and intervention mechanisms. 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, the economic literature is lagging behind. If the relationship between economic theory and policy recommendations is reasonably well defined during “normal” times, in times 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. Literature has shown results that are ambiguous or contrary to those produced by the usual “technology”, especially in relation to the approach that relies on the interest rate as the single instrument. Same applies to managed floating exchange rate regimes. Recent empirical papers that refined the analysis started by several academics argue against sharp fluctuations in the domestic currency. Instead, mitigating excessive volatility, especially in developing countries with rather shallow capital markets and limited access to hedging, seems to be an appropriate policy.

This kind of monetary and financial framework that ensures systemic stability has been my main task during the last years. This means giving priority to avoiding "the next crisis" and building buffers to minimize the effects of disruptions. In my country, the decades of macroeconomic instability and recurrent crises were not harmless in terms of welfare.

These factors, which undermined the power of some traditional monetary policy instruments, have played a key role in the design of our current monetary and financial system. In particular, our risk management strategy based on four pillars (calibrated convergence between supply and demand in the monetary market, managed floating exchange rate regime, development of external liquidity buffers, appropriate financial regulation and supervision) is compatible with these aims as well as with the tools available. This scheme, which was carefully developed along recent years, now allows us to overcome each episode of stress, minimizing the impact on the real economy and avoiding inconsistencies that might make it unsustainable over time. Recently, we have experienced periods to significant financial stress in the domestic market and our monetary and financial framework has delivered. The fact that we have successfully navigated four episodes of financial stress in the last two years (July-October 2007, April-June 2008, September-November 2008 and March 2009) is an ample proof of the robust nature of the approach adopted by the Central Bank.

In each of the events, we first reacted firmly to normalize the money demand and stabilize the foreign exchange market. Then, with simple instruments, we ensured liquidity provision to guarantee systemic stability. Finally, we implemented an array of measures including reforms on the markets for Central Bank securities, the development of additional mechanisms for liquidity provision, changes to enhance futures market depth and transparency, and instruments to facilitate supply of foreign currency.

In particular, we acted to neutralize the effect on money supply of the increased demand for foreign currency by injecting liquidity, mainly through the redemption of Central Bank Bills and Notes (LEBAC and NOBAC) on the secondary market and partial renewals. This avoided placing excessive pressure on interest rates, at the same time as ensuring compliance with the monetary targets. We also offered swaps between fixed and variable interest rate instruments to set a reference for the term structure of nominal interest rates for longer periods than are currently traded on the market. In addition, to prevent excessively cautious behavior by banks and to encourage the use of their surplus foreign currency resources to trade financing we made available a new option to access to foreign currency repos. In this context, the managed floating exchange rate regime has proved its worth for the period the economy is going through. This does not mean that we ignore structural changes that could affect the real equilibrium exchange rate (commodity prices, the value of the currencies of leading trading partners, development of global supply and demand, among other factors). We will continue to prevent excessive fluctuation in the exchange rate that could potentially impact on expectations and could represent unbearable threats to systemic financial and monetary stability. Our system worked as a dam to the rest of the economy, providing for the first time in decades monetary and financial stability.

While challenges for us, policy makers around the globe are significant, now we seem to understand that policy recipes vary from one country to the other. Developing and making operational flexible but robust policy frameworks is therefore highly desirable. I mean approaches with goals that are consistent with the history, the idiosyncrasies and the instruments available in each economy. The ongoing crisis is making somewhat obvious that financial stability is relevant for central banks for instance. My message is that a goal that has been mostly ignored (or left as a “by-product”) in a country, could be as important as any other one in certain circumstances. Furthermore, in my view, the way we handle the changing links and trade-offs between the different goals and instruments is what would make us succeed as policy makers. 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. Today, this approach seems to be the rule rather than the exception not only in the emerging world but also all across developed countries.