Martín Redrado: The impact of global financial turbulence on financial markets in Latin America – the monetary policy response

Remarks by Mr Martín Redrado, Governor of the Central Bank of Argentina, at the 2008 Annual Meeting of Latin American Chief Executives of the Institute of International Finance (IIF), hosted by Corpbanca, Santiago, 2 April 2008.

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Latin America faces definitely a hostile international financial scenario. This episode is the most important global crisis of the past decades. And, it is here to stay.

In the U.S. the current situation shows troubling signals. Daily reports of economic indicators reflect the weaknesses of the economy. The subprime meltdown continues to boost defaults and foreclosures, now well beyond the real estate market. In the banking system today's pressures come from two sources. The first one is a continuous uncertainty about the value of underlying assets, underscored by a deterioration in economic growth. The other is associated with the nature of financial intermediation: banks have adopted a position of increased risk aversion and demand high premiums to offer funds. As a result there is an erosion on both credit quality and availability which, at the end of the day, translates into a further worsening of the real economy. In order to offset a credit crunch a recapitalization of lenders seems inevitable.

We are witnessing a growing use of unconventional tools to deal with the crisis in the developed world. The often criticized "pragmatism" is taking the stand both economically and politically. Tools like the ones used in the Bear Stearns transaction, which – with no precedents – extended the Fed's "umbrella" to investment brokerage houses. After this, it would be hard to avoid further direct assistance to help struggling homeowners to avoid the housing crisis, where the recession is spreading from residential to non-residential.

In this context, the Fed proved a strong commitment to providing liquidity to the financial system. The move – somewhat delayed – has been more aggressive than expected, leading real short term interest rates into negative territory.

Fed action is also directly addressing liquidity concerns, making bank assets more fungible and reducing the risk of liquidation. From my standpoint, this is nothing but the prevalence of the ideas that Bernanke has worked on during his whole academic tenure. Actually, one of his first contributions to the economic literature was to prove the strong links between the liquidity squeeze in the banking system and the credit crunch that led the U.S. economy to the Great Depression. He also deeply studied the particular issues of monetary policy under stress such as the zero nominal interest rate case.

Ben has insightful knowledge on how liquidity constraints in the banking system could translate into problems in the real economy. He thoroughly acknowledges the boundaries of monetary policy that only have interest rates as a tool. I discussed this with him many times for the case of emerging markets.

This background helps to better understand the wave of liquidity injections that the Fed has adopted since mid-2007. This view can also explain the recent disagreement between the FOMS members at the time of voting changes in rates.

However, the jury is still out there. There is no guarantee that credit will be restored soon as we are clearly facing a solvency problem. Also, credibility is at stake. The shift away from "market" measures to a "rescue" kind of approach may encourage reckless behavior in the future. It may also undermine the "inflation fighter" track record of the Fed. The aggressive moves are going far beyond than the so-called "Greenspan put" that was behind the scenes over the last years.

In the euro area the "re-coupling" story seems very reasonable to me. Growth prospects are rapidly deteriorating and the risk of recession should not be underplayed. The European downturn could take longer to run its course than the U.S., but it will probably also last longer. In fact, borrowing costs for consumers and firms have already increased as banks ran up losses on investment tied to U.S. mortgages. Further losses in the banking and financial system could soon be disclosed, impairing bank lending and hitting corporates in particular.

A reversal in the capital flows of banks from subsidiaries in the emerging world to meet liquidity and solvency requirements in their main houses in Europe is something to closely monitor. On the other hand, persistent inflation and budget deficits may prevent policy makers from moving aggressively to stall the vicious circle of mounting financial losses and recession.

Today intervention is a "worldwide" phenomenon. In the UK, Mervyn King is prepared to adopt a "long-term resolution approach", which includes acquiring illiquid assets from banks to improve their financial condition and cutting interest rates to provide liquidity.

We have seen all across the developed countries the kind of "unconventional policymaking" that was very much condemned in the emerging world: policies that, at the end of the day, are fully backed up by tax-payers monies.

The picture in the emerging world is quite different. For the first time we are not the epicenter of a crisis so conditions for contagion are less obvious.

Latin American countries in particular seem to be better prepared to face this new financial turmoil. The majority of the economies in the region are experiencing robust growth, underpinned by a buoyant domestic demand. This is mainly due to sound macroeconomic policies followed during the last years. Fundamentals are definitely more solid. In a context of soaring commodity prices, growth in south-south trade flows, together with strong fiscal policies, monetary prudence and robustness and sounder financial systems were crucial to foster sustainable growth.

