Martín Redrado: Effects of the crisis and different policy responses – emerging vs. advanced economies

Speech by Mr Martín Redrado, Governor of the Central Bank of Argentina, at the Money and Banking Conference 2009, Central Bank of Argentina, Buenos Aires, 1 September 2009.

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Welcome once again to our already traditional space for discussion in the Southern hemisphere. While the agenda covers the most current economic and financial topics, as usual, the aim is more ambitious: to see beyond the short term; to look through the economic cycle into the medium term, anticipating the challenges that we have in face.

The international crisis triggered economic policy responses that were both suited and aggressive. And we have learnt from this framework. In central banking, it has become evident that we need a more comprehensive view including financial stability as a key goal for every monetary authority in the planet.

Moreover, in contrast with what happened with previous episodes, now emerging countries, have the chance to participate in the decision-making of how to design the new international financial architecture. For example, we take part sistematically in international bodies such as the G-20 with a view of making an intelectual contribution in the world economy.

Our knowledge and experience in managing turbulences is valuable and also show that "there is life after a crisis".

Another example is the participation of emerging economies – and of Argentina as a full member since June – in the newly created financial stability board (FSB) and Basel Committee on Banking Supervision.

The FSB is beginning to play a key role in the new system. The inclusion of emerging countries – with more experience in adjusting regulatory frameworks to avert crises or mitigate their impact – will provide a new perspective to the board. We will have higher quality standards and, thus, a greater probability of adequately applying them at the national level.

Through our direct participation in the Standing Committee for Vulnerabilities Assessment, we are working towards opening private sector access to credit, policy sustainability and strategies for exiting the crisis. Also, we take part in the Basel Committee on Banking Supervision, where we have proposed concrete steps towards liquidity management and the regulatory treatment of currency mismatches.

Further evidence of increased integration is the currency swap agreements with our colleagues from the central banks of China and Brazil. An agreement on contingent liquidity lines in foreign currencies for nearly 12 billion dollars also reflects the confidence of our peers in our monetary and financial system as well as in the policies the Central Bank of Agentina is implementing.

The strength many emerging countries – particularly in South America – have shown in overcoming the crisis will allow us to strenghten our position in the global economy.

The impact of the crisis has been stronger in those emerging economies with external imbalances, higher financial fragility and fixed exchange rate regimes. But, through its "second round" effects, the spread of the crisis has compromised short term economic growth of most developing economies, even those with relatively robust positions.

As to most economies in our region, this episode has found them in a better position than in previous occasions, with higher growth rates, an improved fiscal position and a relatively sound external front, supported by a previous foreign reserve accumulation process through sterilized operations. It is clear that, in a very favorable international context, cyclical factors had an influence on these developments. However, the better performance the region achieved was mainly due to the gradual assimilation of the lessons learned from a past characterized by recurring macroeconomic instability episodes.

The magnitude of an unprecedented crisis has forced us to face some difficult policy dilemmas. In fact, for the first time in a long period, it has given policymakers, a clear opportunity to make a difference with the past. The world was headed to the abyss at a very high speed. A new great depression.

But, now we can say that such free fall was left behind and that policymakers around the world, have been up to the occasion, being able to avoid the abyss and instead overcome a period that will probably be inscribed in history as a great recession.

Of course, this does not mean there is room for complacency.

On the contrary, great challenges that need full attention still remain ahead of us; not only for policymakers but also for the entire profession.

In South America we got around the challenges trying to preserve most of the basic equilibriums achieved in the external and fiscal fronts. We suddenly moved from a context characterized by an abundance of financing to a much more adverse scenario. Most governments have adopted a set of expansionary measures aimed at mitigating contractionary trends. The chance of adopting these measures in an adverse context has been a relatively unusual phenomenon in the region, traditionally characterized by highly procyclical policies.

And this is the behavior we have adopted in Agentina. We have built a monetary and financial framework that gives priority to avoiding "the next crisis", a concept that is present in every citizen’s mind. We have designed the mechanisms to confine the shock and prevent it from affecting the rest of the economy. For the first time in decades, the central bank has been an anchor of stability for our entire economy.

