Martín Redrado: Financial risk management in emerging countries

Remarks by Mr Martín Redrado, Governor of the Central Bank of Argentina, at the 12th annual conference of the Central Bank of Chile "Financial stability, monetary policy and central banking", Santiago, 7 November 2008.

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The global economy is going through its worst stage in decades. The fall of Lehman Brothers undoubtedly marked a turning point in this process of historical destruction of value of financial assets. The juncture of liquidity and solvency risks led to a period of significant and persistent deterioration in credit markets that rapidly started to hinder economic growth worldwide. Since then, central bankers and economic authorities have been focusing their efforts on defusing the threat of financial disintermediation due to the severe consequences that this implies both for the stability of the financial system and the health of the real economy.

Within this context, the international financial crisis finds developing countries in a position that considerably differs from other episodes in the past: instead of causing the crisis, they are the ones suffering its impact at this time.

And this point is not a minor one given our history of macroeconomic volatility and instability. We have quite an experience in dealing with crises and we perfectly acknowledge the economic and social pain that they entail. In fact, financial crises in emerging economies – and in Latin America, in particular – have yielded low economic growth together with sizable fiscal costs that placed heavy burdens on both the private and public sectors. Not only financial crises deeply affected key macroeconomic variables in the short-term, but they also sow the seeds for limited economic and social development in the long-run. Many times the collapse of the credit markets resulted in a breakdown of monetary and fiscal institutions, including the meltdown of the payments system with second-round effects on economic activity. Bank bailouts typically entailed high fiscal costs, thereby raising public debt, debt service requirements and the cost of financing for the overall economy. Compared with other regions, Latin America ranks the highest in terms of the average number of episodes per country, as well as for recurrence over the last 30 years. About 35% of our countries have experienced recurrent crises; a figure almost three times higher than in any other region. Systemic crises have been costly throughout the world, but particularly so in Latin America: on average fiscal costs have been greater than 20% of GDP, almost twice as high as in the average OECD country. Fiscal and quasi-fiscal costs to rebuild the banking system accounted for 12% of GDP in developed countries and almost 18% of GDP in emerging market countries. Moreover, banking crises have caused significant output losses, with estimates ranging from 12% to 14% in medium – and low-income countries.

Given the associated costs, as the problems are being addressed in the developed world, it is therefore, I would say, a first order condition to minimize the impact on the rest of the world. Not only for the benefit of emerging markets – victims of contagious in this case – but also for the much-needed smooth ride of the global economy. We must recall that 75% of global economic growth between 2003 and 2007 (measured at PPP) is explained by developing economies, which grew at a remarkable average rate of almost 7% during that period. On top of that and with a longer-term perspective, the need to revisit the way the international financial architecture is evolving to avoid the recurrence of these episodes (something that we know very well in the emerging world) becomes a priority.

In the first part of my remarks, I describe how the emerging world is dealing with the crises. In particular, economic policy responses will be assessed with special emphasis on the challenges faced and the financial risk management strategies pursued by developing countries. Then, I provide my view on how the developed world is handling the crisis with a few ideas on the role that international financial institutions must play.

As reflected by historically high and sustained economic growth and inflation rate differentials compared to developed economies at record-low, emerging markets are, in general, reasonably well-suited to face the current crisis.

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

This performance has been achieved by a combination of a favorable international context and sound macroeconomic policies consistent with the goal of reducing the macroeconomic volatility so typical of the emerging world. This outcome, I would say, has been based upon several pillars with anti-cyclical components:

1) Fiscal solvency. Today fiscal responsibility in most of the emerging world is not a feature from the left or the right: it is just common sense.

2) Monetary robustness with well-regulated financial systems. 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.

   This scenario in which the international financial system faces extreme difficulties resulting from imprudent lending policies, assets of dubious quality, a permissive regulatory framework and an excessive degree of leverage, contrasts with the reality of the domestic monetary and financial system in most of the emerging world. And here the progress of Latin America compared to other emerging market regions is remarkable. While financial systems in emerging Europe are relatively more vulnerable to a reversal in capital flows, more dependent on external resources (mainly, because of large current account and fiscal deficit), with a credit cycle more exposed to the real estate sector and where transnational banks have the lion's share of the market, Latin American financial systems are less risky as they have maintained high levels of liquidity, solvency and capitalization. Also, with more traditional credit products they have been offering to the public in recent years, Latin American financial systems record almost no direct exposure to toxic assets.

