Martín Redrado: Consolidating growth through innovation

Speech by Mr Martín Redrado, Governor of the Central Bank of Argentina, at the Conference "Consolidating Growth through Innovation", organised by the Council of the Americas, Buenos Aires, 7 August 2007.

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We are gathered here today to exchange and develop ideas on innovation as a tool to consolidate growth.

The first thing that came to mind when I was preparing this speech was to try and explain what role innovation has played regarding the current monetary and financial policy strategy, what it has contributed during these years in office, and to what extent it promotes macroeconomic stability.

All in all, the question is: how innovating and how effective is the existing monetary and financial policy framework in Argentina?

I must say that, paradoxically, in answering this question the financial market turbulence of the past two weeks gave me a big hand.

What we are experiencing today has enabled us to see our global monetary and financial policy strategy in action. Far from being erratic, each move in this strategy has been in line with the intertemporal goals of equilibrium in the monetary market, the preservation of the value of currency and the stability and depth of the financial system. I say "intertemporal" because the Central Bank has "an across-cycle" view rather than a short-term one.

Worsening recession in the US real estate market, its impact on those who are more exposed to these assets, and their effects on consumption and investment hit both developed and emerging countries alike.

In industrial countries, the fall of the markets in the past two weeks swept more than two thirds of this year's returns away.

I believe we are witnessing a belated "re-pricing" of risk in financial markets that is entering a new stage where there is a "spillover" toward the set of asset classes and global investors worldwide.

Evidently, the fall of the US real estate market will deepen and thus affect growth. Defaults on low-quality mortgage loans are being largely absorbed by financial institutions; therefore, the effect on aggregate demand will depend on how they requirements for new loans are being adjusted.

The Fed will react more aggressively only if the phenomenon goes beyond an expected (and even welcome) "correction" of financial asset prices and becomes a credit crunch threatening economic stability.

In my view, sound economic growth in the rest of the world is undoubtedly a positive factor that balances (and also mitigates) the US weakness.

Against this turbulent backdrop, which leads to tighter credit, especially in the riskiest countries, Argentina has shown that it has the necessary exchange rate and monetary institutions to provide its population with a horizon of solvency and predictability.

And even though predictability and innovation do not always go hand in hand, our monetary policy capacity to react to an external crisis served to maintain the horizon of stability. At the same time, this has resulted in an innovative behavior compared to the spasmodic responses that Argentina featured over history.

Greater uncertainty is a good exercise to understand that it is possible to live with international volatility, without fearing for the future of our savings or the stability of our jobs.

Action taken, encompassing a set of financial and banking regulations and direct intervention in the monetary, foreign exchange and financial asset markets, responds to a preventive and consistent strategy developed in the past few years to ensure the necessary capacity and strength to prevent frights in times of turbulence.

Prudential foreign reserve accumulation is an example that speaks for itself. As with every insurance policy, it represents an "abstract" benefit while it is not used, but a "concrete" one in financial stress situations: the $44 billion in the Central Bank's coffers were enough to discourage speculation.

The current managed floating regime aims to prevent excessive short-term volatility that affects spending, saving and investment decisions. At the same time, the current framework avoids providing "foreign exchange insurance" that would favor the inflow of "hot money".

Along these lines, avoiding a hysterical reaction by the monetary authority in the first two days of the international turbulence was key to prove the adequacy of the current exchange rate regime. The "fear of floating," well-known in the economic literature, is still alive in the Argentine collective memory, even among sophisticated analysts and the specialized press.

Afterward, and in order to reduce uncertainty, our action combined direct intervention in the foreign exchange market – in coordination with state-owned banks – to avoid inflationary pressures. Then we continued with the provision of liquidity in the money market so that the natural increase in interest rates would not become persistent and thus threaten credit dynamics.

To that end, monetary policy instruments were used such as the absorption of Central Bank securities (Lebacs and Nobacs) which, far from being conventional debt securities – they are backed by reserves – make up liquidity "cushions" that may be used in turbulent situations. Indeed, we have begun to buy back short-, medium- and long-term securities to inject liquidity to the market, proving that they are in fact monetary policy instruments. Besides, regulatory measures were adopted – bimonthly calculation of banks' liquidity requirements – to "decompress" stress situations in the money market.

Clearly, for the current transition stage of the Argentine economy, there is no other viable and sustainable alternative than the current managed floating regime. A system based on free floating, still called for by many, would have involved the risk of going back to the devaluation-inflation spiral that has been so recurrent throughout our economic history.

In the past few days, however, we also learnt that in spite of the necessary foreign exchange stability for the current transition stage, there is no "foreign exchange insurance." We have seen that on Wednesday 25, when the upward trend was most marked, the exchange rate increased, leading to a volatility that ruled out hopes of guaranteed profits.

When devaluation expectations became noticeable, threatening to manifest itself in the rest of the economy, we made it clear that we will mitigate steep increases potentially having an inflationary impact or causing uncertainty.

Once the foreign exchange rate was stabilized, we adopted measures to reduce the upward pressure on interest rates, a process that will continue until normalization is achieved.

But, what do we mean when we talk about a stage of transition?

In post-crisis periods, the macroeconomic fundamentals usually overreact to then gradually readjust themselves and converge towards a long-lasting scenario.

These transition stages take time and raise enormous challenges. Our neighboring countries' experience teaches us that flexibility and gradualism in both policy design and implementation are the adequate way of riding them.

During the Money and Banking Conference organized by the Central Bank of Argentina, Vittorio Corbo, President of the Central Bank of Chile, stressed the sequential process undergone by the Chilean economy following the crisis of the early 1980s. Four elements have been of utmost importance in this long process: consolidating fiscal solvency as a countercyclical tool, reestablishing external sustainability, restructuring liabilities, and rebuilding the financial system. Once all these aspects were addressed, progress was made in the consolidation of a regime that is nowadays highly credible. Thus, in 15 years, Chile managed to lead inflation from around 30 percent to the current annual 2.9 percent, after patiently building credibility and institutions.

