Martín Redrado: The Argentine response to the financial turmoil

Speech by Mr Martín Redrado, Governor of the Central Bank of Argentina, at the Euromoney conferences, London, 13 September 2007.

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The first thing that came into mind when I was drafting this speech was to explain the basis of our monetary and financial strategy and to what extent it has contributed to promote macroeconomic stability over the last years.

I must admit, paradoxically, that the financial turmoil of the lasts weeks gave me a big hand. This is the first time, as in many other Latin American countries, the whole macroeconomic program – which includes our global monetary and financial policy strategy – is under stress.

So, this stress test provides us with a unique opportunity to witness our policies in action. It also allows us to assess the internal consistency and intertemporal sustainability of our approach.

As markets have come under pressure, emerging economies have shown general resilience. But, not all are in the same category.

In a de-leveraging scenario, countries with solid economic fundamentals (or "liquidity suppliers"), which include large fiscal and current account surpluses, flexible exchange rate regimes and abundant foreign reserves are likely to outshine the "liquidity consumers".

As we analyze the behavior of this asset class, Argentina's performance in the monetary, financial and exchange rate markets shows that we are in the first camp.

In a nutshell, our country is riding the storm due to better macroeconomic management. We have established a new framework that, in my view, is going to last for the next decades. It is based on the interaction of five pillars:

1. Fiscal solvency;
2. External sustainability;
3. A prudent and consistent monetary policy that ensures the equilibrium between supply and demand in the monetary market;
4. Countercyclical financial policies. They include active FX accumulation and management. Moreover, the development of a sound and well-matched financial system acts as a buffer against any turmoil; and
5. A managed floating exchange rate regime.

Let me elaborate upon the interaction of these pillars and how they are key to keep the economy moving to its long-term equilibrium.

Firstly, fiscal accounts show a surplus, boosted by increased tax revenues. The primary balance currently stands at almost 3.5%, achieving five consecutive years of budgetary discipline. As a result, the ratio of debt to gdp continues to decline. Financing requirements are manageable in a context of restrained access to capital markets for emerging market economies.

Secondly, since 2002 the current account balance is projected to remain positive in 2007 for six consecutive years, an unprecedented event since the mid-1940s.

Argentina is taking advantage of structural changes in the world economy that yield high commodity prices for several of its exporting products. This fact, combined with factors such as the abundance of natural resources, a reasonable infrastructure and the high level of education standards, put the country in an interesting competitive position in the global economy.

Shipments of manufactured products (of both agricultural and industrial origin) are leading the growth of exports.

This increase has occurred together with a greater diversification in terms of products and, especially, destinations. This has been boosted by a very active trade policy pursued over the last years to open and diversify markets.

For example, the number of countries Argentina sells its products has grown steadily from 159 in 1999 to more than 190 in 2006. This factor clearly helps mitigating the risks associated with adverse shocks in some of our trade partners.

And, despite a likely deceleration in the US and, probably, in Europe, I am not expecting a significant shift away from this scenario any time soon. Today, commodity prices depend almost exclusively on the long-term equilibrium between supply and demand in each particular market. And these balances have been virtually unaffected by recent financial turmoil.

Especially, for soft commodities, where demand seems to be immune to recent developments. In fact, agricultural prices have shown persistent upside movements recently associated with a structural change: a sustained growth in demand (rather than negative supply shocks as in other times in history).

Steady demand is based on higher consumption from emerging market economies worldwide. The middle east, southeast Asia and Latin America are delivering the best economic performance of the last decades. Together, they act as a positive factor that balances (and also mitigates) the prospective weakness in the US and Europe.

Wheat prices, for instance, showed a new record high last month explained by higher demand coming from the emerging world (mainly India). This will keep inventories low and the ratio stock-consumption at minimum levels.

Escalating shipments have also their grounds on the increasing use of agricultural products such as corn as inputs for producing substitutes to fossil fuel (to be consumed in industrial countries).

According to recent USDA studies, corn needs for energy demand will grow, in quantity, more than the world's total production for, at least, the next five years.

This phenomenon contributes to sustain high quotes. As a by-product, it affects food prices overall due to its impact on the cost of producing meat and dairy products.

Consequently, we are experiencing higher food prices worldwide. The impact on inflation is particularly large in developing countries, where foodstuff usually has a higher weight in the consumption basket (and, consequently, a higher weight in cpi).

Additionally, in these countries, cereals dominate the daily diet (according to FAO, cereals represent 52% of the diet in developing economies compared to only 31% in the developed world).

However, emerging market economies – both foods exporters such as Argentina and many other countries in Latin America and consumers, including many Asian countries – are also facing sustained increases in food prices.

Therefore, the twin surpluses (fiscal and external) have been a trademark of the Argentine economy over the last years and are expected to remain so. As opposed to what happens in other emerging markets, being able to show a positive cash flow that comes from the real side of the economy together with a flexible exchange rate regime and a solid central bank gives the country a paramount position to face external turbulences.

