Martín Redrado: Latin America and Argentina – the effect of international financial turmoil

Keynote speech by Mr Martín Redrado, Governor of the Central Bank of Argentina, at the Bank of Russia, Moscow, 26 June 2008.

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Emerging markets face definitely a hostile international financial scenario. The global economy is going through its worst stage in more than a decade. As I said over a year ago in Basel when shocks first hit financial markets, volatility is here to stay. And we will witness its consequences for some time to come.

Credit markets in developed countries are still deteriorating. Money markets continue to show signs of tension despite innovative tools generated by monetary authorities. Libor and Euribor rates are recording wide spreads compared to yields on low counterpart risk such as U.S. treasuries. This is largely due to credit risk perceptions among banks, with some degree of overshooting in financial institution spreads. Current prices of banks' CDS show that it will take time to correct this situation. As uncertainty regarding each institution's exposure to "toxic waste" persists, banks continue to avoid lending among themselves. Then, demand for liquidity as a precautionary measure to confront potential materialization of contingent liabilities is what predominates in the financial markets.

Even though exceptional central bank steps helped mitigating pressures at the most critical times, they are still insufficient to recover investor – or, even worse, consumer – confidence.

In the U.S., current conditions show at least a substantial difference from previous episodes: the trigger to current turmoil is the real estate market. Therefore, the adjustment is different and, maybe, deeper than before. The social sensitivity that arises from this sector is reflected in U.S. Congressional initiatives, which attempt to generate an orderly resolution, calling upon the government, banks and investors to share the burden of expected losses.

In the euro area, divergence is probably a reflection of disparities among member countries. While Germany grows at higher-than-expected rates, Mediterranean economies, at the other edge, are virtually stagnant. The credit cycle begins to show the first signs of what, in other times, were periods of credit tightening, especially due to an incipient deceleration in household financing. For these reasons, a reversal in the capital flows of banks from subsidiaries in the emerging world to meet liquidity and solvency requirements in their headquarters is something to closely monitor.

We are witnessing a growing use of unconventional instruments to deal with the crisis in the developed world. We have experienced an unprecedented increase in U.S. liquidity windows to avoid disruptions in the financial system and to recapitalize it. When examining academic contributions by board members such as Bernanke or Mishkin, it is clear that the risk management approach underlies the Federal Reserve's current behavior. In Europe, pragmatism is also a commodity. We see that the major central banks are prepared to adopt, without hesitation, a systemic liquidity approach, which includes, among other mechanisms, acquiring illiquid assets from banks to improve their financial position.

We have seen all across the developed countries the kind of "unconventional policymaking" that was very much condemned in the emerging world.

But today´s outlook in developing economies is different. For the first time, we are not at the epicenter of the crisis. Also, conditions for contagion are less evident. While there are currently signs of a slowdown in industrialized economies, emerging ones have continued to grow at the rates close to the ones seen in recent years.

Prices of financial assets in emerging markets and those of Latin America in particular continue to reflect the turbulent international market scenario. However, they show a relative degree of strength both vis-à-vis their performance in previous situations of high volatility and the performance of other class of risky assets (e.g. High yield in the U.S., structured products). Also, there is marked differentiation between specific countries. This is the case, for example, of certain countries in Eastern Europe, Asia and Africa with significant current account and fiscal deficits, making them more vulnerable to foreign capital outflows.

Latin America is for the first time in decades managed under stronger macroeconomic principles. Most of the economies are experiencing robust growth, underpinned by a buoyant domestic demand. They show prudent fiscal and monetary policies and better-matched, more solvent and deeper financial systems. The region is finally leaving behind the well-known "original sin" as the form of currency mismatches that characterized the past decades, significantly reducing our exposure to foreign currency debt.

In perspective, the eighties are acknowledged as a period of deep fiscal dominance, which ended up in a collapse of many economies derived from overspending and over-indebtness processes. These, in some cases, led to hyperinflation episodes. Recently, many emerging markets reduced the fiscal stimulus as economic growth became more stable and resilient. As a result, financing needs are not an issue as in the past, even though shallow capital markets all over the region act as a constraint for sustainable growth over the long term. In fact, financial development is key – and will be even more so in our agenda. 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 as foreign capital flow out to other markets with more predictable returns.

On the liability side, important progress has also been made in the region. The public debt to GDP ratio decreased almost 30 percentage points over the last five years. This reflects, in part, better liability management, which also shows up in the enormous reduction in the exposure to foreign currency debt, providing solid grounds for developing domestic yield curve in local currency.

