Martín Redrado: Financial turbulence – impact on developed and emerging economies (opening address)

Opening address by Mr Martín Redrado, Governor of the Central Bank of Argentina, at the Central Bank of Argentina 2008 Money and Banking Conference "Financial turbulence – impact on developed and emerging economies", Buenos Aires, 1 September 2008.

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During the last years, we have consolidated this conference as an international forum, which includes some of the most renowned academics and monetary policymakers from developed and emerging economies.

I very well understand the effort that many of you have made to be here, so I would like to thank all participants and, very especially, those who, coming from abroad, join us every year.

Organizing this conference is not an isolated effort. This is part of a comprehensive strategy of being an active professional member of the international financial community.

The title of this conference was chosen last year, and it probably is more applicable now than then. The financial turmoil of the past year, which very clearly affected some specific sectors in the U.S., does not recede, and keeps spreading to other markets and regions in the world. There is a general consensus that global economy now poses one of the greatest challenges in the post-war period.

Financial disruptions, through tighter credit conditions and undermined confidence, have imbued the real economy with recession in the main developed countries. The situation is worsened by renewed inflationary pressures, partly due to an unprecedented rise in commodity prices. In this process, there is a convergence of structural factors and cyclical forces associated to the prosperity of the global economy in the previous period.

Due to some of these factors and to the implementation of sounder and more prudent macroeconomic policies, emerging economies turned out to be relatively resilient. However, it is not realistic to think that they can be completely "decoupled" from the events in the developed world, especially if the external context continues to deteriorate.

A characteristic of crises is that great efforts are devoted to go through them as quickly as possible. This may occasionally sow the seeds for future problems. In turn, these periods plainly reveal structural weaknesses.

Looking forward, one of the crucial issues to focus on is how to unwind the massive interventions and collaterals used by the most important central banks. In my view, the extensive liquidity provided was a necessary response. It is arguable whether or not there was a late response and if it would have been better to have had a preestablished framework. This might have allowed better assessing the effects and providing a more predictable scenario by specifying in advance the measures for reabsorbing that liquidity in the future.

In the emerging world, there is no doubt that a structurally growing demand is in place, not only for food but also for energy, minerals, metals and all sorts of commodities. Expansion in developing countries is mostly due to a process by which large emerging regions are catching up with improved living standards. Against this backdrop, recovery of credit and financing is essential to solve the income and price challenges faced by the global economy.

If there is a clear message to draw from this crisis, it is that there is no such thing as "one size fits all". A few days ago, in Jackson Hole, the focus was on how to prevent the crisis from worsening and maintain stability in this new context. The most important lesson I have learnt is that there is no optimal solution *in abstracto*. Especially, when dealing with complex economic policy dilemmas.

This brings about the existence of so-called "financial cycles" and markets tendency to instability that may result in severe macroeconomic disruptions. The world faces an unprecedented combination of negative economic events: financial crisis, recession and inflation. This phenomenon is very rare for developed economies. For emerging economies, unfortunately, this trinity is much more familiar. In our way, we have a long experience in dealing with the consequences of these critical events.

In fact, several of the problems we are currently discussing are surprisingly recurrent and show that there are similarities between crises. These factors, together with some new elements which made recent adjustments somewhat dramatic (such as the role of new financial instruments and players), have forced us, policymakers, to implement original solutions.

During past decades, crises in the emerging world have helped clarify the connection between the objectives of monetary and financial stability. As currently takes place in the developed world, it also highlights the importance of liquidity and capital regulation.

In times of hardship, it is necessary to have in hand criterions to temporarily apply "reduction ratios" to adjust capital requirements for the instruments most affected by the crisis resolution mechanisms. This is based on systemic factors, which are somehow involuntary for institutions operating under these conditions. This approach buys the system some time (a relatively less scarce resource in times of crisis) and minimizes the need for a government capitalization.

In this new framework, central banks from the main developed economies also had to revise their usual regulation, operation and intervention mechanisms. By implementing new facilities, they significantly expanded their scope. As a result of the difficulties experienced by bear sterns and, despite the fact that the prudential regulation and supervision network was focused on the behavior of commercial banks, the fed "throw away the textbook". Because of its critical role in the process of credit generation, and for being involved in a complex network of financial transactions, the eventual bankruptcy of an investment bank in a context of generalized leverage was expected to cause systemic events. This new prominence of market-based intermediaries will have long lasting effect on the creation of the theoretical schemes behind monetary policy.