On the liability side, significant progress has been made. The public debt to GDP ratio decreased almost 30 percentage points over the last five years. This reflects in part in better liability management, which also shows up in the enormous reduction in the exposure to foreign currency debt.

The region is finally leaving behind the well-known original sin that features last decades (currency mismatches), providing solid grounds for developing a domestic yield curve in local currency.

Also, all over Latin America, financial systems are well-matched, well capitalized and less exposed to public sector debt; another sin from the past.

While financial assets deteriorate given the greater volatility worldwide, a different pattern was observed compared to past episodes. The impact was moderate all across assets classes and the recovery was achieved at a faster pace consistently with improved fundamentals. Also investors are differentiating among countries. Eastern Europe, for instance, shows a different exposure vis-à-vis our region and Asia. In emerging Europe wide current account and fiscal deficits have been financed by large foreign capital inflows that could revert at any time, triggering a crisis.

However, Latin America is not fully immune. In my view, the region will not be affected in 2008 while some slight impact on growth rates would take place next year. Tighter financing conditions will marginally affect both the corporate and sovereign sectors.

Even though financing needs are not an issue as it was in the past, shallow capital markets throughout the region act as a constraint for sustainable growth over a longer term. Financial development is key – and will be even more so in our agenda. It allows agents to substitute assets in local currency to protect themselves against inflation, restraining the discretionary use of monetary policy. The depth of the financial system and its integration with international capital markets has a powerful disciplinary effect as it reduces incentives to follow expansionary policies (at the expense of higher inflation) as foreign capital would flow out to other markets with more predictable returns.

Anyway, this time the effects of the financial crisis are more likely to be transmitted through the trade channel rather than the financial channel (which historically affected the most Latin America). However, in my view, the challenges would be coming more in the form of managing the social tensions that could come as a result of record-high commodity prices (mainly in terms of higher domestic inflation).

The perspective of slower growth globally driven by the U.S. (and Europe) is obviously a red light but the impact will be limited. Structural and seasonal factors are driving commodity markets. Among them, it is worth mentioning supply shocks from climate hazards and geopolitical conflicts. Another factor is the increase as from the second half of 2007 in the speculative demand to protect against the depreciation of the dollar and asset losses. Looking ahead, weak growth in the U.S. And its eventual contagion to other economies would restrict non-speculative demand for commodities, especially oil and metals.

And here it is necessary to distinguish between the effects on hard and soft commodities.

Agricultural commodities would be less affected mainly because of their lower income elasticity and the relative strong fundamentals of emerging economies (and not only in China and India), where demand increased the most.

Soft commodities accumulate increases ranging from 100% to 150% since the beginning of the century with an acceleration in 2007-2008, that is leading to historically low stock to consumption ratios; the lowest in the last three decades.

In the cases of soy and corn, demand is consistently outpacing supply due to a hike in food consumption in the emerging world and a growing demand for biofuels in the industrial countries. While supply stays in historically high levels it cannot keep up with the enormous demand. Just to give you an example, corn inventories are 30% below the average of the last ten years.

Speculative trading on commodities as an asset class will remain strong. The continuity of monetary policies aimed at reducing reference rates could also favor it. In Latin America, the challenge is to take the necessary policy measures in order to avoid that this exogenous volatility turns into domestic or endogenous risks.

Food price rises can potentially lead to wage demands which, given the stickiness of this component of business costs, would result in a subsequent increase in headline inflation. However, this risk is more evident in emerging countries than in developed ones, where the weight of food products in cpi is lower. In Latin America, inflation will remain the dominant theme and the risks on this front will remain skewed to the upside.

In Argentina the monetary and financial regime has faced the most significant challenge since the crisis of 2001-2002, but when we look at the results it is clear that we definitely managed to rise to it. For the first time in decades regardless of external and domestic disruptions, as the ones seen in the last days, the central bank is providing monetary and financial stability, two essential public goods for sustainable development.

We know that the country has a long history of macroeconomic instability. Monetary regimes have unsuccessfully shifted from one extreme to the other. Therefore, in an economy with precedents such as confiscation of deposits (1989, 2001), hyperinflation (1989, 1990), mega-devaluations (1989, 1990, 1991, 2002), and a default on the public debt (2001), the monetary system cannot set itself an exclusive goal, ignoring the economy's idiosyncrasy and vulnerabilities. To achieve long-term monetary and financial stability, this historical evolution needs to be taken into account. Hence, the central bank must have an "across the cycle" view rather than a short-term one.