   Argentina, with a still small banking system, in this field exhibits strength on all these fronts due to the efforts the central bank has been carrying out in recent years. In fact, the health of the domestic system has been strengthened, as it has an ample stock of liquidity, with liquid asset accounting for slightly more than 40% of total deposits if central banks bills and notes are considered and with almost no assistance from rediscounts. Respecting solvency, financial institutions (contrary to the situation in developed economies) have doubled their equity during the past five years and exhibit a very low level of non-performing loans (3%). Likewise, as a consequence of the prudential regulation, the exposure to the public sector has been drastically reduced, and at present only accounts for 13% of the assets (the government has switched from being a net debtor to become a net creditor of the banking system). At present only 11% of the deposits are in foreign currency, and they are only used to fund those who have repayment capacity in foreign currency. This is the main source of dollars that the financial institutions have, as foreign funding is only 4% of liabilities. Also, a very stable and broad deposits base is the key financing source of the domestic financial system. The banking sector went from being a source of instability in the past to become a source of strength to the real economy as it has been buffering the impact of the international crises on economic activity.

In Latin America potential sources of contagion are limited to a reduction in lending by subsidiaries of international banks and the impact of higher risk aversion and slower growth on capital flows (portfolio, FDI and remittances). A related issue of concern is the ability of less sophisticated investors exposed to emerging markets to properly understand that those capital outflows from global institutions were just the reflex of margin calls or the answer to capital adequacy in developed countries (instead of outflows as a result of fundamentals deterioration in the emerging world). This flight to supposed "safer heavens" could be very costly as it could trigger a run against the domestic banking system or the local currency, given the natural tendency towards financial instability in emerging economies. Medium-term challenges remain the same: reducing existing inequality in access to financial services in both geographical and socio-economic terms while keeping an adequate balance of risks and deepening the markets, especially, in local currency.

3) More flexible foreign exchange regimes. They provide additional degrees of freedom to deal with highly volatile financial flows and increased risk aversion. The recent episode proved that there is no "one-size fits all" exchange rate arrangement. In my country, the managed floating exchange rate has proved to be the most adequate foreign exchange regime at this time in our economic history. A country with decades of macroeconomic volatility and dollarization which during the past 25 years has spent more than a third of its time outside its dynamic stability path (a range within two standard deviations of the long term trend) is a good reason to believe that we are not yet ready to let the exchange rate floating like it does in neighboring countries.

4) Better liability management with a reduction of net foreign debt and currency mismatches. The public debt to GDP ratio in the region 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 a domestic yield curve in local currency.

5) External strength due to mainly trade dynamism (diversifying destinations and products). Just as an example, the share of exports to the US, one of the major destinations of foreign sales, from 2002 to 2006 dropped from 33% to 27% of total Latin American exports and from 21% to 18% of emerging Asia's foreign sales.

6) Accumulation of international reserves. The later has been, in my opinion, the common pattern all across the emerging world. Today, there is no good substitute for a sound external liquidity policy at the country level. We have been highly criticized for the costs associated with the FX accumulation policies but clearly the net benefit was a very positive one given the current need to use the resources when pressure on domestic financial markets increased mainly due to exogenous factors.

Despite the progress made, the magnitude of this crisis affected significantly our countries. Everything revealed short when matured financial markets are under stress. In the financial arena, a combination of greater uncertainty, no credit availability and wealth destruction due to lower asset prices started to affect investment and consumption decisions with the consequent impact on economic growth. In this context, emerging markets with current account deficits and fiscal deficits were hit the most as they became more vulnerable to foreign capital outflows.

In Latin America and emerging Asia the key impact of the crisis comes from the trade channel. Here we can distinguish to effects. The direct one: less trade due to lower income in the developed world means less economic activity in emerging economies (let's recall that, even though in a diminishing trend, 51% of emerging markets exports are directed to the developed world). The indirect effect has to do with commodity prices.

From the records reached at mid year, commodity prices fallen significantly in recent months. Last month our commodity price index suffered the largest contraction since the beginning of the series in 1996 (by more than 25%), dropping back to levels similar to June 2007.