All over Latin America, financial systems are well capitalized and less exposed to public sector debt, another sin from the past. Not long ago, we used to have not only central banks but also the financial system financing the treasury with no limits whatsoever.

On the external front, the steady increase in commodity prices has provided a significant boost to the increase in exports for many of the countries in the region. This together with more flexible exchange rate arrangements and more diversified trade patterns has resulted in a rise in current account surpluses and in positive flows of foreign direct investment.

But, prospects of reduced global growth are undoubtedly a warning signal for the region. Against this backdrop, we can see two effects coming: a direct one on the level of activity through lower trade flows, particularly from countries tied to the U.S. such as Mexico, Chile, Ecuador, Venezuela and the Caribbean. Especially given the specificity of their products for the U.S. market, in which case a re-routing to other countries would be more difficult. Some of these economies are also impacted through the remittances channel. Many Central and South American countries are heavily dependent on family remittances from immigrants who work primarily in the construction sector in the U.S., an activity which is suffering the brunt of the crisis.

The other effect is indirect in nature: it entails an impact on international commodity prices as a result of lower growth. I believe this effect will be mild insofar as recession in the U.S. does not worsen.

Both hard and soft commodity prices soared early this decade, particularly, in the case of the former, leading to one of the longest-lasting upward trends.

Soft commodities have accumulated increases ranging from 100% to 150% since the beginning of the century, with an acceleration in 2007-2008. This is leading to historically low

stock to consumption ratios; the lowest in the last three decades. Just to give you an example, corn inventories are 30% below the average of the last ten years.

Unlike past cycles, the current situation combines not only supply shocks, but also – in my view – elements of structural change, disrupting the typical price pattern in most commodities, characterized by a reversal to the mean process.

The evolution in the demand for commodities has played a major role in price behavior in recent years. Thanks to the above-trend growth of the most populated emerging economies, deep changes are taking place in the social and economic approaches of those regions. This structural shift has led to an unusual demand for infrastructure and housing, that is, to a large extent, pressing on hard commodity prices. In addition, higher per capita income alters consumption habits, mainly in the form of more and better foodstuffs (e.g., China currently consumes almost 55 kilograms of meat per year per person, while 10 years ago it was consuming 40 kilograms and, in 1990, only 28 kilograms). Agricultural commodities also show low income elasticity.

Meeting these needs for goods and services somehow entails a virtuous cycle for vast emerging regions, where there has been a significant growth in wealth, fostering even more the demand for certain products.

A relevant example is the marked growth of Indian and Chinese demand for gold for jewelry, a factor that accounted for approximately 75 percent of the rise in world purchases for that purpose in 2007.

In the cases of soy and corn, where my country is a key international player, 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. Although this initiative should undoubtedly be welcome, rushing into it could be counterproductive. In this sense, in the U.S. – the largest provider of corn – demand for this cereal to produce ethanol is gradually absorbing the export balance, clearly tightening global supply. In Europe, biodiesel shows the same behavior, although feedstock is more diversified, just like the case of ethanol, which is produced mainly from wheat. Nevertheless, subsidies to biofuel development are a central issue given the distress caused by the worldwide surge in food prices.

Finally, another phenomenon adding uncertainty is the fact that these commodities are now considered a financial asset class. The interest they arouse in investors may be due to the fundamentals of physical markets still dominating the trend. However, if speculation becomes more widespread, we might enter into a more volatile stage. The futures markets play a major part in setting international prices for many agricultural and energy commodities. Preserving its adequate operation is one of the top priorities for policymakers. The recent U.S. Commodities futures trading commission initiative to gather more detailed information on transactions conducted by noncommercial traders is a step towards this goal.

This combination of elements poses a new conundrum, whose evolution in time is plagued with uncertainty and risks. Anyhow, it is difficult to think both in prices returning to historical averages and in rises similar to those of recent years.

Insofar as growth in emerging countries converges to sustainable long-term rates, commodity prices will regain a more predictable pattern of behavior, which will also contribute to lower international volatility.

Under the background of this international setting, in Argentina the monetary and financial regime has faced the most significant challenge since the crisis of 2001-2002. However, when we look at the results achieved, it is clear that we definitely managed to rise to it. For the first time in decades regardless of external and domestic disruptions, 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.

It follows logically that, in the past 25 years, our economy has spent over a third of its time off the dynamic stability path (defined as the range between two standard deviations of the long-term trend), against Australia's 18 percent or Brazil's 25 percent. Argentina shares its resources and position in the world with these countries, and it is expected to be somewhat symmetrical with them as regards the impact of external shocks.