As usual, and regardless of undeniable costs, times of crisis are breeding ground for creativity, but also for the inevitable revision of previously accepted principles. In times of turmoil, theoretical consensus on "what to do" and "how to do it" tends to vanish. In other words, if the relationship between economic theory and policy recommendations is reasonably well defined during "normal" times, in times of turmoil, this relationship becomes much weaker.

Admittedly, sometimes this may be due to the relative complacency characterizing boom periods, and to the inadvertent way in which changes build up, with consequences that become apparent very vividly when it is perhaps already too late.

As I see it, "the perfect storm" is revealing us the non linearity of reality, and that our models need to be reformulated and surely made more complex.

In other words, every crisis should be seen as an opportunity to revise fundamental structures. It is now clear that financial regulation policies, with their slight variations at a global level, were to be revised. The excellent paper recently presented by Adrian and Shin of the Federal Reserve of New York is definitely a step in the right direction. This paper has, at least, two elements worth considering: first, it reintroduces financial intermediation as an essential part of economic models and second, it gives monetary aggregates a role to play in the central bank policy function again.

In addition, it arrives at a conclusion that I have been claiming in discussions with my colleagues for some time: far from being disconnected, financial stability objectives and the rest of the traditional monetary policy objectives are two sides of the same coin.

That is, we have reached a point in which economic theory is having a hard time keeping up with praxis. For this reason, the costs and benefits of policies becomes blurring, posing significant challenges to central bankers. The difference is that now these challenges are not only faced by emerging countries, like in the past, but also haunts the developed world.

This highlights the importance of "the risk management approach" in the design of precautionary strategies for monetary policy. In fact, the crisis afforded central banks of developed economies some flexibility in their instruments. We, as monetary authorities in emerging countries, are much more used to employ diverse tools.

This reflects the need for a more pragmatic approach, derived from a less linear reality and with traditional transmission mechanisms that are not as deep.

Even the emerging countries with inflation targeting regimes were forced to make their systems more flexible to face a new inflationary environment resulting from a changing global economic structure. In the end, we all operate under similar principles, but are surrounded by different realities, circumstances and idiosyncracies.

This reminds me of José Ortega y Gasset's expression in Meditations on the *Quixote*, "I am myself plus my circumstance".

With this, I am not proposing a return to the classical dilemma of rules versus discretion in monetary theory during the 1980s. I believe that Kydland and Prescott, as well as Barro and Gordon have been very convincing. In my opinion, we should discuss the possibility of giving equal weight to the rules and the need for a flexible response to specific events; these events are the ones precisely not considered in the design of those rules due to their low likelihood of occurrence.

In policy design, monetary authorities should explicitly try to avoid ex ante the emergence of imbalances that could lead to financial instability. The aim is to "reduce the frequency and severity of bouts of financial instability in the future", as Ben Bernanke argues.

Recent literature has shown results that are ambiguous or even contrary to those yielded by the usual "technology". As regards the rules implemented via the interest rate channel, in the past 15 years the conventional wisdom was that short-term interest rates could be used to change the whole yield curve and thus affect economic agents' decisions.

Recent work shows that this may not be the case and that the impact of short-term rates on real variables is substantially different. In turn, a 2007 paper by Black and Rosen shows that the effect of the interest rate policy varies according to the bank's size and that it has an asymmetric impact between small and large bank customers.

My reading is clear: the intellectual stature and experience of all players involved in the controversy prove that there is no single policy or one optimal approach that could be defined in a vacuum. Every policy option has its costs and benefits: there is no such thing as a free lunch. The key is to choose whether we want to avoid "going long" or "falling short".

Naturally, beyond any attempt to mitigate this trade-off, the strategy and policy choice will crucially depend on the attitudes of the government and its people towards risk.

It will also depend on their intertemporal considerations, because the profit and loss profile of alternative regimes will not always coincide. Furthermore, past trends in the relevant economy and the starting conditions will naturally affect our policy choice.

Our Central Bank's approach to monetary policy in and for the specific circumstances of the Argentine economy can be understood in this framework. This approach is three-fold: (1) a robust monetary policy that ensures the equilibrium between supply and demand (2) a counter-cyclical scheme of foreign reserve accumulation to mitigate vulnerabilities and reduce macroeconomic volatility; and (3) a managed floating exchange rate regime.

Our economy has been systematically prone to recurring and marked macroeconomic instability episodes. The occurrence of shocks (in terms of trade or in the conditions to access external financing, among others) and the existence of shock-amplifying mechanisms have been a source of recurring macroeconomic instability in the past.

