Martín Redrado: Institutional framework and economic growth

Speech by Mr. Martín Redrado, Governor of the Central Bank of Argentina, at the Bank of Mexico international conference, Mexico City, 19 October 2009.

Institutional framework and economic growth is a most challenging topic. Institutions are increasingly relevant to economics and they bear an incontestable relation to growth. In turn, the world is undergoing institutional financial architecture reconstruction to resume the sustainability path. I think, therefore, that this topic could not be timelier.

Let me focus on the institutional progress made by emerging markets and, in particular, by Latin America. Here we can make a distinction. On the one hand, we have what I consider to be new macroeconomic institutions in our region, which had distinctive effects both on the growth process of the past few years and on the economic policy responses to the crisis. On the other, in the microeconomic reform agenda, the region is structurally lagging behind, and recent progress has been more mixed.

In this sense, I will specifically refer to one of the main institutional reforms across both the macro- and microeconomic areas – the strengthening of local and regional currencies, the development of finance markets in those currencies, and the growing importance of such currencies for regional integration.

The new macroeconomic paradigm in Latin America has been built upon the lessons from our history of macroeconomic volatility, and still needs to consolidate itself definitively finding the right balance between credibility and flexibility.

While there are several ways to implement it according to the specificities of each country, the basic principles – which, in my view, have already been institutionalized – can be summarized into five pillars: (1) robust monetary and financial policy approaches, (2) more flexible exchange rate regimes, (3) fiscal solvency, (4) external sustainability with market openness, and (5) financial policies that favor the creation of liquidity and solvency buffers.

Our monetary and financial policy options are part of an extensive review of the importance central banks should assign to the various goals set, particularly, what role and weight should be given to price stability, output stability and financial stability.

In my opinion, the monetary policy paradigm is changing following the present crisis – financial stability has come to play a role it has never played before in the central bank agenda worldwide: it is no longer taken for granted, but needs to be sought and defended every day. This is happening nowadays in developed countries where financial stability has historically been a tool rather than an objective, taking into account the depth of their capital markets.

In developing countries, instead, with our long history of recurrent crises, financial stability and the need to preserve the money market infrastructure – rather than players themselves – through prudential tools were already an explicit part of central bank objectives.

As the present crisis unfolds, we see that both developed and emerging countries with monetary schemes based on a single tool such as the interest rate have had to adjust themselves as they go along. Indeed, financial stability objectives have been implicitly as well as explicitly added, and the tools adjusted to new priorities – many central banks have had to revise their usual regulation, operation and intervention mechanisms.

We still lack a single, homogeneous definition of “financial stability,” with the concept varying from one central bank or international agency to the other. It is clearly difficult to objectively determine what financial stability really is and, along with that, how to take on these challenges in operating terms.

We have reached a point where economic theory is having a hard time keeping up with praxis. Recent literature has shown results that are ambiguous vis-à-vis to those produced by the usual “technology”. As regards the rules implemented via the interest rate channel, in the past 15 years the conventional wisdom was that short-term interest rates could be used to change the whole curve and thus affect economic agents’ decisions. Recent work shows that this is not the case and that the impact of short-term rates on real variables is substantially different.

For this reason, a lengthy discussion is taking place about the most adequate theoretical models, which is of course very healthy, since it humbles us all. Anyway, regardless of objectives and tools, autonomous central banks devoted to monetary policy design and implementation have been of the essence for macroeconomic stability in Latin America and emerging countries as a whole.

For Argentina, the assessment of the monetary and financial regime should take into account some distinctive factors. The decades of macroeconomic instability and recurrent crises have not been harmless in terms of welfare. Although Latin American countries have shown lower growth rates and higher macroeconomic volatility than other regions, the case of Argentina is on a different scale. Considering the past 30 years, average growth in Latin America was less than half of Asia’s, with volatility nearly doubling Asian levels. In that period of time, average growth in Argentina was three times lower than in the Far East, while volatility turned out to be eight times higher.

This caused huge economic and social losses, impacting on our development possibilities and leading to changes in citizens’ behavior. In fact, portfolio dollarization, fiscal and financial dominance, and the negative correlation between changes in bank savings and exchange rate fluctuations are some of the distinctive features of this process.

These factors, which undermined the power of some traditional monetary policy instruments, have played a key role in the design of our monetary and financial system. It is essential to ensure “buffers” that help, above all, eliminate the feeling of “the next crisis around the corner.” Our strategy has enabled us to overcome each volatility episode in the new international context (four in the past two years), minimizing the impact on the real economy.

A lesson learned from the crisis is that in emerging countries structurally characterized by fiscal deficit and current account imbalances, asset prices were hit the hardest.

The impact has undoubtedly been stronger in the emerging economies with distinct external vulnerability and higher financial fragility, for example, economies with high expenditure, currency mismatch, and hard pegs.

In Latin America – traditionally characterized by highly procyclical policies – this financial and external soundness has nevertheless allowed for something unprecedented. I mean we have had room for manouver to mitigate the effects of the crisis, which for the first time was not centered around the emerging world.

Fiscal responsibility in most of our countries has ceased to be discussed in terms of the left or right – it has simply been accepted as common sense. The windows of opportunity have been taken advantage of to reduce the external debt, minimize currency mismatches and reduce the excessive concentration of banking system’s credit risk in the public sector.