These phenomena have severely harmed long-term performance, and were not cost-free in terms of welfare: excessive volatility is probably the main reason for our country's economic stagnation in the last three decades of the previous century. Furthermore, the past quarter of a century was prolific in terms of the lessons learned from the crises of diverse origin and the consequences for the monetary and financial regime. We know that the channels through which excessive volatility affects economic performance are different. In this type of economies, where society has developed a high risk aversion and the need to prevent a new crisis becomes a priority objective, macroeconomic policy coordination is critical.

If there are doubts about the intertemporal solvency of any of the macroeconomic policy set, the conventional monetary policy room for manouver can be limited. When designing monetary policy, it is important to take the fiscal, financial and external conditions into account. An autistic monetary regime that dodges these issues, at the risk of becoming an additional source of uncertainty, would be of no use.

In Sargent's words, there is no robust monetary regime for an inconsistent fiscal policy. Our twentieth century history says a lot about the close link between the lack of fiscal solvency and inflation. Even though in recent years the restriction has eased thanks to the surplus public accounts, the literature on fiscal dominance problems is not limited to the current period. It is well known that tax revenue structure depends on the current relative price structure – hence the need to address the question under a general equilibrium approach.

Similarly, doubts as to the financial system's solvency or external sustainability can also limit monetary policy room for maneuver. As to external solvency, it would be wrong to tailor exchange rate policy to temporary trends: part of the current pressure for the appreciation of emerging currencies relates to commodity prices (through the current account) and the investors' risk appetite (through the capital account), which may clearly be temporary instead of permanent forces.

Further research in the economic literature has highlighted the difference in treatment according to whether the trend is caused by permanent or temporary factors. In a financial world characterized by capital flow volatility, a massive amount of capital may lead to some kind of "Dutch disease," with unsustainable paths and high real variable volatility.

This kind of problem might be often the case in small economies, where the local financial market may be negligible as compared to international flows, and where it is very difficult to know the equilibrium level of real variables.

Thus, temporary forces that work from the market side may lead to nominal exchange rate overshooting (whether up or down). Far from adjusting towards the long-term equilibrium level, this may cause excessive volatility and distort relative price signals for savings and consumption.

All in all, it is clear that uncertainty faced by an economy such as Argentina's is not limited to the notion of risk. While in the latter case the stochastic process to generate data is known, in the former the true model of macroeconomic operation is unknown. A frequency

distribution bar chart of the Argentine GDP in the last 25 years would show that it is equally probable to grow or fall at a 10 percent rate, so there are empirical problems to project the trend of fundamental variables. I remember that the 1998 national budget provided for a 4.7 percent economic growth for the following year, and in 1999 the decline ended up surpassing 3 percent. This an eloquent example to illustrate the problem. Similar references could be made to the consumption path or long-term equilibrium exchange rate.

Against an uncertain background, my approach is to prevent euphoria, adopting prudent, gradual and coordinated policies to lead the economic convergence process towards its "cruising speed." In that framework, the classical dilemma of rules versus discretion cannot be addressed with a "corner solution." Extreme strategies such as rigid and lock-in rules would not only lead to nowhere but also not even meet the initial aim of building fast credibility if agents do not perceive their consistency with the other policies.

On the other extreme, we cannot pursue pure discretion strategies. The demand for flexibility might be the perfect excuse for "not having a plan" and validating persistent trends in nominal variable imbalance. Between both ends, the pillars of our development model must gradually and patiently be built based on a path that adequately combines the right doses of flexibility and credibility.

This approach is not an isolated case in the world either. Only 50 percent of inflation-targeting countries – where there is theoretically no central bank intervention in the foreign exchange market – effectively pursue a free floating regime policy. In the field of monetary policy, this resulted initially in the recovery of the basic functions of money, with the normalization of the financial system. In the current phase, it refers to the rebuilding of transmission channels of traditional policy tools to adequately use them when the economy nears its steady state.

Then, 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. 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. 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, our's monetary and financial framework 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.

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 financial policies to provide buffers against volatility. 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 effect of the Mexican crisis of 1995 in terms of the magnitude of outflows, but had a mild impact on domestic variables. The monetary and financial system truly protected it against financial contagion.

A true 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. Another of the achievements of the financial policy implemented by the central bank has been the reduction in exposure to the public sector, which currently accounts for only 14.6% of assets, almost 36 p.p. below the maximum reached in the period following the crisis in 2001-2002.