These trends were often underscored by the macroeconomic policy itself, which tended to behave procyclically. This explains the preventive approach underlying the current monetary policy design and also reveals our asymmetric approach to the shocks affecting the domestic economy.

On numerous occasions we have insisted on the idea that the past haunts us and leads us to adopt a prudent and asymmetrical strategy in response to exogenous forces: until enough evidence proves otherwise, we are forced to “dramatically shift the burden of proof” and assume that every negative shock is permanent and that, a priori, positive forces are temporary.

Naturally, this has a bearing on economic policy as a whole. Therefore, a prudent fiscal strategy of building up excess savings in good times should be a natural consequence of this asymmetric approach to shocks.

The same happens in the monetary and financial field. The buildup of liquidity buffers in good times allows us to weather the storm in an unprecedented way for our history, both for exogenous and endogenous reasons.

In the past few months, we took strong measures to ensure monetary and financial stability. We noticed a marked mis-alignment in the demand for money which activated the warning signs on our control panel. In other words, there was a diversion in one of the variables from values provided by our scheme in the base scenario. Private sector deposits experienced a temporary decline of 8% in less than a month during may. To put it in perspective, in three months, deposits fell by 17% during the Tequila Effect.

Taking all this into account, and having assessed the costs and benefits of using each instrument, we focused all our efforts in restoring money market equilibrium. This is no more than a professional response based on the risk management approach applied to the Argentine monetary policy.

The Central Bank surgically and sequentially implemented a set of ten measures. First, we strengthened the demand for Argentine pesos and once the foreign exchange market was relatively calm, we undertook actions to reinstate liquidity, so as to ensure financial stability and the well functioning of the payment system. In fact, we adopted the following prudential scheme:

1) First, we adapted our operations in the repo market: we established a scheme to offer liquidity at a fixed (up to 3 billion ar pesos) and a variable (badlar) interest rate. By offering a wider variety of options, we ensured the availability of resources in appropriate conditions to provide liquidity to the system.

2) We renewed only partially central bank securities coming due and repurchased some others with near term maturities.

3) We extended the limits to operate in the futures market, both for the Central Bank and some of its counterparties.

4) We allowed the reference foreign exchange rate for futures and forward transactions between the Central Bank and its counterparties to be settled by the Emerging Market Traders Association (EMTA). This measure is clearly a vote of confidence in our approach.

5) We begun to do open market operations through government securities market by purchasing instruments that can be liquidated in pesos or dollars in the secondary market. This mechanism worked as an additional tool to provide liquidity beyond the banking sector, and at the same time, enabled the intervention on the different segments of the yield curve, avoiding distortions in its temporal structure.

6) To alleviate the seasonal effects on the traditionally illiquid month of July, we unified the financial institutions' minimum cash requirement for June and July in a single bi-monthly term. This improves the institutions' liquidity management.

7) We developed a mechanism for US dollar-denominated repo supply. This was an additional way to ensure dollar supply at times when the dollar increased its share in investors' portfolios and when it was necessary to lower depreciation expectations.

8) The Central Bank started to participate in the NDF market with operations up to 12 months and with counterparties whose credit quality was not lower than A-.

9) We opened a new repo window to include as collateral certain instruments (Bogar and guaranteed loans) that cannot be used in traditional repo operations. This enabled institutions that had no significant central bank bills and notes positions in their portfolios to access our liquidity provision mechanisms.

10) Finally, we offered new maturity options for reverse repos, readjusting the cost in line with the new term structure.

That is, the system was adapted through a set of ten measures to stabilize the foreign exchange market and then correct the remaining monetary and financial variables. In a nutshell, we have taken all the necessary steps to ensure full systemic liquidity in pesos and dollars. And, as a result, fluctuations in financial variables were limited, and the real economy was not negatively affected.

This is not a change on our policies. It is the same framework implemented in the last few years but facing a different scenario. The current situation is a stress test for the strength of this strategy, and ratifies the consistency and validity of its fundamental pillars.

To sum up, conferences such as this one, featuring many dear colleagues with whom we usually interact in seminars around the world in a peculiar time like the current one, are breeding ground for analyzing the impact of the crisis and its scenarios. Moreover, given the current international economic scenario, history is providing the money and banking conference with a unique opportunity, through a better understanding of reality, to influence policy redesign both in the emerging and the developed world.

Welcome to all of you and thank you very much.