Special mention should be made of the building of liquidity networks both in foreign and local currency. This has been a common pattern among Asian and Latin American emerging countries and, in my opinion, has been well institutionalized since it raises confidence for domestic economies. Today, even after the worst of the crisis is over, there is still no international lender of last resort. Consequently, there is no adequate substitute either for a foreign reserve accumulation policy at the national level.

This is also the case with construction and development through the prudential regulation of banking systems with high liquidity and solvency buffers to cushion shocks instead of amplifying them. It is still the responsibility of each country to develop their own countercyclical policy so as to overcome periods of limited financial market access, preventing domestic variables from being significantly affected.

Thanks to these policies, the monetary and financial system in Latin America as well as in Argentina, despite facing a series of turbulences, has managed to operate within the guidelines set.

There have been no bank closures, the institutions have kept their robust liquidity and solvency levels, savers have been able to make the portfolio decisions they have deemed fit, credit has kept growing – though at a slower pace. For the first time in several decades, after patiently working for five years, the Central Bank of Argentina has become a true stability anchor, providing three public goods unprecedented in the country: monetary stability, financial stability and foreign exchange predictability.

As regards the institutional impact on growth, the literature does seem to have risen to the occasion. The neo-institutionalist school has come to prominence in the past few decades with the spread of its explanatory power.

From the very beginning, its founders have sought to answer a fundamental question – why do some nations achieve self-sustained growth, while others remain economically stagnant? Neo-institutionalism highlights the role of the historical background. Unlike the neoclassical school, it focuses on a dynamic vision.

In my opinion, when we talk about economic institutions, the concept of pyramid comes in very handy, and what better place than the Mayan and Aztec land to make a reference to it. Societies build their institutional arrangements in stages, one after the other, one over the other, each on top of the previous one.

To keep progressing with this pyramidal arrangement at the regional level, it is essential to develop financial markets in domestic currency.

In this sense, there are several important factors, both at the macroeconomic and microeconomic levels. The microeconomic factors include an increasing dedollarization of the economy and reduced vulnerabilities related to potential sudden stops in capital flows.

This is particularly important since currency mismatches have been the basis of the major financial crises among emerging economies. A marked reliance on borrowing in strong currencies makes countries more vulnerable to domestic currency depreciation (which is strongly tightening). Furthermore, the development of finance markets in local currency is usually associated with improved liability management facilitating risk management.

Among the microeconomic factors, it is key to develop a yield curve in local currency that reflects the opportunity cost of funds for different terms, leading to more efficient resource allocation. In addition, less reliance on external (generally short-term) capital flows allows for a tighter control over monetary policy.

In spite of this decade's achievements, major progress remains to be made, which is most remarkable in our region – above all, with respect to the issuance terms (so that the shift from "hard currencies" to "domestic currencies" does not entail changing the currency risk for the rate risk) and an increased share of fixed-rate nominal issues.

While the latter's share has grown in all emerging regions, it is still low in Latin America (less than a quarter of the total debt, with a predominance of variable-rate instruments and, to a lesser extent, indexed debt). Additionally, liquidity in secondary debt markets, while growing in the past few years, remains limited and uneven.

International financial institutions (IFIS) can also play an even more important role to achieve this aim. One way is for IFIS themselves to issue in emerging country currencies. In this sense, they often work as a catalyst agent, leading the start-up in local currency both in domestic and international markets. Certain issues by IFIS have been true pioneers in some countries, paving the way for other issuers and attracting foreign investors.

Just as institutions determine economic performance, we should not overlook the reverse causality – economic growth and human capital anticipate institutional improvements, just as institutional quality increases along with national wealth. China is the most telling example of this.

The challenge facing us, economic policymakers, lies in designing institutions that allow us to continue putting these principles into practice. In such institution building process, we should not forget that there is no one-to-one correspondence between the roles of good institutions and the form they take. Implementing the reforms mentioned does not entail blindly following certain templates to be applied under all circumstances. There are several ways to implement adequate policies to further development and institutional stability. The pace of institutional reform implementation – both at the micro and macro levels – cannot be kept separate from the specificities and the economic and social environment of each country.

The depth, quality and implementation pace of institutional reforms are at least as relevant as their sustainability in time. Otherwise, all efforts will be vain. The reforms need to be consistent and socially sustainable. They cannot be imposed by force or imported from foreign countries, but should be inherent to the society in question. They should be the result of collective decisions made by groups with different powers and preferences.

Even if this collective decision making process takes time, the fact that reforms are carried through out of "conviction" rather than "necessity" increases their chance at success and sustainability in time.

It seems that the world now understands policy recipes vary from one country to the other in this complex scenario. And this is of course welcome, especially for emerging countries, where we also need to catch up with economic development, address social tensions and, more importantly, build lasting and useful institutions at once for the whole of society.

The two-fold challenge facing the region, then, is not sequential but synchronic – growing and building institutions simultaneously, since they are mutually determined and reinforced, while ensuring the due consistency and consensus in the building process to avoid a pendular reaction. To that end, rather than shock policies, gradualism and the ability to adjust that we have demonstrated in the past few years have provided more fertile ground for progress in terms of meeting our peoples' demands.