Martín Redrado: The hemispheric growth agenda - financial and economic outlook

Speech by Mr Martín Redrado, President of the Central Bank of Argentina, at the 36th Washington Conference on the Americas, "Latin America: financial and economic outlook *vis-à-vis* the global challenges", Washington DC, 3 May 2006.

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1. International context

Global economic and financial conditions remain favorable for the region. Commodity prices are soaring and look sustainable for at least the next 24 months, economic growth is still high and international interest rates are at historically low levels, despite recent hikes.

During this year, global growth has become more geographically balanced with subdued inflation in the three largest regions of the world. Expansion projections have been revised upwards, rising from 4.3% three months ago to 4.8%. Two-thirds of such increase is explained by growth in three countries: Russia, China and India.

And this is not a negligible fact. The inclusion of China and India in the global economy has had a significant impact on trade patterns and on terms of trade. On the demand side, as population migrates from rural to urban labor markets, demand for food has increased, driving commodity prices up in a sustainable way since 2002. China's involvement in world economy has boosted interest for agricultural products and for industrial commodities such as base metals and, in particular, oil, amid a context of growth in investment and manufacturing activity in Asia. On the supply side, the production of industrial goods at low cost has increased competition, helping to keep inflation restrained worldwide.

I contend that a number of latin american countries are more China sensitive than interest rate sensitive.

Among industrial countries, the us remains the major driver for growth with limited pass-through from headline to core inflation. Japan virtually left deflation behind and China keeps growing at an outstanding pace; still in the neighborhood of 9-10%-rates. There are some signs of a more solid recovery in the euro area, although the expansion is still modest. Meanwhile, growth in most emerging countries remains solid.

2. Global risks

However, risk factors for emerging markets, and Latin America in particular, are slightly biased to the downside mainly due to a number of uncertainties. Let me point out four risks.

First: increasing protectionism. There is little hope that multilateral trade negotiations would make real progress. This trend may also be fueled by the continuity of the current status quo in the light of escalating global imbalances.

Second: oil prices, short-term risks relate more to the geopolitical arena than to the fundamentals of exploration and exploitation of resources. On the demand side, the renewed interest on financial instruments such as the exchange-traded funds and their widespread development, open access for individual investors to spot and future markets, this new phenomenon generates new pressures that may be out of line with changes in the underlying fundamentals.

Third: asset inflation - mainly in the real estate market - and, in particular, how this issue has impacted on consumption and wealth effects in industrial countries. Although in some economies such as England and Australia housing prices began to decline, there is still noticeable uncertainty about the accelerated asset inflation and its consequences on the real economy.

Fourth: the adjustment of "global imbalances". In particular which region will absorb the greater costs is a critical factor to asses potential spillover effects. My view is that the correction will imply both a rebalancing of world demand together with price adjustments. Obviously, the key question is whether we will have a soft landing or a hard one. While in the past we have not seen many soft adjustments for this kind of imbalances, the pace of technological progress and structural changes in productivity together with labor flexibility, make it harder to extrapolate the past into the future.

In any case, the behavior of commodity prices, interest rates differentials and the demand for assets denominated in dollars will be the relevant angles to level the field during the next years. ***Any scenario requires our economies to adopt countercyclical macroeconomic policies. Why? Because we are more vulnerable to external factors.*** The agenda includes foreign reserve accumulation, fiscal discipline and strong financial systems, capable of buffering the possible impacts of global financial turbulence on domestic variables. This is no time for complacency. This is time to build strong countercyclical policies. Save in the good times to spend it in the downturn.

3. Latin America

It is true that today our region is better prepared than in the past. The external and fiscal accounts of latin american economies have improved significantly over the last years. In this framework, our countries have made progress towards more flexible exchange-rate regimes, continued to accumulate foreign reserves, made net payments to multilateral financial institutions, increased domestic savings and developed domestic capital markets. Therefore, the macroeconomic fundamentals from a risk management perspective are much stronger due to: 1) fiscal solvency; 2) monetary prudence; 3) external sustainability with exchange-rate flexibility and countercyclical policies; and 4) better regulated and deeper financial systems.

The current account surplus and a primary fiscal surplus has reduced indebtedness in virtually all countries in the region. Latin America has been showing a current account surplus for three years in a row, which reached about 1.3% of GDP in 2005. Fiscal solvency has become a public good highly and undoubtedly valued by our society. Most importantly, fiscal discipline is not an asset for the left or right. It is just common sense. There is also increased price stability along with a greater social demand for restrained inflation. Central banks in the region have been able to meet these demands by pursuing prudent monetary policies.

