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

Closing 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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When we started planning this event, by mid last year our goal was to exchange diagnoses and innovative ideas that, at the end of the day, would contribute to redesign global policies. And when I say "us", I mean policymakers and academic economists merging the views of both the emerging and developed countries.

This is exactly what, in my opening address, I suggested we should aim for: taking advantage of this unique opportunity that the international financial crisis provides us in order to reflect on the efficacy of our policies and thus, based on experience, improve the quality of our instruments.

We also undertook to consolidate, in Argentina, an international scenario for debating international finance in these unique circumstances for the global economy. This contributes to our engagement with the world; very often we face many everyday challenges that prevent us from reflecting on more global matters which also affect us.

That is why I would especially like to thank my central banker colleagues and friends from the academic world, with whom I usually meet in various international fora, for promptly accepting my invitation to come to Argentina.

Uncertainty persists about the duration and depth of the current global financial crisis. With recession increasing in the advanced economies, it remains unclear how it will continue to spread; what is clear is that the U.S. economy is not disconnected from the rest of the world, as Randy Kroszner stated yesterday in his very convincing remarks.

In this framework, developing countries are relatively stronger vis-à-vis other past events. This is reflected in financial assets that fluctuate less than, for example, comparable U.S. and European assets.

Countries with large fiscal and current account deficits mainly financed with short-term capital flows (e.g. Eastern European, unlike Latin American and Asian countries) are the hardest hit.

In fact, if we aggregate emerging countries with current account deficits above 5 points of GDP and compare them to the rest, we see a difference of almost 500 bp in CD spreads whereas, at the end of 2007, values were similar.

Another recurrent theme during these days was the pervasive global inflationary scenario, which poses a challenge both for the developed and the emerging world. In his very interesting analysis of inflation levels in emerging vis-à-vis developed countries, Stephen Cecchetti wonders what these levels would look like if developed countries switched weights with emerging countries and used the consumption basket of the latter. Clearly, the impact of shocks and consumption patterns vary according to each economy and so do economic policy responses.

In the field of policies, another recurrent theme throughout the debate was that each economy has its unique characteristics. It is obvious that, in emerging economies, markets are less deep and instruments, more fragile.

A few minutes ago, Roberto Frenkel pointed out that in economies with a low degree of financial intermediation, the aggregate demand is not so elastic relative to the interest rate, making the fiscal policy more responsible for aggregate demand control.

For example, trade-offs between ensuring monetary stability and rebuilding at the same time the same transmission mechanisms are unknown to the developed world. In turn, innovative products arrive at our economies with some delay, at least in a massive way. That is why we insist on the need to have, at least, a good understanding of this problem when designing global policies and regulatory mechanisms.

However, what was typical among emerging countries (that is, that bank runs turn into more widespread crises, which include attacks on currency, capital and credit flight, and decline in activity), now threatens developed countries.

This is nothing new, but it is especially relevant in the light of recent events in the global economy. As witnesses of the responses, we see that policy design and implementation also adapt to the different characteristics of each country in the developed world. Financial instability appears as a greater demand for risk rewards. On this matter, Professor Edmund Phelps remarks set us in the right direction.

The debate is complex in itself: there are those who favor *ex ante* preventive interventions and those who underscore the importance of a decisive *ex post* action to mitigate the effects of financial collapse.

In turn, some advocate for financial stability issues to be exclusively dealt with through prudential regulation (so that monetary policy may focus mainly on achieving nominal stability objectives) whereas others claim that monetary policy design must take into account the possible *ex ante* accumulation of trends towards financial imbalance.

Finally, some support a greater involvement of fiscal authorities when dealing with solvency issues, and emphasize the need to preserve monetary policy to address liquidity problems.

Yesterday, Tom Hoenig said that the current crisis is a great opportunity for debating the Federal Reserve's mandate. *Financial stability* is a new objective that should be added to the traditional price stability and long term growth objectives. This brings about the question of the effectiveness of monetary policy instruments, such as interest rate or liquidity provision mechanisms, in achieving simultaneous objectives.

If there had been more comprehensive mechanisms to deal with cases like this, maybe it would not have been necessary to make such an intensive use of these instruments.

As Jacob Frenkel remarked in the opening session, "it is not about preventing the crisis but making financial systems more resilient".

In emerging countries, it was clear that systemic stability had to be maintained, given our history of macroeconomic volatility and recurrent crises. But in the most industrialized countries, where capital markets are deep and highly integrated into the banking system, financial stability was traditionally regarded more as an instrument than as an objective in itself. However, we can now see the fiscal, monetary and financial instruments working "side by side" towards a common goal.

As Mario Blejer stated moments ago, "in times of crisis we need to adapt their action to prevent the crisis from spreading over the rest of the economy".

Current regulatory policies have a procyclical component that must be dealt with in upcoming reforms. José Antonio Ocampo's proposals on countercyclical capital requirements have been subject to discussion for some time, and so have moving provisions in the Spanish case.

In my view, in order to achieve financial stability, we will probably need to reform existing regulations. In fact, several panellists, such as Viñals and Ocampo, paved the way for a debate on increased policy coordination given the increased interaction of financial markets and the difficulty this implies for independent action. As I see it, this will not stop the increasing financial innovation process but will strengthen the related risk management. In

this sense, the degree of interdependence of the global economy in general, and of financial markets in particular, increasingly requires joint international actions.

A greater harmonization of domestic and international regulation will prevent regulatory arbitrage from being used to obtain extraordinary revenues, which was one of the causes of the current crisis.

