

## **Martín Redrado: Dynamism and soundness in the face of the crisis**

Article by Mr Martín Redrado, Governor of the Central Bank of Argentina, published in *El Chronista*, 8 May 2009.

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The decades of macroeconomic instability and recurrent crises that we have faced in Argentina were not harmless in terms of welfare.

Although Latin American countries have shown lower economic growth rates and higher macroeconomic volatility than other regions, the case of our country is on a different scale. If we consider the past 30 years, the average growth in Latin America was less than half of Asia's, with volatility that nearly doubled Asian levels.

In that period of time, Argentina's growth was three times lower than in Emerging Asia, while volatility turned out to be eight times higher.

This process triggered enormous economic and social losses, hindering on our chances to develop and leading to changes in our citizens' behavior. Indeed, the consequences of this process include portfolio dollarization; fiscal, financial or external dominance; obstacles to develop a long-term credit market; and the marked negative correlation between changes in retail deposits and foreign exchange fluctuations.

These factors, which undermined the power of some traditional monetary policy instruments, have played a key role in the design of our monetary-financial system. In these cases, it is essential to ensure systemic stability and build "buffers", which give priority to avoiding "the next crisis" and minimize the effects of disruptions. In particular, our risk management strategy based on four pillars (permanent equilibrium in the monetary market, managed floating exchange rate regime, maintenance of external liquidity buffers, appropriate financial regulation and supervision) is fully compatible with these aims as well as with the tools available.

This scheme, which was carefully developed along recent years, now allows us to overcome each volatility episode in the new international context, minimizing the impact on the real economy and avoiding inconsistencies that might make it unsustainable over time. This has not occurred by chance. It was the consequence of the Central Bank's deliberate strategy, which has prepared us to deal with the new scenario in the best possible way. One of the main structural reforms in our system has been, for example, the design of a specific regulatory framework preventing currency mismatches, reducing the exposure to the public sector, and maintaining prudence when introducing financial innovations.

In addition, we accumulated international reserves during the "good times" (when the opportunity cost of doing so was low), so now we have a sizeable stock to weather financial turmoil. In turn, the implementation of a sterilization policy to keep money supply in check enables us to count with domestic liquidity management mechanisms that have been tested and are now very useful for injecting money into the system, if necessary. It is just the same scheme working under different circumstances. This is also reflected in the foreign exchange regime, which has always worked to mitigate excessive volatility, avoiding abrupt fluctuations that could jeopardize the economy's financial stability.

After this crisis, financial stability will definitely start to play a role it has never played before in the priority list of central banks worldwide. Both developed and emerging countries have had to adjust monetary schemes focused on the interest rate as the single instrument to maintain stability. In fact, financial stability objectives were implicitly and explicitly added, and instruments were adjusted to new priorities. Within this framework, many central banks have had to revisit their usual regulation, operation and intervention mechanisms.

In this regard, the literature is lagging behind. 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. We have reached a point in which economic theory is having a hard time keeping up with praxis. Literature has shown results that are ambiguous or contrary to those produced by the usual “technology”, especially in relation to the approach that relies on the interest rate as the single instrument. The same applies to the managed floating exchange rate regimes. Recent empirical papers that refined the analysis started by several academics argue against sharp fluctuations in the domestic currency, mitigating excessive volatility, especially in developing countries with rather shallow capital markets and limited access to hedging instruments.

In our case, we have been fully consistent with our history, idiosyncrasy and, thus, with the instruments available. We can now claim that our strategy is so sound that it has enabled us to overcome four stress episodes in the past 20 months (July-October 2007, April-June 2008, September-November 2008 and March 2009) and it has proved to be adequate to go through these hard times with unusual stability. Despite the current scenario, and for the first time in decades, we are able to ensure monetary and financial stability for the Argentine people.