This scenario together with higher private capital inflows has helped to develop countercyclical policies by means of foreign reserves accumulation. While, the decision regarding the level of foreign reserves that a country should hold is generally associated with the need for a certain amount of liquidity to meet external liabilities, I would like to stress the role that foreign reserve accumulation plays as an insurance and deterrence mechanism for emerging countries. ***I believe it is the responsibility of every country to develop its own set of countercyclical policies*** that would help weather limited access to financial markets without causing a significant impact on domestic variables. ***Building a precautionary cushion of foreign reserves is particularly important for emerging markets in these benign times.***

Also, there has recently been a shift in the focus of international financial rules. The old paradigm is in crisis, but no replacement has yet been found. The problems in distinguishing between financial turbulences that arise from temporary or permanent causes may lead to contagion effects; an uncertain transition from bail-out to bail-in; problems arising from moral hazard, are as present today as they have been in the past. Therefore, in the absence of an international lender of last resort and with an incomplete international financial architecture, the accumulation of international reserves for prudential reasons has to be contemplated. In fact, today I believe that, ***there is no good substitute for sound liquidity policies developed domestically to deal with exposure to the potential risks I described earlier.***

And this is not a policy exclusive to Argentina. Following the macroeconomic and financial instability of the second half of the 1990s, the main emerging countries, especially those that have endured financial crises, have favored the accumulation of reserves as a mechanism to reduce the vulnerability of our economies and persistent exchange rate volatility. Foreign reserves held by central banks have grown by 220% over the past decade, at double the rate at which reserves were accumulated during the previous decade.

In the particular case of argentina, the accumulation of foreign reserves has been complemented with a strong sterilization policy with a number of absorption instruments to clear pesos in excess of money demand. The issuance of central bank securities (LEBAC and NOBAC) has been the monetary authority's natural absorption factor. These securities – with maturities that range from one month to two years – generated a monetary contraction of over 10 billion pesos in 2005.

Another remarkable (and rather unique for Argentina) absorption instrument has been the payback of rediscount lines by commercial banks, which has become one of the main contractive factors in 2005 and continues to be in 2006 as ***many financial institutions are anticipating payments from liquidity assistance provided by the central bank during the crisis.*** These payments reflect the upturn of the banking sector and also show the commitment of the central bank to keep the quality of its balance sheet. This factor represented an additional absorption of 12 billion pesos.

Additional sterilization instruments include activity in the repo market, which provides for a corridor of benchmark short-term interest rates and the stock of treasury bonds in hands of the central bank as a result of the recall of quasi-monies carried out by the national government after the crisis. This policy could not have been pursued without the strong balance sheet the central bank is able to show. In fact, these absorption instruments were utilized while preserving a positive balance sheet, which currently shows a profit of over 2 billion pesos. For 2005 finally, the public sector acts as a major source of monetary contraction as well, by purchasing part of the us dollars required to meet foreign obligations.

Therefore, as an autonomous institution that has emerged from a major crisis, the Central Bank of Argentina does not perform any monetary issuance to finance the national government nor it provides incentives to increase the exposure of the financial system to the public sector (but quite the opposite). ***The central bank has been accomplishing its monetary program - with a restriction in monetary agregates for 2005 and 2006 - for eleven consecutive quarters.*** Consequently, for the first time since 2002, the monetary base reflected a shrinkage of 1.5% in real terms in 2005.

Among several measures taken to boost credit and to develop an enhanced regulatory framework, ***we issued regulations that limited credit to the public sector and currency mismatches, which were two key sins of the past.*** As a consequence, a de-dollarized financial system currently relies on a lender of last resort in pesos and its exposure to the public sector diminished to 31% of the assets, after reaching levels of more than double during the crisis. In other words, strict ***limits on exposure to the public sector have been set up in order to leave behind the "crowding out" of previous decades, when loans were mainly heading for the government and welcome the "crowding in",*** providing the right incentives to finance private projects. This development is entirely consistent with the goal of minimizing the "fiscal dominance" that has historically characterized the region.

But, central banks in the region have also progressed towards ensuring financial stability through deeper and better regulated and supervised financial systems. In Argentina, the central bank achieved sustained progress towards the definite resolution of pending issues which have held the financial system at risk, by means of a proactive regulatory and supervision policy. These developments include adequate regulatory incentives aimed at strengthening risk management, greater transparency and the safeguarding of consumers' rights, as well as the recovery of solvency in a framework that encourages medium- and long-term lending.