Cecchetti also dealt with this issue and gave us something to think about — something we also emphasized in the opening address. The central bank interest rate is not a complete indicator of financial conditions. We need to improve financial stability measures.

In the case of developing economies, Madame Hu was in favor of using reserve requirements instead of interest rates to deal with the evolution of liquidity conditions. For many economists, she argued, this was “old-fashioned”, but for China it proved efficient. In fact, the use of the interest rate in segmented, shallow and unconnected financial systems has obvious limitations. This shows that the control of monetary aggregates can be appropriate under certain circumstances in many emerging economies.

This underscores a point I usually make about monetary policy, which was developed by Marty Feldstein. The profession focused so much on rules that the reference to interest rate and to monetary policy appear to be synonymous. Marty just claimed that monetary policy will continue to lack the ability to strengthen the economy because of the unusual conditions in the housing sector and credit markets, and because the rates were very low and failed to keep the economy going. Central banks have other tools that are perhaps more traditional, but have fallen into abeyance in some countries, such as discount windows and reserve requirements.

As you can see, the discussion agenda is long and complex and there is no single optimal approach that could be defined in a vacuum. The coexistence of different policy recommendations was confirmed this morning when two prominent scholars such as Bennett McCallum and Jan Kregel analyzed monetary policy from a theoretical perspective.

In our country, we saw an example of commitment to systemic stability in the past few months with the full implementation of the robust and consistent approach launched in recent years. All instruments were available. We focused all our efforts on restoring the money market equilibrium.

Our system was able to cushion the impact of external disruptions on macroeconomic performance, confirming that the central bank's prudential and countercyclical policies were right, both in the monetary and the financial fields.

Something similar occurs with the exchange rate channel. In my opinion, the current managed floating exchange rate regime is the most appropriate to weather financial turmoil at this time of our economic history.

Analyzing the Asian experience, Zeti has just stressed the importance of foreign exchange predictability for companies to focus their efforts on micro issues.

This reinforces my belief that a managed floating exchange rate regime is the only one possible for the current moment of Argentina signed by a history of volatility.

One of the most distinctive features of the aggregate operating dynamics in Argentina has been the recurrent macroeconomic instability episodes. It is no accident that, in the past 25 years, our economy spent over a third of the 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 has similar resources and position in the world to these countries, and should have some symmetry with them as regards the impact of external shocks. These phenomena have severely harmed long-term performance, and were not free of charge in terms of welfare: excessive volatility is probably the main reason for our country’s economic stagnation in the last three decades.

Furthermore, our economy is still on its way to its long-term path after exiting an unprecedented crisis, which simultaneously included an institutional breakdown, a huge devaluation, the destruction of the financial system and the default on the public debt.

In Argentina, the monetary policy transmission channels are just being rebuilt, since credit to the private sector accounts for 12 percent of GDP, still far below the Latin American average. Moreover, consumer credit reacts weakly to interest rate fluctuations.

Therefore, the hasty adoption of certain instruments would not only be useless but also hamper their future use. We cannot "take shortcuts"; rather, we must patiently rebuild the power of monetary policy tools. For this reason, comparing the situation of the various emerging countries may lead to wrong diagnoses and policy recommendations.

But it was the reinsurance policies (reserve accumulation and the construction of a solid financial system) that afforded us high liquidity cushions to be prepared for times like these. What would have happened under the same circumstances with a pure floating exchange rate regime in place? Are we prepared for the exchange rate to fluctuate in a short time, as it does in neighboring countries? I do not think so, not yet, given our long history of instability and dollarization. This is something we will learn over time.

It is against this background that Argentina made the decision to settle its debt with the Paris Club, which reflects the country's willingness to pay and creditworthiness. This decision is part of a comprehensive strategy to access the debt markets voluntarily — not only for the government but also for the private sector. Furthermore, this is a clear proof of what this seminar aims at: an opportunity to turn over a new leaf which is, undoubtedly, a step forward in our country's international financial integration.

After paying the debt, Argentina will continue to maintain robust international reserve levels as a percentage of GDP, both in comparison with other countries and with its own previous historical levels. We are building up reserves thanks to a trade balance surplus which is expected to continue in the next few years. Even after debt repayment and without considering future trade surplus, the international reserve stock is well above its optimal level in terms of imports for the next months, short-term external liabilities and monetary aggregates.

In turn, the national public sector holds AR$30 billion worth of deposits, identical funding is guaranteed in the domestic market and there is a similarly sized fiscal scenario. This exceeds next year's public debt maturities (capital and interest).

This decision is fully consistent with the monthly trade surplus of USD 1 billion expected for next year — which ensures one of the three basic pillars of the current monetary regime: the prudential international reserve accumulation strategy that also supports the monetary absorption instruments used to regulate the means of payment adjustment.

Therefore, this decision is in keeping with our commitment to repeat in the next five years the fiscal performance of the previous period — a primary fiscal surplus of 3.2% of GDP —, and with an economic program fully engaged in the efficient and prudent coordination of various anti-inflationary policies. On the one hand, both the fiscal and the revenues policies should be consonant with the behaviour of primary spending and revenues, respectively. On the other, monetary policy should not only keep fostering the recovery of domestic money demand, but also attempt to consolidate the remonetization of the Argentine economy. The sound coordination of all these policies will most likely extend twin surpluses (fiscal and external). For our country, these surpluses have become the pillars of sustained growth with social inclusion.

For the first time in decades, the Central Bank of Argentina has effective tools to protect our economy against any sudden changes. This is the best contribution we can make to ensure two essential public goods: monetary and financial stability, which were missing in the economic history of the past 50 years. Thank you all and see you next year.