## Martín Redrado: Opening address at the conference "Monetary Policy under Uncertainty"

Opening address by Mr Martín Redrado, Governor of the Central Bank of Argentina, at the 2007 Money & Banking Conference "Monetary Policy Under Uncertainty", hosted by the Central Bank of Argentina, Buenos Aires, 4 June 2007.

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Today we are commemorating the 72nd anniversary of the creation of our Central Bank. I would therefore like to thank all those who contributed to the building of this key institution for the Argentine people.

I would especially like to thank our foreign visitors: the Central Banks of Brazil, Chile, Uruguay, Colombia, Peru, Bolivia, Paraguay, and Honduras; the monetary authorities from Germany, Italy, Spain, the Netherlands, Finland, England, India, Russia, Poland, Greece, Turkey, Pakistan, South Africa, Indonesia and Zambia; the United States Federal Reserve; the European Central Bank; multilateral agencies such as the Central American Monetary Council, the Latin American Reserve Fund, the IMF, the World Bank, the IADB, the United Nations, and the Bank for International Settlements; prestigious universities such as Harvard, Chicago, Columbia, UCLA, and Stanford; and representatives from the private sector joining us today from all parts of the world.

This year's conference seeks to focus on an essential topic for central bank action: the implementation of monetary policy under uncertainty.

Uncertainty is at the very core of monetary policy implementation itself, so the different dimensions of how monetary policy works should come into play when designing the framework for policy implementation.

Both uncertainty inherent to the development processes of domestic economies and uncertainty associated with the transformations undergone by the global economy especially due to financial innovation, together with the greater integration of emerging countries, have led to a new horizon for monetary policy design and implementation. We will attempt to approach this horizon in this forum for reflection and analysis. Of course, we will also try to share experiences because the issue is so complex that it calls for us not only to consider the theoretical soundness of existing policy design models, but also their practical application.

Maybe later than expected, the literature has again focused on the evident fact that uncertainty is not just an important feature of the monetary policy landscape; it is the defining characteristic of that landscape.

Despite some important precedents such as those set by Brainard in 1967 and Craine in 1979, it was only recently that theoretical thinking on monetary policy started to systematically include the specific difficulties policymakers face every day in an uncertain and erratic environment.

In fact, until not long ago, the consensus in academia on monetary policy mostly overlooked the issues related to structural change and uncertainty – as reflected, for example, in Lars Svensson's presentation at the 1999 Jackson Hole Symposium. This literature implicitly assumed that we, central banks, were aware of the true economic model, that we were able to correctly observe all relevant variables, and that we accurately knew the nature and sources of the various random forces affecting the economic system.

In this conceptual approach, the only remaining "uncertainty" was actually the effective value of these stochastic disturbances. In terms of the Knightian distinction between risk and uncertainty, it was, at most, a risk situation where policymakers seemed to know the random distribution within the various contingencies. They also seemed able to quantify the likelihood of the several possible events occurring, ultimately assuming that the future would replicate the past. However, in most cases central banks evidently face a quite different reality: many risks are essentially not quantifiable because quite often not only the likelihood of each individual event is unknown, but also the whole range of possible contingencies.

In short, uncertainty makes monetary policy implementation an extremely hard task, even in industrial economies. In emerging countries, where institutions are still in the process of consolidation, the central banker's task is even harder: the instruments have a limited power and the boundaries between the scenarios which require intervention due to market failures and those that belong to the usual turbulences in a dynamic market are not so well-defined. This is especially true for countries that have had a fixed exchange rate for decades and, for several reasons such as fiscal, financial, or external dominance, have suffered from macroeconomic instability, marked by currency substitution and the dollarization of liabilities, which have hampered monetary policy implementation.

Uncertainty about how the economy really works and about the true value of the parameters together with data quality and timeliness (and, consequently, the robustness of estimates) is an essential constraint that not only affects the central bank, but also the private sector. There is huge uncertainty about the future behavior of the main domestic variables, especially in relation to (both goods and factors) relative price dynamics and that of the various sectors of the economy.

Another important restriction is given by the difficulty in identifying the nature of shocks, especially external shocks. The world continues to tread today a path of sustained expansion in a context of stability. This pattern of growth is even healthier than in recent years, because it is better balanced due to the relative weakening of the United States and the good performance of the euro area and the emerging Asian and Latin American economies.

The international scenario offers extraordinary liquidity, with interest rates that continue to be historically low.

Risk aversion is at its lowest for every standard (the VIX index, for instance). This is also true for the term premium. Every indicator shows excess savings as compared with the demand for capital in a world thirsty for attractive investment opportunities.

In that sense, much has been contributed by the ongoing financial innovation that is definitely changing traditional financial intermediation. Structured credit and its derivatives (credit default swaps) are already surpassing bonds and stocks underwriting. Against this backdrop, players that are highly leveraged by hedge funds in particular as a source of liquidity become more relevant.