In this context, financial institutions managed to obtain positive earnings in 2005 for the first time since the 2001-2002 crisis. Both public and private financial institutions also received capital contributions for more than 1.2 billion pesos in the second half of 2005 for a total of 12.5 billion pesos over the 2002-2005 period. In a process that is expected to continue, ***foreign banks accounted for more than two thirds of total capitalizations, which is a clear indicator of the renewed confidence of the international community on the domestic financial system.***

This favorable development, along with the ongoing dynamics of banking capitalization, is consolidating the soundness of the financial system: ***Argentina today has a much smaller, better matched, deeper and less riskier financial system than in the past.***

Therefore, a combination of fiscal solvency, external sustainability, a sound financial system, and a prudent monetary policy ensures that recent price behavior by no means poses a threat of spiralizing inflation, because ***– unlike prior episodes – there is no uncontrolled expansion of domestic credit, whether through the financing of public sector deficits or by unrestricted assistance to the financial system.*** Inflation processes in Argentina have in general been preceded by a considerable stream of demand for dollars, which is quite the contrary to what is happening now. The current situation is not at all similar to what occurred in the past two decades. During the 1980s, Argentina was hardly competitive and the growing fiscal deficit was financed by printing money, which ended in hyperinflation. In the 1990s, low inflation lived with growing twin deficits (fiscal and current account) that were entirely inconsistent with the exchange rate regime at the time. Argentina currently exhibits the largest primary fiscal surplus of the past 50 years, a financial sector that is paying back its debt to the central bank, and a significant current account surplus supported by the sustained growth of exports.

There are reasons to believe that "temporary" factors are putting pressure prices today. Due to the limited pass-through to domestic prices that followed the devaluation of the peso, there should be a natural adjustment in relative prices in a context of sound economic growth and a narrowed output gap, as well as some imported "inflation" in the framework of a more open economy and an international market with rising prices (crude oil and commodities in general).

In my view, a strict hold on the growth of monetary aggregates in a way that encourages savings without affecting investment nor leading to short-term and volatile capital inflows combined with a responsible fiscal policy with countercyclical components and a prudent wage policy is the right way to go in order to keep inflation on track in Argentina. We should not ignore the fact that we are talking about an economy that is still in transition, where key economic variables have not reached their long term equilibrium levels yet, credit markets are small and the trnsmission mechanisms of monetary policy are highly undetermined. It is important to keep in mind that ***it took long to countries that suffered huge economic crises to fully stabilize their economies and achieve sustainable growth.***

In fact, the approach of countries such as chile, to fully stabilize their economies included fiscal discipline, external debt normalization, reconstruction of the financial system and avoidance of an acceleration in inflation in a sequential manner. All of these countries put in place gradual policies after the collapse of their economies.

4. Challenges

Latin American countries today are better prepared to face eventual changes in the international environment than in the past due to sound macroeconomic policies. The key challenge though is to make theses policies long-lasting. In fact, the current favorable international context and ***the expansion cycle of the global economy provides an opportunity to learn from the past and to generate persistent institutional changes.***

In the 1980s, monetary policy acted as a mere financing instrument for unsustainable fiscal policies. Even under the monetary arrangements of the 1990s that prevented the financing by the central bank of fiscal deficits, imbalances led to indebtedness crisis, which ended up affecting the whole economy, including the financial system. ***The sound macroeconomic fundamentals the region stands on today contribute to generate a stable economic framework and work towards the goal of avoiding the "fiscal dominance" of past decades based upon the implementation of countercyclical and flexible macroeconomic policies.***

Regarding the Argentine financial system, while the recovery from the crisis occurred at a remarkable pace, there are still some outstanding tasks for the medium-term. Although there has been a clear upturn in private credit in 2005, bank lending currently stands at almost 11% of GDP, well below historic and international levels.

Policy makers in the region now face the challenge of designing institutions that provide the means to make these sound policies persistent. Depth and quality 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 and involve consensus among the different social groups.

We know that ***economic institutions cannot be imposed in an authoritarian manner or imported from other countries, rather, they are endogenous to each society*****.** They are the result of a collective decision-making process institutional reforms should be carried out on "conviction" rather than on "need" to enhances its probability of success and persistence over the long-term.

The dual challenge of the region is not sequential but simultaneous: growing and creating institutions at the same time, since they define and reinforce each other, thus securing adequate consistency and consensus. This process calls for a gradual nature, for flexibility and for the ability to adapt to the chalenges of the world economy.

The Central Bank of Argentina will continue to pursue a prudent, predictable and transparent monetary policy, which includes countercyclical components to reduce external vulnerability and to provide the conditions for a solid expansion of the financial system within a context of financial stability. This is our contribution towards sustained growth.