Although all commodities exhibited sharp falls in their prices, of the different products those most affected were metals (whose prices fell 30% in the past month), followed by crude oil (that was 27% cheaper) and agricultural commodities (with a 24% decline during October). The weakening of oil was accompanied by falling prices for main cereals and oilseeds that are used to make bio-fuels, like maize for ethanol and oilseeds for bio-diesel. Furthermore, during October climate conditions improved which was reflected by higher output and inventories estimates, while the cheaper oil was reflected by lower transport costs and (to a lesser extent) grain production costs. In the soy complex, adding to the influence of the financial crisis and the large fall of crude oil prices were the estimates of larger world stocks from the 2008/2009 harvest, mainly in the united states and Latin America. For maize, in October the climate improved significantly in the US Corn belt, which generated expectations of higher yields, while the USDA increased its estimates of world stocks for the 2008/2009 crop cycle. Although maize prices have suffered a sharp fall from their maximum in June 2008, they are still 58% above the average for the past decade. Wheat prices mainly fell due to the expectations of a larger global supply. In fact, both the USDA and the International Grains Council (ICG) estimated more abundant harvests in United States, Canada, Russia and Ukraine, which would compensate for the smaller output in Argentina and Australia due to the drought that affected their crops. Larger supply expectations have also led to a relaxation on some of the restrictions on foreign trade imposed during the past year by the major exporting countries in order to supply their respective domestic markets. Offsetting this, during recent months the demand for the cereal for use as forage has grown due to the falling prices, so the stock/consumption ratio is still low.

In my opinion, as the world economy slows down further it will drive prices of primary products down, even though structural factors like the demand for food by the emerging regions and the development of bio-fuels, added to the demand to rebuild the reduced current inventory levels, will provide price support. I therefore feel that although volatility may continue the prices of commodities have already experienced most of their adjustment to the new international economic scenario.

This implies a more hostile international environment for emerging economies, where recession risk is on the up-side. At the same time the probability of second-round effects are increasing through the trade channel, via slower growth in developed economies, or by the financial channel. In this respect, BIS data shows that 74% of banking cross border financing to emerging markets is originated in western Europe (the US 11% and Japan 4%). Besides, 91% of eastern European exposure is concentrated on Europe. In the case of Latin America the main banking creditor is Spain with proximately 32% of regions banking cross border credit.

In this context, emerging economies has a narrower capability to embrace monetary and fiscal policy when compared to developed nations. It's difficult to think about an emerging economy increasing base money in a 35% in less than two month or even reducing target interest rates close to zero, as the US done, with no adverse consequences on agents expectations about inflation or the sustainability of the exchange rate regime. It is also difficult to imagine en emerging economy launching a financial rescue package equivalent to 7% of GDP financed by tax payers, as the US did, with no impact on the perception about the inter-temporal fiscal consistency.

Emerging countries are also more prone to suffer the contagion to different markets. In most of the episodes financial crisis are accompanied by balance of payment distress (given the tendency of agents to withdraw deposits and use the proceedings to buy FX) and/or fiscal constraints (because of the potential impact on government accounts of financial bail out, or an FX depreciation in a context of currency mismatches on public debt). And this is way the current situation of financial crisis living together with a growing demand for domestic currency and public bonds as in the US is unknown for the developing world, allowing the policy makers to provide liquidity to the financial system and fund the banking bailout with fiscal resources avoiding a twin crisis.

In this sense is understood the use of a broad set of policy measures in developing economies to try to limit the impact to the financial markets in an attempt to avoid contagion. Those measures where directed to several features:

1. Sustaining liquidity
2. Reducing volatility in FX rate
3. Allowing capital inflows
4. Keeping domestic and external financing available

A difference seen for some time in current events was a divergence on the stance of monetary policy between developed and emerging countries. The inflation fear seemed to be more profound in our countries, leading to a tighter bias. However, as prices and expectations began to show signs of deceleration, central banks all across emerging regions started to ease policy somewhat, and devoted special attention to FX markets evolution. One of the reasons is the significant exposure of the corporate sector to FX risk (particularly important in the trade sector where debt and many contracts are dollar denominated) thus avoiding any eventual inflationary pass-through.

We witnessed aggressive responses from policy makers in benchmark countries as Brazil and Russia. In Latin America central banks from Brazil and Mexico provided liquidity in foreign currencies that amounted to around 10% of foreign reserves in just one month, however some distinctions should be made in terms of the way in which those intervention were carried on. Brazil used just 20% in spot markets and the majority of the operations were through FX swaps and to a lesser extent repo operations.

