Martín Redrado: What's wrong with the current framework of global financial architecture?

Speech by Mr Martín Redrado, Governor of the Central Bank of Argentina, at Bank Indonesia's 7th Annual International Seminar "Global financial tsunami: what can we do?", Bali, 13 June 2009.

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Climate change is not the topic of this seminar, as it was last year, but it is appropriately embedded in the label for the occasion. This is particularly appealing for the turbulent times the global economy is going through. The international environment seems to be emerging from a unique combination of natural catastrophes: extensive droughts on credit markets, earthquake on trade and a flood of distrust. And, as if the former weren't enough, we are now confronting the risks of an A-flu pandemic.

In a context of several structural changes that the economy is experiencing worldwide, there are also different microclimates. First, I will briefly provide my vision on where the global economy is heading to. For this purposes, I will assess the recent developments on these "micro-environments" as they add several question marks to the likelihood of achieving a sustainable and long-lasting recovery. Then, the lessons learned so far from the crisis in terms of the changes needed in regulatory and policy frameworks both at the national and supra-national levels will be addressed. In the case of how the global financial infrastructure is evolving and what path it should follow, I will stress both its lender of last resort role and its regulatory function.

The U.S. economy is still on "de-leveraging" mode. The two-fold hit of financial assets and home equity loss led to a significant wealth destruction combined with debt overhang that is calling for a stronger correction of savings. This process has already begun with PCE figures. They reveal a savings rate that jumped from zero early last year to about five percent today. Further adjustment is in the pipeline. The labor market is still on the downside, amid continuing massive lays-off in manufacturing sector. Although some particular areas seem to be bottoming out like construction and services – there is some evidence that the intense declines in output that we have seen are over – spending is still weak. We can describe, so far, what we are witnessing recently is as a "jobless recovery".

On the monetary and financial side, the string of initiatives launched one after the other have not delivered as expected in terms of kicking start the credit market. PPIP, TALF, TSLF, TARP; it is even hard to track such an extensive list of programs aimed at supplying liquidity, fresh capital and re-starting securitization but more with the goal of boosting market activity than crowding it out. On the demand side, one drawback going forward is that financial institutions are not likely to take advantage of excessive leverage as it happened in the past. On the supply side, much debate is around exit strategies. Particularly, how the Fed is going to deal with the massive liquidity provision, which is seen as an increasing inflationary risk. However there is a point to be made on the opposite direction: I mean a deflationary scenario as a result of the unwinding of the liquidity provision. If the Fed obtains any profit due to its operation (given a revaluation of financial assets bought, which would, of course be, a good news) it would end up withdrawing more cash from the market than the formerly issued. This could trigger a new dry up on the markets. So, it is not just about returning to the pre-crisis balance sheet of Fed.

In my view, the roadmap for a sustainable recovery of should have several features such as: i) long term funding, which is still absent; ii) households balance sheets repair (the micro-fundamentals point to additional adjustment still to come); iii) banks balance sheets repair; the banking will be redesigned on the basis of simpler criteria, with lower leverage and more capital. Burying the old system and enabling a new one to emerge will take time; and iv) long-run fiscal and monetary sustainability.

On the other edge of the Atlantic, Europe is caught in a delicate situation. First, the divergence between policy makers about fiscal and monetary policy measures to prevent a deepening of the slump. And, second, the “East menace”, which is the sizable exposure of its banking system to Eastern Europe risk. Currency mismatches and their impact on credit risk still poses significant challenges for the region. In fact, the whole periphery (both East and West) is under scrutiny due to the brutal adjustment in aggregate spending that is yielding sky-rocket unemployment.

In the emerging world, the adjustment is also taking place. And, in some cases, it is showing up the hard way. We witness Asian economies suffering from a collapse on trade which is mostly region-driven. Figures reveal that U.S. imports did not fall as much as intra-Asia trade. On the positive side, inventories data in East Asia suggest that the retrenchment on industrial activity might be over. Again, here also the “green shoots” could be the effect of anti-crisis packages rather than a more lasting effect with domestic consumption taking the “driver’s seat”.

