Why is monetary policy more demanding in emerging markets? Lessons from Latin America

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Outline of the presentation

- Liberalization and burdens on monetary policy management
- From the holy trinity to the impossible duo?
- Conclusions

Liberalization and burdens

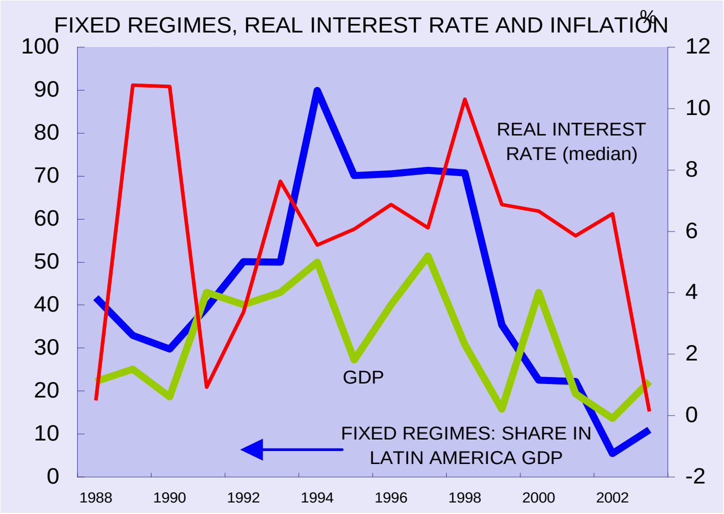
- **LA approach to Capital account liberalization**
  - shock therapy
    - *Swift capital account liberalization, seen as catalyser for structural changes*
    - *'A priori' ambitious reform process*
      - A FORTIORI: "Meant well, tried little, failed much"
    - *Macroeconomic stabilization*
      - Through external anchors,…turn out to be problematic

Liberalization and burdens

Rapid stabilization, capital flood, expansion

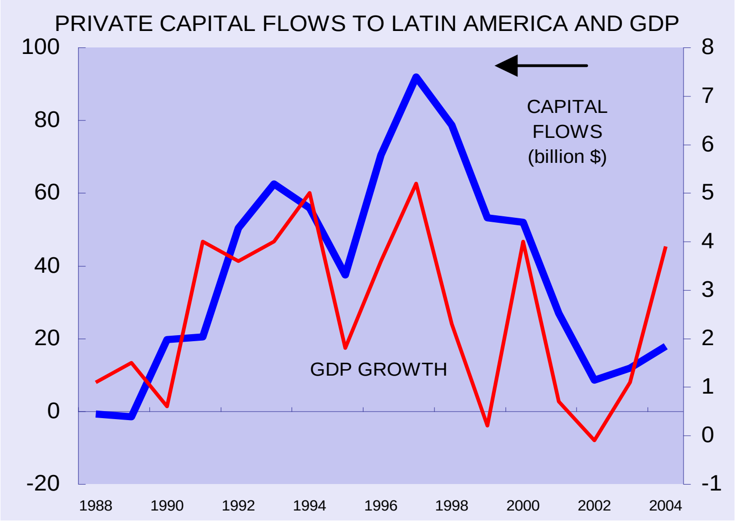
Latin American aggregates:

Exchange rate regime and real variables



Sources: IMF and own calculations

External capital flows and growth



Source: IMF

Liberalization and burdens

- **Capital flows = Accelerated external borrowing**
  - Compounded with low savings
  - Overborrowing syndrome (McKinnon)
    - *implicit government guarantees through exch. Rate pegs*
  - Economic expansion masks difficulties
  - Public, financial and corporate sector
    - *A different type of difficulties arises from each*

- **Problems for monetary management**

Liberalization and burdens

- **Deadly traits**
  - Unbalanced opening
    - *Capital account wide open v. Current account closeness*
    - *Exposure to external financial shocks*
    - *Globalization and volatility of flows*
  - High debt+high costs
    - *Original sin and debt intolerance*
  - Dollarization
    - *Implicit and explicit currency mismatches*
  - Weak initial conditions and slow strengthening
    - *Fragile economic governance*
    - *Underdeveloped domestic financial system*
    - *Weak or insufficient fiscal discipline*