The fast introduction of innovative products and the deepening of cross-border placements lead to a greater supply of funds for a new universe of investors in financial markets, enabling a greater diversification and spreading of risk among asset holders. This risk transfer reduces the financial system's vulnerability and strengthens its ability to cushion shocks.

In addition, the weakening of the home bias in investment portfolios and the spread of strategies such as the carry trade have helped reduce risk in fixed-income assets in emerging countries.

In this context, Latin America exhibits the most robust expansion in the past thirty years, based on a better macroeconomic management that includes fiscal discipline, external sustainability, and the adoption of flexible exchange rates and consistent monetary policies. This has significantly contributed to improving the region's financial position, as reflected by narrower spreads.

However, the reasons for today's narrow spreads are, in my opinion, beyond market changes resulting from financial innovation or the emerging countries' mostly sound fundamentals.

In my view, many of the reasons lie in the gradual adjustment of global imbalances. A certain deterioration in the productivity of the US economy is associated to an expectation that the US dollar will depreciate, leading investors to seek assets in other currencies. This is reflected in a clear trend towards developing economies' assets (mainly Asia but also Latin America) and, consequently, in narrower spreads and stock markets hitting record highs – in short, it results in higher funding opportunities for all the emerging world.

Such a process – which takes place gradually and is coupled with a transition towards a more diversified asset portfolio for central banks – offers great opportunities but also poses significant challenges for our countries.

On the one hand, it is reflected in a foreign capital inflow having several effects on our economies such as the following:

1. Our region, in spite of its recent achievements, is still very vulnerable to changes in global growth, fluctuations in commodity prices, and sudden changes in international financial conditions. Therefore, what in developed countries is a "correction," in the countries of our region – where, besides, there is a higher risk of contagion – may amount to a crisis.

2. On the other hand, our exchange rates tend to overreact, which may affect the financial system, thus hampering stability.

3. Due to the very nature of the process, it is difficult to establish *ex ante* its permanent or temporary nature in order to make policy decisions accordingly. Rajan and Subramanian (2006) have highlighted the difference in treatment according to whether the trend is caused by permanent or temporary factors. Actually, this dilemma is not new at all, and it was discussed by Keynes and Ohlin in the 1930s, when they analyzed the issue of compensations in the Germany of the first postwar. In my view, it would be preferable to take every positive shock as temporary.

4. It is also important to recognize that, depending on the level of emerging countries' development (depth and recurrence of crises in the past, timing as regards the end of the crisis, degree of economic normalization, institutional development, etc.), neither our financial markets nor our currencies are always ready to channel such capital flows (nor their inherent volatility). The financial systems continue to be small, debt markets in local currency are still in their infancy, and secondary markets are not liquid enough. In fact, Prasan, Rajan and Subramanian (2006) conclude that, in contrast with predictions from standard models usually calibrated for developed countries, emerging countries that committed themselves to external savings have not grown faster in the long term. This difference is attributable to the local financial systems' inability to efficiently allocate foreign capital.

5. Finally, the search for other currencies introduces an "imported volatility" that distorts relative price signals for consumption, savings and investment decisions in our economies, small economies with inherent sources of instability where it is difficult to know the equilibrium level of real variables.

In this context, we see that all emerging markets are taking the necessary precautions (to a greater or lesser extent and according to their needs). Some of them have established capital inflow controls; others, like Argentina, seek to mitigate exchange volatility, accumulating international reserves at a time when our balance sheet situation allows us to do so. Chile and Mexico, for instance, take the opportunity to build-up fiscal resources through the operations of state-owned exporting enterprises and the Treasury.

For an economy, which have suffered a severe institutional crisis and is still in transition towards its long-term cruising speed, a managed-floating regime emerges as a useful tool to mitigate these effects while advancing in the development of an adequate financial infrastructure to create conditions for resources to be efficiently channeled towards the funding of worthy investment projects and, in turn, strengthen traditional monetary policy instruments.

While there were some turbulences in the recent past with no significant effects, this adjustment process towards equilibrium has not yet been tested. This requires us to implement sound and consistent policies to comprehensively protect our economies against external misalignments.

In the case of Argentina, this implies, for instance, providing monetary and financial policy with long-term sustainability on the basis of four main pillars – a consistent monetary policy that ensures money market equilibrium; a countercyclical prudential approach; a system that is independent from public sector needs; and a policy framework that boosts credit to firms and households.

The first of these pillars is largely determined by our recent history: in Argentina, monetary regimes have unsuccessfully shifted from one extreme to the other. While in the 1980s money supply was rising uncontrollably in line with the monetization of the fiscal deficit, in the past decade the strictures of the convertibility regime were neither consistent with the economy's flexibility nor with the fiscal behavior. What mattered was not the label of the regime, but the internal consistency of its policies.

In an economy where macroeconomic variables are still seeking a long-term stability path and transmission mechanisms through credit are still limited, the current monetary policy helps us to ensure the strict and ongoing money market equilibrium.