On our side Latin America has been better prepared to face this crisis both when comparing with history and with the way other emerging markets are being affected. And, of course, these developments have not been achieved by chance. Following the crises of the 1990s and 2000s, our countries have taken important steps to strengthen macroeconomic management, prudential regulation and oversight. Improved current account and fiscal positions, large amounts of external liquidity, better liability management and robust monetary frameworks are several features that place my region not even in the first row of the fire line at this time. I would like to stress, in particular, the strengthening of balance sheets, including the built up of liquidity buffers to face external shocks and the reduced currency mismatches – one of the key sins of the past. The development of a domestic currency capital market was a corner-stone that allow the monetary and financial system to act as a shock smoother rather than a shock amplifier.

Several challenges lie ahead to restore a normal path in the world financial system. Let me tackle this issue by sharing my views on some of the relevant topics that need to be addressed at the national and supra-national order.

At the national level, one of the key structural changes is that financial stability is now ranking higher on every central bank goals 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 my region, financial stability has always been at the forefront of the central banks´ tool kit due to our recurrent crisis. 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 economic 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. Instead, mitigating excessive volatility, especially in developing countries with rather shallow capital markets and limited access to hedging instruments, seems to be an appropriate policy.

This kind of monetary and financial framework that ensures systemic stability has been my main task during the last years. This means giving priority to avoiding "the next crisis" and building buffers to minimize the effects of disruptions. In my country, the decades of macroeconomic instability and recurrent crises 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 Argentina 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 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 current monetary and financial system. In particular, our risk management strategy based on four pillars (permanent equilibrium in the monetary market, managed floating exchange rate regime, development of external liquidity buffers, appropriate financial regulation and supervision) is 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 episode of stress, minimizing the impact on the real economy and avoiding inconsistencies that might make it unsustainable over time. Over the last two years, we have experienced four periods to significant financial stress in the domestic market and our monetary and financial framework has delivered. In each of the events, we first reacted firmly to normalize the money demand and stabilize the foreign exchange market. Then, with simple instruments, we ensured liquidity provision to guarantee systemic stability. Finally, we implemented an array of measures including reforms on the markets for Central Bank securities, the development of additional mechanisms for liquidity provision, changes to enhance futures market depth and transparency, and instruments to facilitate supply of foreign currency. Our system worked as a dam to the rest of the economy, providing for the first time in decades monetary and financial stability. So in my view, there is a need to rethink the paradigm for Central Banks so that we have the tools to provide monetary and financial stability.

Now let me move from the national level to the global one. In this instance a more sophisticated supra-national framework is urgently needed to deal with financial stability. Any roadmap should have at least the following ingredients:

i) Greater convergence in financial regulation and supervision standards among countries;

ii) Rethinking the role of the IMF;

iii) Reinforcement of macro-prudential supervision and regulation tools;

iv) Reformulation of asset valuation methods;

v) Avoidance regulatory arbitrage and control of shadow banking system;

vi) Redefinition of the credit rating agencies function.

Current events show that cross-border banking operation has both systemic and macroeconomic consequences domestically and internationally. This calls for coordinated actions between national authorities together with a more aggressive "stepping up" from international financial institutions. Let me be very clear: the international architecture is in desperate need of a "guardian" for global financial stability. This is, of course, a well-suited role for the IMF given its global reach and infrastructure.

So far, the IMF has announced a series of measures, which revisited its traditional credit practices and created new credit lines, such as the Flexible Credit Line (FCL) and the Exogenous Shock Facility (ESF). These are welcomed steps but also "baby" steps. As long as a comprehensive set of products for different countries with different particular needs is not developed, any attempt to perform this role effectively would fall short. The IMF should have the fire power to deal with global events but should also have the proper equipment. This means making available instruments to ensure the adequate circulation of liquidity worldwide.

This may include: short-term credit for liquidity purposes for central banks tailored to the specific needs of the country , guarantee schemes to develop a particular domestic credit market and a variety of products for countries facing capital outflows that are unrelated to their economic fundamentals, among others.

It is not a matter of chance that so many bilateral swaps agreements between Central Banks emerged during the crisis. It is a natural response of the system to the lacking of an international provider of liquidity of last resort going forward. In my view, while this is very welcomed, the arrangements are not enough it terms of size and length to provide an alternative to self-insurance via foreign reserve accumulation. In fact, the development of all of the bilateral agreements and the regional initiatives such as Chiang Mai just prove the need for international cooperation in a context of an absence of a multilateral organization in a position to perform as a kind of “central bank of the central banks”. This is the next step we need to go for.

And for this to happen, the role of the G-20 is critical. So far, the group has managed to build consensus on the relevant issues and has been able to make some progress both in the reform of the international financial architecture (expansion of the FSF and the Basel Committee, the capitalization of the IMF, revisiting of the IMF international lender of last resort role, and speeding up the governance reform process of the IFIs) and in coordinating macroeconomic policy responses to the crisis.