From the 'holy Trinity' to the 'impossible duo'

- **EARLY NINETIES HOLY TRINITY : trade-off bw**
  - Fixed e-r rates , free capital mobility , independent monetary policy
  - Successful stabilization
  - Initial expansion **BOOM** + Capital flows attraction
  - Monetary policy
    - *Accommodating appreciations in real terms (endogenous monetary policy)*
    - *High real interest rates*
    - *Control of inflation*
- BUST
  - Expansion peters out
  - External and internal disequilibria
    - *current account deficits*
    - *exchange rates disequilibria*
    - *Uncover fragile fiscal, financial system positions*
  - Overborrowing
    - *Debt accummulation beyond tolerance*
  - Contingent deterioration of sustainability
    - *When exchange rate, costs of financing move up*

From the ‘holy Trinity’ to the ‘impossible duo’

- **Exchange rate regimes strains**
  - Ex ante failure of exit strategy
    - *Inflation stabilization means pegs outlive their utility*
    - *Financial crises (from mid-90s) force pegs out (traumatic)*
  - Exchange rate hollowing out
    - *But bias towards floating*
    - *Only very open small economies dollarise*
      - Exception Ecuador
  - Ex post successful transition to floats
    - *Regime shift in expectations (from high to low inflation)*
    - *Inflation does not goes beyond control*
    - *Reduced pass-through*

From the ‘holy Trinity’ to the ‘impossible duo’

- **Keys for success**
  - Room for manouvre to strenghten CBs
    - *De facto autonomy*
    - *Vanishing inflationary taxes and resource to public sector financing*
    - *Technical competence*
    - *Development of basis for alternative strategies*
    - *Deepening of domestic markets*
- **Current traits**
  - Move toward (more or less explicit) inflation targeting
  - Fear of floating remains. Allows for reserve accumulation

From the ‘holy Trinity’ to the ‘impossible duo’

- **Challenges and difficulties**
  - Impossible duo: **‘de iure’** floats + monetary independence
    - *Globalization as limiting factor, in general*
    - *High exposure to external flows and financial vulnerability heightens difficulties for monetary management*
    - *Dollarization = worsening factor*
      - Implicit mismatches materialise
      - Flight from domestic currency
      - Perverse debt dynamics
  - Consequences
    - *Asymmetric ‘Exchange rate dominance’*
    - *Maintenance of fear of floating =* ***‘de facto’*** *managed e-r regimes*
    - *Procyclical monetary policy*
      - Tighten in or just after of turbulences = downturn due to adjustment
      - + procyclical fiscal policy = inadequate policy mix

From the 'Holy Trinity' to the 'impossible duo'

- **Asymmetric exchange rate dominance**
  - Quiet times = 'canonical' inflation targeting regime
    - *Instruments $\rightarrow$ transmission mechanism $\rightarrow$ inflation targeting*
      - Plus perfectioning of instrument and transmission mechanism
      - Strengthening of financial system…
  - Turbulent times = 'suspension' of inflation targeting
    - *Turbulence = sharp e-r depreciations + sudden stops*
    - *Instruments $\nrightarrow$ inflation target*
      - Financial, fiscal vulnerability surfaces
      - …and economic policy (including monetary) focuses on financial stability
      - **INFLATION TARGET, no PARAMOUNT TARGET**
    - *Instruments $\nrightarrow$ transmission mechanism*
      - Financial systems runs for safety
      - CBs and government apply 'crises management' measures
        - » *Liquidity provision*
        - » *Exchange rate hedging*
        - » *Absortion of government paper*
        - » *Changes in reserve requirements*
        - » *Use of international reserves related to IMF –programs…*
      - **SHOCKS TO TRANSMISSION MECHANISM =LOSS OF EFFICACY**

From the 'Holy Trinity' to the 'impossible duo'

- **Inflation targeting resilience related to vulnerability**
  - Differences among countries:
    - *Low vulnerability: Chile, México = capable to implement inflation targeting in good and bad times*
    - *High vulnerability: Brazil = suspension in turbulences*
- **Brazil: 'de facto' suspension of IT in 2002**
    - *Paramount policy target:*
      - crises management, return of confidence
    - *Policy reaction*
      - Inflation target mandate asks for increase in interest rates
      - Currency defense, arguably, too
      - However:
        - » *NO defensive increase of interest rates during turbulence*
        - » *Measures to reduce exchange rate speculation*
      - Reasons
        - » *Perceived as self-defeating, increasing banking system strains*
        - » *Transitory collapse of transmission mechanism*