Historically Latin American central banks were used to intervene in a direct way (with interest rate cups, credit quotas, reserve requirements and lending through discount window) in a context of highly segmented and shallow money markets. Notwithstanding, we are seeing a turn towards indirect intervention in the way of modifying monetary and credit conditions by liquidity supply and demand operations.

This is the appropriate way given that it aims to reduce uncertainty and to facilitate an orderly unwinding of FX positions. At the same time, these policies are taken in the context of high international reserves levels. Although these measures are a step in the right direction, it remains to be seen their sustainability in a context of persistent capital outflows. In such an environment, they need to facilitate corporate debt restructuring, bank consolidation, increase transparency in corporate FX positions, and eventually to promote the inclusion of OTC trades to some form of stock market system become evident.

In my view, to put in place a broader than ever set of policy tools both in the emerging and the developed worlds is the way to go. When it comes to divergent policy objectives as inflation was on the upside, financial stability on the downside and the real economy on the side line, letting just one policy tool – the interest rate – do the whole job clearly falls short. As an emerging market policy maker, the use of the whole central banks balance sheet is not an unusual response to financial markets distress, and even on normal times given that the existence of shallow credit markets reduces the impact of the credit channel for monetary policy.

In the case of Argentina, the central bank has been able to ensure two essential public goods: monetary stability and financial stability. With this aim we have patiently and persistently built up the monetary and financial instruments to moderate different kinds of shocks. This strategy includes elements like a keeping the balance between supply and demand for money, the prudential accumulation of international reserves in a context of a managed floating exchange rate framework, a solid financial regulation and supervision, together with different mechanisms to provide and absorb liquidity.

However, the solidness of any structure is only put to test at turbulent times. In slightly more than a year the prudential layout of monetary and financial policies has thus been successful in two stress episodes and at the beginning of the third continues exhibiting robust indicators. The first episode was related to the beginning of the subprime crisis (July-October 2007), the second was the abrupt misalignment of monetary demand (April-June 2008), and the third episode is associated with the severe worsening of the international crisis (as from mid September 2008). In order to overcome them, we adopted a series of measures in sequence. We first restored the demand for money and normalized the foreign exchange market and later ensured the adequate supply of liquidity in order to guarantee systemic financial stability. This enables Argentina to face one of the worst financial crises in decades. This situation is ratified when the degree of coverage of the financial system's consolidated assets is analyzed. The current levels of international reserves are very high in historical terms and cover 62% of private sector M3 compared to less than 40% coverage before the 2001 crisis. The current levels are also 10 percentage points higher than these indicators at the end of 2004. This also happens when the coverage ratio is compared to the central bank liabilities. This strength makes it easier to act in a context of a weaker demand for money. Therefore, the normalization of the domestic money market is underway and private sector deposits and loans are recovering their long-term growing trend in a framework of solid bank liquidity conditions.

The combination of prudential and countercyclical policies that the central bank has developed on the monetary and financial level, added to the fiscal and external surplus, will therefore allow for the impacts of the international disruptions on domestic macroeconomic performance to be cushioned. Although the reversal of the capital movements seen in Argentina since the second half of last year is significantly larger than what happened during the "tequila effect", the impact on real variables has been so far limited. Aggregate activity has maintained a rising trend, although not as steep as at the beginning of the current expansive cycle. On the other hand, together with the moderation of growth of the level of activity and the recent correction of international commodity prices, in a stable exchange rate regime less pressure on domestic prices is foreseen.

Notwithstanding, the limitations faced by emerging economies to deal with extreme externals shocks makes a strong case for global mechanism of liquidity provision in an timely way. Other way, countries might be tempted to try to address the shocks in an uncoordinated way probably by taking measures to close the economy thus hampering the progress made for the last decades on globalization. The backfire could be seen either on financial integration (by controlling capital outflows to preserve international reserves or a strong depreciation of the currency), or it can be seen on trade policy (rising barriers on imports to protect local producers). It is also worth noting that self-insurance via international reserve accumulation or counter cyclical funds seems not to be enough when confronted to the magnitude of current event.

As a consequence actual situation stress the need for a global resolution and a compromise from the developed world to help reducing the impact of the adverse financial shock that is hitting the emerging economies.