Nevertheless, on the fiscal side, the consolidated primary balance reached an outstanding 5.3% in 2004 to decline about two percentage points to current levels. Going forward, a commitment to increase the primary surplus is essential to keep a sustainable growth towards equilibrium.

So, the need to preserve and deepen these surpluses is a priority. Mainly, because we are still going through a transition phase typical of post-crisis periods. And, these transition stages – where key macroeconomic variables converge to their long-term values – take time and raise enormous challenges.

For instance, it took long to countries such as Chile to fully stabilize their economies and achieve sustained growth. Our neighbor put in place a gradualist approach during the normalization period. It involved four common elements that have been of utmost importance: consolidating fiscal solvency, reestablishing external sustainability, restructuring liabilities, and rebuilding the financial system.

Once all these aspects were addressed, progress in the consolidation of a full-fledged inflation targeting regime was achieved. Thus, for several years, Chile lived with higher inflation, while patiently building credibility and institutions.

So, the experience of other emerging economies shows that flexibility and gradualism in both policy design and implementation are the adequate approach during this phase of their history.

In Argentina, despite a notable recovery, several features of the current macroeconomic performance indicate that the economy is still heading towards a new long-term equilibrium. Neither in our history nor in the international experience is possible to find precedents for the 2001-2002 crisis.

Unlike the case of Brazil, Mexico or southeast Asia, the abandonment of the convertibility regime included simultaneously an institutional breakdown, a huge devaluation, the destruction of the financial system and the default on the public debt.

In addition, the country has a long history of macroeconomic instability. Monetary regimes have unsuccessfully shifted from one extreme to the other. While in the eighties money supply grew vis-à-vis the financing of the fiscal deficit, in the past decade, the rigidity of the convertibility regime was neither consistent with the structure of the economy nor with the government fiscal behavior.

There are several examples of the normalization phase that is still taking place: monetary transmission channels are just being rebuilt, since credit to the private sector accounts for only 11 percent of the economy, still far below the Latin American average.

Therefore, patiently rebuilding the power of monetary policy and developing the required infrastructure is an important 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.

So, the Argentine economy is simply at different a stage after the crises compared to the current situation in other Latin American countries.

Thus, hasty diagnosis and, as I heard from many analysts, simplistic comparisons among the various countries' situations may lead to inappropriate policy recommendations. The path towards an effective inflation targeting regime is a sequential one. Building strong pillars is the track of a Central Bank that operates strategically.

Under these circumstances, a sustainable and long-lasting reduction of the inflation rate in Argentina depends on the comprehensive, joint and coordinated action of the monetary policy, the fiscal policy, the wage policy, and the competition policy during the transition phase.

And this, takes me to the last three pillars I mentioned, which are the outcome of the monetary and financial strategy set by the central bank of Argentina over the last years. In fact, the turbulences we are experiencing today has enabled us to see our monetary and financial policy strategy in action:

- A prudent and consistent monetary that ensures the equilibrium between supply and demand in the monetary market.
- Countercyclical financial policies. They include active FX accumulation and management and a sound and well-matched financial system that acts as a buffer against any turbulence.
- A managed floating exchange rate regime.

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-the-cycle” view rather than a short-term one.

In the first place, our policy guarantees the stability by ensuring the equilibrium between supply and demand for money. Thus, we see that the current regime of control over money supply combines the necessary doses of monetary prudence (as shown by sixteen running quarters of compliance with self-imposed monetary aggregate targets) and flexibility (which has enabled us to weather recent turbulences).

We have consolidated the monetary policy scheme based on the control of money supply since it is the most adequate for an economy in transition, which still makes intensive use of relatively liquid means of payment and has a relatively low bank penetration.

The strategy is implemented through various instruments which allow us to absorb the supply of pesos derived from our FX accumulation policy. This aggressive policy is feasible because the central bank has a strengthened balance sheet and positive annual results.

Instruments include the placement of securities at fixed and floating rates, the repo market, the reserve requirement policy, and the early payment of rediscounts. The latter resulted from central bank incentives and led to a significant monetary absorption over the last years.

We have also been working to deepen the repo market and to empower its interest rate as a reference policy tool. We have been gradually but persistently hiking this rate. Since 2005, the interest rate on 7-days repo operations has increased by more than 500 basis points, acting as an important absorption instrument.

Recently, we have established a regular auction mechanism to provide daily liquidity and we have expanded the universe of securities taken as underlying assets for these operations.

What does the recent trend in money supply reflect? M2 shows a downward trajectory, with a steep fall in its year-over-year change in 2007-2006 vis-à-vis growth rates in 2003 and 2004. In fact, for the first time after the crisis, the money supply is growing below the nominal gdp. These are clear indicators of our monetary policy prudential bias.