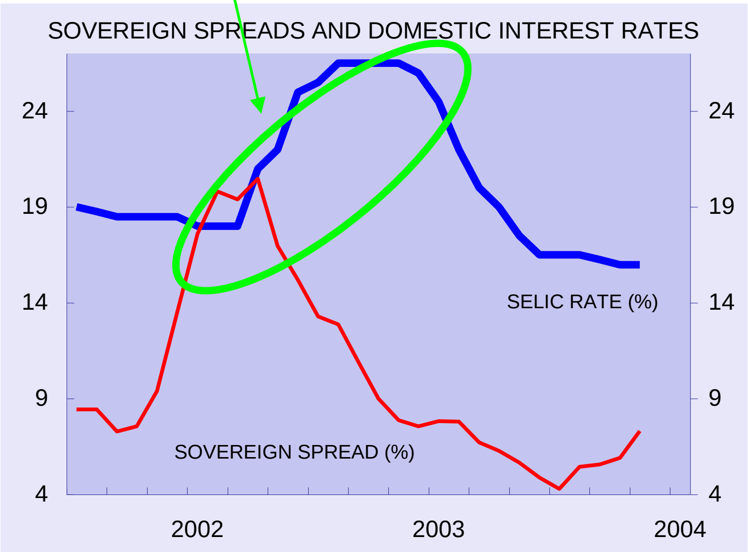
From the 'Holy Trinity' to the 'impossible duo'

Brazil: 'de facto' suspension of IT in 2002

Lagged e-r effect

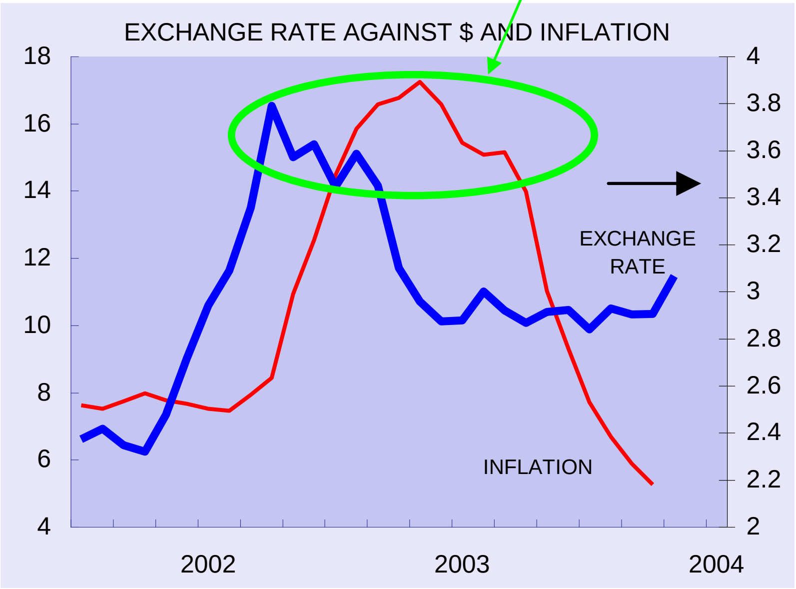
Lagged monetary policy reaction

Brazil: financial conditions from 2002 to 2004



Source: BCB, JP Morgan

Brazil: financial conditions and inflation from 2002 to 2004



Source: BCB

Conclusions

- Success history in terms of low inflation
- Still burdened by difficulties
- No way back. Globalization is here to stay
- Strategy
  - *Reinforce monetary management regimes + reducing vulnerability <<reciprocal feedback*
  - *How (see successful cases: México, Chile)*
    - Higher formal independence of CBs
    - Pursue dedollarization
      - » *Awareness of costs (currency flight?)*
    - Deepening of domestic financial markets
    - Fine tuning of monetary regimes in parallel with financial advances
    - Fiscal discipline and debt reduction
    - Current account openess