As I see it, the appropriate response should materialize on short run and long term solutions. So it is important to characterize two tasks: the urgent ones and the fundamental ones. The former is to take quick and definite actions to avoid the crisis continues to propagate to developing nations recurring to actual resources and the set of institutions that are already in place.

As pointed earlier, a global liquidity provider is a must to limit the contagion effect on emerging economies and to prevent failure of institutions with global systemic consequences. This way, both the FED and IMF recent actions are very welcome.

In the first case, the currency swap mechanism recently launched by the FED could be permanently in effect (not just during moments of crisis) for countries that show a high volume of cross-border operations. Alternatively, solutions that require less public-sector involvement through regulatory incentives for the private sector participating in such transactions, where they can acquire adequate coverage for episodes of volatility could be explored.

In the latter case, the more efficient process for accessing the liquidity window is a step forward in the right direction. However the fund is letting aside most vulnerable economies, a situation that should be taken into account because other way those economies could be putted in the front line of speculative actions. Taking a look at which countries knocked the IMF door we can see that it was a last resort measure, and was made after exhausting available source of funds and even seeking for aid from other sovereign countries.

So in the long run we must take steps towards two situations: 1) institutionalize global mechanisms for liquidity provision and coordinated actions to address global crisis; 2) a global regulatory framework for financial markets particularly to work on avoiding further asset bubbles.

Although the authorities in the United States and Europe are placing increased emphasis on solvency problems at aggregate level, for adequate management of the current crisis there is still need for progress on mortgage restructuring (for example by means of a holc-type scheme for the purchase of mortgages at a discount for re-financing). Only once the real estate market is stabilized it would be possible to find a real floor for the crises. Other short-term actions may include: interrupting marking-to-market (at least temporarily) as on distressed markets proved to be more harmful than helpful, an even more coordinated approach by the leading economies (to reduce US$/euro volatility) and progress towards the setting up of a clearing house for CDS.

In addition, the current crisis has shown the need to strengthen and partly redesign financial system regulation and supervision, to complement the traditional micro-prudential approach with a greater weighting for macro-prudential measures. The principal objective of these tools is to be able to monitor in an aggregate manner the systemic risks faced by financial systems, evaluating their potential impact on the real sector and adopting preventive measures. Furthermore, this approach could be reformed by means of the implementation of countercyclical measures that act on the financial system, some of which could be adjustable, such as dynamic provisioning over the course of the economic cycle, or the setting of capital requirements in accordance with the stage of the cycle.

The main methodological techniques for such a system may include: stress test development at aggregate level, systemic early-warning systems providing alerts at a macroeconomic level and warnings of situations endangering financial stability. Another of the leading objectives of the macro-prudential approach is to mitigate the pro-cyclical nature of financial systems. Proposals such as the ones put forward by Goodhart (time-varying capital requirements on the basis of credit growth) or Kashyap, Rajan and Stein (capital insurance mechanism) as additional elements in the capital-regulation toolkit are welcomed. In addition, in times of hardship, it proved very useful 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. Also, some central banks and regulatory authorities have begun to define as a priority for both banks and non-banking financial institutions the making of additional efforts to “save” some of the profits in boom periods to generate liquidity and capital cushions for use during crisis periods. Compliance with such requirements could send out positive signals as to the health of the financial sector, enabling a gradual rebuilding of confidence.

In addition, there is a need to promote strong liquidity buffers to ensure that core financial institutions can withstand prolonged periods of market and funding illiquidity affecting both secured and unsecured funding. Recent work of the Basel Committee on Banking Supervision (BCBS) is welcomed but questions remain. For instance: what benchmarks supervisors will use to gauge the robustness and adequacy of banks' liquidity buffers when competitive pressures reassert themselves. Also, the principles underscore the importance of establishing a robust liquidity risk management framework that is well integrated into the bank-wide risk management process. In the case of many emerging countries, given our history of macroeconomic volatility and recurrent crises, the "old-fashioned" liquidity requirements keep having a crucial role as a both prudential and monetary tool, which proved to be very effective in turbulent times to keep the banking system up and running. It also serves as a complement to the capital requirement framework.

In a nutshell, countries in the world face significant challenges, which, for us, emerging markets, are magnified as we have to catch up with growth and, most importantly, build institutions and credibility at the same time. In fact, it is more a synchronic than a sequential two-fold challenge. To implement these policies effectively, the only possible way is to keep a consistent (I mean consistent with the history and idiosyncrasies of each economy) and gradualist approach.