Also, state-owned banks have started to manage their liquidity more in line with the rest of the financial system. Let’s recall that they hold 26 billion pesos of liquidity from the various government agencies of which about 10 billion pesos are still on sight deposits.

This prudent monetary stance contributed to achieve a more stable macroeconomic position. The different measures of core inflation that we track are showing today very similar monthly variations to those experienced in 2006: around 0.7% on average; ranging between 0.4% and 0.9%. Additionally, in the first quarter of 2007 (last data available), the gdp deflator grew below the average of 2006.

Then, through the full use of all available instruments, we have contributed to the stabilization in core inflation while fostering the stability of the financial system.

But, make no mistake on this: the Central Bank is concerned about current levels of inflation. There is no reason for complacency.

As a consequence, further joint work between fiscal, monetary, wage and competition policies needs to be done to make sustained progress over the next years.

Prudential FX accumulation is another 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 situations of financial stress: the $43 billion of external liquidity in the Central Bank’s coffers are enough to discourage speculation.

An additional element of the strategy developed in the past few years to face contingencies is the recovery of banking liquidity and solvency. Due to an improved regulatory framework, we developed a sound financial system today that acts as a “turbulence buffer” rather than “amplifier”.

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. To strengthen our monetary and financial system, we have also adopted measures that are producing what I consider to be one of the major breakthroughs in our history: a 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 less than 17 percent of total assets, vis-à-vis around 50 percent during 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 domestic pesos.

This action not only strengthened the stability of the system but also crowded-in the private sector, helping to deepen the market. In a context of high growth of credit to firms and households, the non-performing portfolio has hit an all-time low.

The system has already shown profits for a couple of fiscal years now, and the process of capitalization and extension of terms for liabilities has been gathering momentum. Thus, we now have a financial system that is more mature and better prepared to face any sort of disruption.

Lastly, the current managed floating exchange rate regime has been at the core of our monetary and financial strategy. On the one hand, it avoids ensuring a “foreign exchange insurance” that favors the inflow of hot money. On the other, it aims to prevent short-term volatility from affecting spending, savings and investment decisions.

And it has been proven that this is the most adequate scheme for this transition towards long-term equilibrium in our economy. Under a free float, the exchange rate would have reached significantly higher quotations, running serious risks of going back to the devaluation-inflation dynamics that has been so recurrent throughout argentine economic history.

Our actions included the – sequential and combined – adoption of a set a tools – monetary, exchange and financial regulation measures – that dodged every possible inflationary impact while injecting liquidity to the system. On the foreign exchange side, the Central Bank has coordinated the intervention with state-owned banks and has acted aggressively through the futures market to stabilize the exchange rate.

We also resorted to the use of monetary and financial regulation instruments: buying back our own securities in auctions and in the secondary market, optimizing the strength of bills and notes auctions according to the prevailing liquidity conditions and intensifying operations in the repo market through transparent auctions, among others.

All in all, Central Bank actions show us the consistency and effectiveness of our strategy. We proved to have the necessary “artillery” to preserve money and exchange market stability and, at once, a wide variety of tools to maneuver in the face of turbulence showing clear symptoms of permanence in time.

Moreover, we have proven our commitment to price stability (with the limitations derived from the instruments we have at hand in this transition stage) from an intertemporal approach, that is, looking *through* the economic cycle. This is the only conceivable course of action for a Central Bank with a strategic vision.

In my view, this framework has been extremely useful in a transition phase to achieve a five-year cycle of high and continued economic growth with social inclusion. Now, it is the time to strengthen and calibrate it to take us to the next level: the challenge is to turn this framework into permanent policies with long-term parameters.

The development of pluri-annual targets for monetary, fiscal and wage policies in order to set up a predictable horizon for long-term investment is an example of the tools that this next stage requires. Looking ahead, an investment rate of, at least, 25% of gdp will be needed to sustain current levels of economic growth over time, helping to attain price stability at the same time.

For this purpose, the harmonization of the whole set of instruments of economic policy should be oriented to protect the purchasing power of national income. It is all about, focusing on macroeconomic stability but from an “*across-the-cycle*” perspective to achieve a sustainable economic policy over time.

Otherwise, all efforts will be vain and we will be trapped in the typical Argentine pendulum, swinging from one end to another of the spectrum of potential policies with no continuity whatsoever. In fact, we face a synchronic challenge: achieving sustained growth and building institutions simultaneously.

To implement these policies effectively for the benefit of future generations, the only possible way is to keep the consistent and gradualist approach to build the right infrastructure so that there is no way back.

The most successful stories are those of countries that understood how important was to reconcile goals with instruments.

Especially, in a stage such as this one, where the combination of fundamental economic policy tools is what will allow us to achieve a gradual and long-lasting reduction of inflation in a context of economic growth that includes all our citizens.

Thank you.