In particular, our risk management strategy based on four pillars (convergence of supply and demand in the monetary market, a managed floating exchange rate regime, a countercyclical policy with liquidity buffers both in domestic and foreign currency, and adequate banking regulation and supervision) allows us to overcome every episode of stress, minimizing its impact on the real economy. Our strategy also prevents inconsistencies that could undermine its sustainability over time.

We have recently gone through periods of considerable stress in the domestic market, and our policies have responded as expected. We successfully overcome four episodes in the past two years (July-October 2007, April-June 2008, September-November 2008 and March 2009), proving beyond any doubt the soundness of the approach adopted by the central bank.

During each episode, we acted firmly in an attempt to normalize the demand for money and stabilize the foreign exchange market. Then, with simple tools – easy to understand by the market – we ensured the supply of liquidity to guarantee systemic stability.

In this framework, the managed floating exchange rate regime has proven useful for the current stage of development, considering our history of macroeconomic volatility. But, it has also proven to be useful in other countries. The literature is clear: even for central banks using inflation targeting regimes, the exchange rate is a significant variable in their reaction function.

In the specific case of emerging countries that are very prone to financial and fiscal crises (such as Agentina), where dollarization/currency substitution levels are high, we have designed a monetary regime that is sufficiently robust to weather the challenges that we face in the transition phase towards a long term equilibrium.

Thus, we have avoided “corner solutions”, implementing a flexible and robust monetary and financial regime based on a managed floating exchange rate regime and the strict control of relevant monetary aggregates.

This regime has allowed us to achieve stability and, at the same time, build a sound financial system (with no currency mismatches or excessive public sector exposure), which has gradually regained its function as savings intermediary.

Given the history of our economy, the monetary and financial policy options are part of an extensive review of the relevance for central banks of the various policy objectives. Particularly, what role to assign and how to weigh up monetary stability, GDP stability and financial stability. For instance, both in developed and emerging countries, monetary regimes focused on a single instrument, such as the interest rate, have become more flexible. Many central banks have had to revisit their usual regulation, operation and intervention mechanisms.

In this sense, it is essential to analyze how this crisis affects the economy and policies. As a matter of fact, there was partly a “surprise effect” due to which early warning mechanisms failed. Therefore, there is a social debt in terms of the capacity to prevent and warn about potential risks.

Furthermore, the dramatic reversal of the previous prosperity has led to a significant reassessment of risk premia. Even the "awareness" of the meaning of risk in itself has changed. Previous confidence in the possibility to accurately quantify and estimate risk has been lost and later proved to be naïve. In addition, academics have come to revalue Frank Knight’s definition of uncertainty, according to which the relevant variable’s probability distribution may be unknown to economic agents. All in all, the crisis has caused greater “humility” in all of us.

Undoubtedly, the interaction of several phenomena, in econometric terms, was what mattered most. The synergy of different factors combined was not taken into account. For this reason, a vibrant and healthy discussion is taking place about the most appropriate theoretical models and paradigms.

Another important debate focuses on fiscal policy. This issue has gained so much relevance that in the most recent Jackson Hole Symposium there was a whole section dealing with it.

Professor Auerbach from the University of California and Professor Gale from Brookings thoroughly compiled a series of empirical and theoretical studies related to the impact of countercyclical fiscal policies, arriving at a single clear conclusion: the controversy on the multipliers will remain open.

This year we have seen a paper by Cogan, Cwik, Taylor and Wieland, from Stanford University, and another by Christiano, Eichenbaum and Rebelo, from Northwestern University, both based on the same “workhorse”, the Smets and Wouters’ stochastic dynamic general equilibrium model, showing opposite results: the former argue the multiplier is below one, whereas for the latter, it is above one.

Why such differences? Because of the assumption that consumers and monetary policy will behave in a certain way. And again, an interesting contribution of Auerbach and Gale’s paper was to emphasize the greater effectiveness achieved when coordinating fiscal and monetary policies.

What can we say about economic policy?