One of the key challenges the G-20 faces going forward is to consolidate as a formal body. That means not only to propose changes to reform of the international financial architecture but also, and most importantly, to systematically monitor its degree of implementation. The next meeting is going to be essential to assess the degree of progress in the implementation of the course of action set forth.

In my view, the creation of the FSB has been the most significant reform in the international financial architecture so far. The FSB will play a key role in the new international financial architecture. It will be responsible for coordinating banking regulation, developing regulatory and supervisory standards, preparing early warning reports and exchanging information with supervisors. Enhanced representation will increase the likelihood of effective implementation of standards and will hike the quality of standards.

For instance, in the case of the regulatory treatment of currency mismatches, we, I mean those countries that suffered significant macroeconomic crisis, have some experience to share. The increased credit risk faced by subsidiaries, when these subsidiaries are significant for the banking group as a whole, imposes significant negative effects for the parent bank and home financial market. Central Banks could strengthen its regulation on credit risk management by requiring banks that before granting a loan, they should assure that no currency mismatches exist in debtors’ balance sheets. This regulation can be imposed by host authorities to subsidiaries in their jurisdictions, and also, by home regulators to the banking group as a whole regarding each of its subsidiaries. This means for example that home regulators ask that the parent bank and each subsidiary inside the group must comply with that requirement. If not, penalties should be imposed, such as increases in capital requirements. The effect of that kind of currency mismatches could be explicitly considered in the Pilar II of the Basel II Agreement. If the effect of currency mismatches are not properly attended by banks, supervisors at the banking group level, should require additional capital to attend the potential effect, at the banking group level, of the worsening of debtors´ income in hosts markets, and therefore, in subsidiaries capital position and then, in parent bank capital positions. Also, the potential effects of currency mismatches should be explicitly addressed in supervisory colleges.

Credit risk transfer is another key aspect of the agenda. Instead of reducing systemic risks, Credit Default Swaps have contributed to raising them. Risk is not always shifted to the parties that are best able to bear it, but to those subject to laxer regulatory constraints. Another topic important to highlight, because of its relevance for emerging markets economies, is the lack of transparency and absence of reliable statistics in the OTC derivatives markets for non-financial corporations. This opacity left policy-makers without information about exposures on OTC transactions done with foreign financial institutions. As we know, the consequences of these exposures in some emerging markets were systemically important and central banks had to provide financial assistance to the market, to avoid major financial distress.

We must work towards encouraging the trading of credit derivatives using electronic platforms or regulated exchanges and the clearing of standardized credit derivatives through a central counterparty. This would help to reduce risk, in part by allowing for the multilateral netting of outstanding notional amounts, and, on the other hand, by the requirement of posting collateral. However, if central banks promote its usage they should be prepared to provide it with access to central bank credit facilities, or to provide liquidity by other means in case of need.

A macro-prudential approach recommends that regulators and supervisors should consider potential systemic risk and the vulnerabilities of the environment in which financial institutions act. It will be fundamental to understand the interaction that exists between the financial system and the real economy. This approach will demand greater cooperation between local and external regulators, requiring them to develop an integrated picture of the financial system, considering not just banks, but also all financial institutions. The analysis of macroeconomic vulnerabilities that could subsequently impact on financial system liquidity or solvency should also be embedded in the regulatory framework. Deviations should be analyzed in relation to the long-term trends for certain variables, such as credit to GDP ratio, assets prices (residential and commercial property, shares and government securities, and currencies), the exchange rate equilibrium (real/effective) and the international capital flows, among others.

To sum up, we can expect that financial markets are going to be different going forward. The former market based financial system should be brought down the umbrella of prudential regulation avoiding regulatory arbitrage. However, this could lead to a time of slower credit expansion given that higher leverage in that sector allowed faster credit expansion which is alleged to underlay faster growth rates. So once again, preventing a credit market bubble calls for tougher surveillance on this kind of financial agents, but at the same time we should be careful not to choke productivity growth. In this financial framework, Central Banks duties should be also rethink particularly regarding the ability to be lender of last resort to non-bank financial institutions. But something that we can be sure of is that a stable global financial market would reduce the “parking” of liquidity leaving the possibility of diverting resources to be more efficiently allocated, helping our countries to keep catching up with the needed development of our societies.