Our country is 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. The Chilean case shows that it takes time to become a normal country.

Unlike the cases 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.

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 12 percent of the economy; far below the Latin American average.

The experience of other emerging economies shows that consistency and gradualism in both policy design and implementation are the adequate approach during this phase. Therefore, patiently rebuilding the power of monetary policy is a key step towards stability.

It is then clear that the argentine economy is simply at a different stage compared to the current situation in other Latin American countries. Hasty diagnosis and simplistic comparisons among the various countries' situations may lead to inappropriate policy recommendations.

Under these circumstances, a sustainable and long-lasting reduction of inflation 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. The path is a sequential one while we build the traditional monetary tools as effective policy instruments.

Within this framework, today's monetary and financial strategy is based on three main pillars:

First, a robust and consistent monetary policy that ensures the equilibrium between supply and demand in the monetary market. This system is the most appropriate for an economy that still makes intensive use of relatively liquid means of payment and has a relatively low bank penetration.

For the first time after the crisis, money supply is growing below the growth of nominal GDP, reflecting the prudential bias of our approach. The control of the growth in m2 is based upon a deep sterilization policy, which its key element is the issuance of bills and notes of the central bank and the development of a repo market. And these securities are by no means straight public debt (the central bank is not using them to finance itself). They reflect postponed liquidity (they will be monetized when circumstances require so as it happened in the second half of 2007).

Second, a managed floating exchange rate regime that enables us to weather situations of financial stress – that is, a regime that provides predictability. We do not want to prevent variables from converging to their long-term values, but we would rather avoid excessive volatility as a source of unnecessary disturbances in economic decisions. On the other hand, we do not want to provide any sort of insurance that favors speculative flows.

Third, countercyclical policies to prepare the economy against shocks. These include the accumulation of foreign reserves and a sound financial system that buffers turmoil, instead of spreading it.

I cannot find a more telling proof of the reasons why we have pursued antyciclical policies – such as foreign reserve accumulation – during these years: the recent external shock we faced can be compared to the "tequila effect" in terms of the magnitude of the outflows, but had a mild impact on domestic variables. The monetary and financial system truly protected it against financial contagion.

Another example of our risk management approach 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".

Our risk management approach addressed three basic aspects to deal with the crisis: preserving sufficient liquidity, foreign exchange market stabilization, and regulatory changes to soften the impact of turbulences on the financial system.

The liquidity stress caused by international financial volatility in the local market was dealt with through measures such as buying back part of the central bank notes directly, or auctioning floating-rate and then fixed-rate repos – distributed among institutions according to their market share, and extending their terms from 7 to 30 days.

Regarding the fx market evolution, the right question to ask is: what would have happened under the same circumstances but with a pure floating exchange rate regime in place? The timely intervention curbed depreciation expectations and, thus, the potential pressure on prices with minimal use of reserves.

Bank regulations were tailored to circumstances in order to minimize the adverse effects of the shock.

The changes involved operational aspects (allowing the use of sovereign bonds as a collateral for repos), accounting standards (valuation of instruments held by banks to maturity to buffer the impact on balance sheets), and liquidity regulations (extension of terms to meet reserve requirements and reduction of the daily minimum cash requirement).

All in all, central bank actions show the consistency and robustness of our strategy, which are allowing us to pass the current stress test with no stress. We proved to have the necessary "artillery" to "buffer" domestic variables while maintaining monetary prudence in the face of turbulences with clear symptoms of permanence in time.

To sum up, policy makers around the globe face significant dilemmas. While challenges are significant, now we seem to understand that policy recipes vary from one country to the other in this complex scenario. This progress is, obviously, welcomed.

Especially for us, emerging markets' policy makers, as we have to catch up with growth, deal with the tensions derived from buoyant economies and, most importantly, build institutions at the same time.

In fact, it is more a synchronic than a sequential two-fold challenge: advancing towards the aims set to develop our economies and building institutions simultaneously. To implement these policies effectively, the only possible way is to keep the consistent (i mean consistent with the history and idiosyncrasies of each economy) and gradualist approach that has guided us in recent years. The approach that seems to be the rule rather than the exception not only in the emerging world but also all across developed countries.