I think, in this respect, there seem to be better outcomes. Quite a number of lessons were learned at various levels:

1. Regarding the importance of financial stability as an objective.

2. Regarding the position of the countercyclical (fiscal and monetary) policy.

3. Regarding the need to create protection buffers, both in terms of liquidity and solvency.

4. Regarding the relevance of coordination of economic policy.

Moreover, the value of immediate action, without relying too much on automatic stabilizers, has proven to be essential. Besides, it was necessary to be forceful (and even overact) in order to overcome economic agents' negative expectations.

For an appropriate international policy coordination, to avoid the temptation to act selfishly was key. Instead of confining economies and failing to cooperate, we globally avoid "beggar-thy-neighbour" protectionisms, through action at G-20 and other fora.

But there is yet another lesson as regards to timing: policies implemented should never be prematurely abandoned. Several authors pointed out how the reversal of the United States' expansionary fiscal policy in the mid 1930s was a setback for recovery. Moreover, it delayed the efforts to bring the economy back on the long-term path, which only happened in 1942. Of course, being careful so as not to frustrate the recovery does not mean we should run unnecessary risks in the opposite direction. The monitoring of potential (non-linear) reversals especially in inflationary expectations must be ongoing.

Economics is a dynamic discipline. Two years ago, many of our colleagues were worried about inflationary pressures derived from the booming commodity, real estate and stock markets. The adjustment process started in the real estate market which, together with the subprime meltdown, caused fears to take the opposite direction: a deflationary environment would most likely be created.

Massive interventions around the world, through fiscal and monetary tools largely reduced the risk of deflation. However, even today, when activity is showing signs of improvement, in some markets the fiscal and monetary policy exit strategy may tip the scales either way. While an early exit could affect the recovery, a late exit could fuel inflation, which would bring uncertainty in terms of employment and economic activity.

It would be senseless to consider only two extreme scenarios: going back to the 1930s or the 1970s. Both episodes have provided economic theory and practice with important lessons.

Therefore, this is the time to maximize efforts to put the world's economy on the track to sustained and credible growth. The best strategy is to match three closely related aspects: the gradual decrease in public incentives, the normalization of credit markets, and the improvement of regulation and supervision. Due to the financial sector's unique features – especially its multiple negative externalities and systemic aspects – governments should reduce their incentive policies as the financial system fully recovers its traditional intermediary role. At the same time, we should implement new prudential regulations and supervision mechanisms to ensure this role is played in a healthier framework.

Although since March, international financial markets have shown significant improvement, after the stress peaks in October 2008 and February 2009, the need for caution still prevails. Expected volatility for the US equity (VIX index) was reduced by half in the past five months, although it still doubles pre-crisis levels. Something similar occurs with interbank market, corporate debt, and CDS spreads of US banks.

Given that institutions operate transnationally, there is a need to implement new regulations to level the playing field. Simultaneously, new regulations should be careful not to stifle credit recovery.

If institutions were forced to comply with new regulations at once – for example, in terms of capital – when unable to increase their capital through stock injections or retained earnings, they would have no choice but to liquidate their assets and cut down on loans, which would have an opposite effect on credit expansion.

After all, all great crises have led to the reformulation of the international financial architecture. The world is facing a new stage where our region has to take a leading role. Many of the world financial crises in the past few decades started and expanded in and among emerging economies. These traumatic experiences taught us a lesson. Our economies started adopting sound policies which have allowed us to withstand the contagion effect of the crisis.

The challenge is to ensure this framework persists after the crisis is over, so that our countries may be inserted in the global economy in a less asymmetric and more effective way. By less asymmetric I mean the need and possibility to reduce the “cost” of being insured against financial crises. In my opinion, this is the path to a more stable, balanced system which is less prone to inconsistencies that jeopardize the sustained development of our nations.

In short, we must deepen those policies that enable us to face changes in the external context and, in turn, to develop our economic institutions so as to better channel benign scenarios and improve the power of our policy instruments, with the aim of being fully responsible for the achievement of the objectives set and, thus, aim higher and higher.

This is the path for monetary and financial policy to provide the stability and predictability needed for the development of our people. Thank you.