The setting of a global cap of 35% on this exposure since July 2007, as well as maximum limits on the basis of bank capital and the jurisdiction of their operations, and the elimination of the bias in capital adequacy requirements, among other measures, made it possibly to definitively crowding-in the private sector.

Balance sheet normalization was also reflected in bank liabilities, as deposits by the private sector have become the sector's main source of funding. Currently, the liquidity rediscounts granted by the central bank during the crisis have almost disappeared from bank balance sheets (amounting to only 0.4% of financial system assets).

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.

The U.S. dollar has historically represented a safe haven for Argentinians in times of uncertainty. Therefore, to curb depreciation expectations by acting in the foreign exchange market has positive implications, not only for money market expectations but also for financial system stability. Thus, we have demonstrated that the current managed floating exchange rate regime is the most appropriate at this time of our economic history.

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.

I mean, it is a regime that, without providing any sort of "foreign exchange insurance," prevents excessive volatility from affecting economic decisions.

The benefits of this kind of policies are well-known in the modern economic literature. Recent studies factor segmentation of and restricted access to financial markets into the analysis of FX policy. The most relevant conclusions suggest that, in terms of maximizing social welfare, the best choice is a less flexible foreign exchange regime, where access to hedging instruments is more limited. And this is a more realistic conceptual framework for our economy.

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. This resilience is not a coincidence. It is actually a consequence of the existence of multiple preventive mechanisms built throughout recent years so as not to jeopardize stability in situations like the current

one. 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.

I always stated that good economic analysis implies not to bundle countries as they follow very different patterns and are at different stages in their paths towards long-term sustainability.

Simplistic comparisons among the various countries' situations may lead to inappropriate policy recommendations. However, we can find some similarities between the Russian and the Argentine cases.

In my opinion, Russia and Argentina share some common economic features in recent history. Both are economies that are in sort of transition phases. Both countries began the 90´s with a process of deep transformations. In the case of Russia it was about building market institutions. In our case it had to do more with the reconstruction of many of these institutions. Of course, these are no easy times and there are no single recipes. Becoming a market economy is not just about privatizing public companies, opening financial markets to the world and deregulating every single market from one day to the next. Unfortunately, both countries learned this the hard way.

Both countries suffered painful crisis that made the traditional tools for the subsequent recovery mostly unavailable. The lack of key fiscal and monetary policy instruments given the collapse and the need to regain confidence on the domestic currency after the default and the devaluation were some of the common features.

But, as well as we share a history of economic crisis, we can also speak up about robust recoveries. The upturn came in place relatively quick and still lasts in both countries. The recovery in economic activity took four quarters to show up an increase in year-on-year terms. Notwithstanding, yearly GDP growth rate averaged roughly 9% since the recovery begun.

A common feature of emerging market crisis is a sharp depreciation of its currencies. In these episodes, the usual "overshooting" phenomena took place, with FX depreciating in real terms 68% in Argentina and 46% in Russia. But, as economies begun to stabilize, currencies entered a process of appreciation in real terms, reducing almost half of the initial jump.

Also, economic activity recovered on the backup of strong export performance, fueled in part by commodities prices. Oil prices begun to increase in 1999, giving a strong boost to Russian economy, and agricultural quotes picked up from 2003, pushing up activity in Argentina. This was the seed for a strong process of foreign reserve accumulation, which allowed for both countries to almost triple stocks in three years since the worse of the crisis.

One of the main drivers of the crisis was banking system. A common feature of those years was the heavy burden of public sector debt on banks balance sheet. Although in Russia the collapse was mainly driven by a sort of sudden stop that made impossible to keep rolling over short term public debt, in the case of Argentina, private deposit withdrawals did the job.

At the end of the day, we can state in both cases that inconsistencies between fiscal (unsustainable public debt dynamics) and exchange rate policy (overvalued real exchange rates) in a context of diminished global liquidity ended up in a crisis. But as well as in the case of FX, terms of trade, reserve accumulation and GDP growth, the recovery took place at a remarkably fast pace.

Even though our monetary policy designs were alike during the aftermath of the crisis (e.g. Control of money growth and managed floating exchange rate regime) we, both, still have a long way to go. There are many pending issues to deal with over a longer horizon such as further deepening of local financial markets, strengthening fiscal and monetary institutions. Meanwhile, find our way out of current domestic tensions derived from high prices in commodities markets is definitely a more immediate source of concern.

To sum up, policy makers around the globe face key 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.