In Argentina, the monetary policy transmission channels are only just being rebuilt, since credit to the private sector accounts for 10 percent of the economy, still far below the Latin American average. Therefore, patiently rebuilding the power of monetary policy tools is a great step towards consolidating growth and stability.

Meanwhile, monetary and financial policy should be conceived under a general equilibrium approach, where fiscal solvency, the monetary balance and external sustainability are mutually determined. Against this backdrop, a sustainable and long-lasting reduction of the inflation rate depends on the comprehensive, joint and coordinated action of the monetary policy, the fiscal policy, the wages policy, and the competition policy.

Thus, we see that the current regime of control over the money supply and the demand for money combines the necessary doses of monetary prudence (as shown by sixteen running quarters of compliance with self-imposed monetary aggregate growth targets) and flexibility (which has enabled us to weather the recent turbulence).

Through this scheme, by trading in the repo market, issuing Central Bank notes and bill, and collecting in advance the rediscounts granted during the crisis, we eliminated any potential excess money supply.

In fact, in the first half of the year we sterilized 80 percent of foreign exchange purchases – up to almost ARS 25 billion. And this did not affect the Bank's positive balance sheet.

The Monetary Program sets indicative targets for all monetary aggregates. However, the achievement of these targets is linked to the change in the means of payment, since in an economy where financial normalization has not yet been achieved, it would be healthy for savings – time deposits – to be more rapidly channeled back into the financial system.

Deposit performance has not been affected by financial uncertainty and time deposits keep growing above the average.

This is another eloquent example of the strategy developed in the past few years to face contingencies: the recovery of banking liquidity and solvency, which allows us to have a sound financial system today that acts as a "turbulence buffer." In turn, improved profitability, together with capitalizations, strengthen the solvency of the system.

Just as reserves play the role of liquidity insurance to the monetary authority, banks' cash is the first defense line against unexpected events. For this reason, banking regulations fostered the recovery of liquidity, equivalent to almost 40 percent of total deposits, one of soundest of the region.

We should not forget about the growing dynamism of banks in getting resources through the international capital market. We have seen several institutions (not only the bigger but also the medium and small) gain access to medium- and long-term funding in capital markets with Argentine peso-denominated, fixed-rate instruments, unlike the case of the past decade.

All in all, besides mitigating volatility and its effect on real variables, action taken prevented the growth of the interbank rate from leading banks to increase the long-term interest rates, such as the rates charged on secured and mortgage loans. This is in line with our strategy to boost credit to households and businesses.

For a while now, we have been creating incentives for the recovery of credit to the private sector from a set of specific measures. These measures had a two-fold aim: on the one hand, extending access to potential borrowers and, on the other, improve the quality, quantity and cost of credit for those who already have access to financing.

Today, credit growth is widespread and has not been affected by turbulence either.

Credit lines of up to ARS 200,000 for small, medium and micro enterprises are growing faster every year.

Agroindustrial production and services were the productive sectors that boosted the extension of financing to firms in the first half of 2007, concentrating over 80 percent of loans.

The latest growth of secured loans is the highest since the recovery begun in 2004, and it takes place in a context where automotive sales to the domestic market reached new record highs.

Something similar happens with mortgage loans. In the past few months, they showed the greatest growth since mid-2005, when they reverted their downswing. Mortgage loans are mostly granted to households, mainly up to ARS 250,000, and currently account for 70 percent of loans – against 54 percent a year ago.

Furthermore, our policies help improve compliance: the nonperforming portfolio was reduced to only 4 percent of private financing.

Finally, we have adopted measures that are producing what I consider to be the major innovations in Argentine economic history.

A monetary and financial system that is independent from the public sector, and that takes and trades in domestic currency, with a lender of last resort that also lends in domestic currency.

In this regard, we have set strict guidelines to reduce exposure to the national, provincial, and municipal public sectors. Ceilings have been established based on the capital of each institution and on the relevant jurisdiction. In addition, an overall maximum restriction was set at 35 percent of each bank's total assets, which is fully effective now.

As a result, banks' exposure to the public sector accounts for only 17 percent of total assets, vis-à-vis around 50 percent during the end of the crisis.

Besides, we took specific measures to prevent those who cannot repay in US dollars from borrowing in that currency, encouraging the development of the credit market in Argentine pesos.

In the financial arena, we see that the government share in banks' total assets was dramatically reduced since the crisis. This crowds in the private sector. The non-performing portfolio has hit an all-time low. The system has already shown a positive balance for a couple of fiscal years now, and the process of capitalization and extension of terms for liabilities has been gathering momentum in the past few years. Thus, we now have a financial system that is more mature and better matched.

In the current monetary scenario, currently there are no symptoms of a weakened demand for domestic currency, and monetary aggregates have been strictly controlled to keep the balance between supply and demand.

All in all, the new international scenario creates new opportunities and challenges for the monetary strategy, but without jeopardizing the continuity of the ongoing program nor disrupting the rules of the game

On the contrary, international volatility can provide greater room for maneuver in terms of use of available instruments, that is, the foreign exchange and interest rates to achieve the intermediate targets (monetary program) and final targets (intertemporal inflation rate) of the

Central Bank's monetary policy, the greatest contribution of it to stability being the transparency and predictability of its guidelines.

Central Bank actions show us the consistency and effectiveness of the innovative strategy we are implementing, both in the monetary and the financial arena. This is a strategy that, in stages of transition such as this one, requires the essential monetary policy tools to act in coordination so as to consolidate sound economic growth with social inclusion.

Thank you very much.