In order to preserve this equilibrium, the Central Bank applies a deep monetary absorption strategy coupled with foreign exchange purchases for prudential purposes. Thus, it has absorbed some ARS 80 billion since 2005. Such a strategy has been implemented through various mechanisms that comprise the issuance of bills and notes, repo operations, the pre-payment of liquidity assistance provided to banks during the crisis, and the minimum reserve requirement policy.

For example, let us take rediscount lines, which have historically represented as asset with a high risk of recovery for the Central Bank. Banks' settlements on the basis of incentives by the monetary authority, both through the payment of monthly installments and through payments made in advance, have acted as an extraordinary money absorption mechanism in recent years.

In turn, through weekly auctions of bills and notes, we have sterilized around ARS 32 billion since 2005, thus increasing the diversity of instruments and the portfolio's average duration.

Furthermore, we are developing the repo market, in order to turn the interest rate into an effective monetary policy tool, widening the modality of authorized operations so as to enhance the efficiency of banks' liquidity management.

In short, the monetary policy adopted by the Central Bank has made it possible to keep the growth of means of payment under control, within the self-imposed targets set year after year. In this way, the growth of the means of payment was, for the first time since the end of the crisis, below nominal GDP growth, reflecting the prudential bias in our approach.

Uncertainty about the potential power of transmission mechanisms requires the monetary prudential stance to be gradual but persistent. Thus – given that the current inflationary phenomenon has many causes and is derived from an economy in transition that has undergone an unprecedented crisis, with formidable structural changes (including the destruction of the financial system and many economic institutions), and where monetary policy transmission channels are still under recovery – , prudence and gradualism positively contribute to achieve intertemporal stability.

In turn, and just as most emerging countries have been doing, the Central Bank continues to implement a prudential international reserve accumulation policy. The current stock of over USD 40 billion is a record high figure and more than triples the lowest amount in early 2003. Thus, the Central Bank generates a true insurance against crises that reduces external vulnerability, lends certainty to public and private investment and develops a domestic capital market in local currency, ensuring macroeconomic equilibrium.

International reserves are an indispensable pillar for Central Bank monetary and financial policy. Therefore, they are also the basis for monetary regulation operations to strictly control the balance between supply and demand in the monetary market.

With a growing stock of foreign currency, the requirements for an adequate management are greater. Thus, during 2006 and so far this year, we got the highest return (around 6.5 percent y.o.y.) from the investment of international reserves since the end of the crisis.

A third state policy claimed by society relates to the monetary-financial system's exposure to the public sector. In this sense, we are gradually minimizing the likelihood of the financial system becoming a source of instability, reducing currency mismatches, decreasing exposure to the public sector, and enhancing solvency.

In the past, the Central Bank and the financial system ended up being mere instruments of an unsustainable macroeconomic policy. In the 1980s, the Central Bank provided indiscriminate assistance to the Treasury and the financial system in the framework of a hardly competitive economy and a growing fiscal deficit, which resulted in hyperinflation. In the 1990s, although inflation was subdued, the growing fiscal and external deficits were inconsistent with the current exchange rate system. The Central Bank issued regulations that favored unlimited financing to the government, discouraging credit to the private sector.

The monetary authority has set strict guidelines to reduce exposure to the national, provincial and municipal public sector. On the one hand, caps have been set based on the capital of each institution and on the relevant jurisdiction. On the other, an overall maximum restriction was set at 40 percent of the bank's total assets, effective since January 2006 and which by July 2007 will be reduced to 35 percent. These measures are producing a structural change in our history: a monetary and financial system that is independent from the public sector.

In the past two years, the share of credit to the government in total assets was significantly reduced, and bank actions are focused today on credit to households and businesses.

The fourth pillar of this architecture is to place banks back to its traditional role: credit should focus on facilitating consumption and investment decisions by businesses and households. The Central Bank's policy has thus created market incentives for the recovery of credit to the private sector from a set of specific measures that have stimulated financing and widened the base of potential borrowers.

In particular, credit to small and medium enterprises reached above-average levels, extending the universe of borrowers to almost half a million. As a consequence, there is a widespread expansion in all credit lines to the private sector and non-performing loans hit a historical low that is currently below the average for Latin America as well.

In short, we must deepen those policies that enable us to face changes in the external context and, in turn, to develop our economic institutions so as to better channel benign scenarios and improve the power of our monetary policy instruments, with the aim of being fully responsible for the achievement of the objectives set and, thus, being able to set more ambitious goals.

The challenge is to crystallize these actions into long-term and persistent policies. Otherwise, all efforts will be vain and we will fall in the classical Argentine pendulum, going from one extreme of the range of possible policies to the other with no continuity whatsoever. It is, in fact, a two-fold challenge; not a sequential but a synchronic one: making progress in the achievement of our objectives and building institutions at the same time. To that end, consistency and gradualism prove essential and are, in my view, the only possible way to ensure policy effectiveness for the benefit of future generations.

Welcome and thank you very much for your attention.