ROUNDTABLE COMMENTS ON MONETARY AND REGULATORY POLICY IN AN ERA OF GLOBAL MARKETS

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During the 1990s the debate around monetary policy in emerging economies confined itself to the role that it should have in keeping inflation under control. There was a near consensus that monetary policy should not look for other objectives. Trying to fine-tune monetary variables in order to use them as a countercyclical policy was considered extremely dangerous. This near consensus was a logical consequence of the very bad experiences of many Latin American countries during the eighties, when those countries tried to use monetary policies to stimulate economic activity and ended up with very high inflation rates.

The current situation, however, has brought about the debate once again. Monetary policy is being used in the industrialized economies as an instrument to stimulate economic activity. Even such an orthodox institution as the International Monetary Fund is recommending that the central banks of the developed world act in an expansionary manner, despite the fact that real interest rates are close to zero in the United States and that nominal rates are zero in the Japanese case.

The question is whether this type of recommendation could be relevant for emerging economies. Latin American countries, in particular, are also presenting many signs of stagnation. From that point of view, their internal markets would benefit from more expansionary monetary policies. In practice, however, many of those countries are facing an increase in their domestic interest rates.

More generally, in the last decade, interest rates in Latin American countries were relatively low during the boom periods and higher when economic activity slowed down. The rationale for this procyclicality of interest rates can be summarized as follows:

1. The rapid process of financial integration during the last ten or fifteen years made domestic monetary policies in emerging economies very much dependent on capital flows.
2. As far as capital flows are highly procyclical, the ability of central banks in these economies to act in a countercyclical way was greatly reduced.
3. Poor macroeconomic fundamentals and a very bad historical record of inflation complicate the situation further and impose strong restrictions on Latin American central banks. As a consequence, they are frequently required to act in a procyclical way in order

to enhance credibility in domestic currencies. In particular, this happens when capital flows toward these countries are suddenly reduced.

Some supporters of dollarization have used the procyclicality of interest rates and monetary policy to argue against the maintenance of domestic currencies in Latin America. In contrast, I will argue that a credible inflation-targeting strategy may provide some room for countercyclical monetary policy in emerging economies. Even in the context of inflation targeting, procyclicality of interest rates will be present because of the procyclicality of capital flows. However, this is a problem that cannot be solved through dollarization. Instead, a proper domestic monetary policy may help to reduce it.

Even with Floating Exchange Rates, Monetary Autonomy Is Restricted

The loss of monetary autonomy for an economy that faces a deep process of financial integration is a well known fact in the context of fixed exchange rates. Mundell (1963) and Fleming (1962) taught us many years ago that monetary policy would be ineffective in an economy facing open capital flows if it was trying to keep a fixed exchange rate. However, the new problem in Latin American countries is somewhat different. Even with floating exchange rates, the autonomy and effectiveness of monetary policy to affect the business cycle will be much restricted because of the pass-through effects of the exchange rate on inflation. In fact, many Latin American countries now have flexible exchange rates, and, still, it is evident that they are not fully autonomous to manage their domestic interest rates.

For instance, the sharp increase in domestic interest rates during the crisis of 1998–99 was observed not only in countries with narrow currency bands, like Brazil, but also in a country like Mexico, that had an entirely flexible exchange rate regime. In the more recent past, Brazil has allowed its exchange rate to float, but, still, that country has been forced to increase the domestic interest rates in a context in which international rates are going down and economic activity is staggering.

In all cases, the increase in the domestic interest rates is closely related to foreign capital flows. Despite the flexibility of the exchange rate regime, when there are sharp reductions in capital inflows, monetary authorities cannot allow for an extreme adjustment of the exchange rate. A too large depreciation of the currency may reduce public confidence in the ability of the central bank to keep inflation under control. In turn, this may reduce the demand for the domestic currency and actually push the inflation rate up. Then an extreme depreciation of the currency may create a vicious circle of inflation and nominal depreciation even if there are no excess demand pressures. Under this scenario, depreciation is not an adjustment mechanism but a source of further disequilibria and part of a destabilizing process.

Under these circumstances, it is easy to understand the “fear of floating” mentioned in Calvo and Reinhart (2000). Such “fear of floating” may be unavoidable and it implies that the domestic monetary authorities will make a procyclical management of the domestic interest rate even if they formally have a flexible exchange rate regime.

In summary, even under flexible exchange rate regimes, monetary autonomy in Latin American countries is much limited, both because of the large swings in foreign capital flows and because of the limited credibility in the ability of their central banks to keep inflation under control.

Procyclicality under Currency Boards and Dollarization

The arguments presented so far could be used against floating rates and in favor of either hard pegs or dollarization. In fact, some supporters of those exchange rate regimes include among their benefits the idea that they *would* stabilize domestic interest rates. Monetary autonomy would be lost, but interest rates would be stable enough to avoid procyclical behaviour.

However, in economies with entirely fixed exchange rates—either because they are dollarized or because they have currency boards—domestic interest rates may behave in a procyclical way. This is because the international financial markets perceive an increase in the country risk when economic activity slows down.

The case of Argentina has a lot of idiosyncratic elements, but it is still a good example of this point. With its currency board regime, Argentina gave up its autonomy to manage monetary policy. This does not imply, however, that the domestic interest rates in Argentina are the same international interest rates as would be predicted by a simple version of the Mundell-Fleming model. The domestic rates are affected by the country risk perception, which in turn is likely to increase when economic activity slows down. Paradoxically, in the current Argentinean situation, interest rates are extremely high and would decrease only if there are signs of economic recovery. Therefore, we have a situation in which interest rates are clearly procyclical and cannot be altered by the domestic monetary authorities.

This problem can arise even with full dollarization. Domestic interest rates in Ecuador or Panama are not necessarily the same as those in the United States, despite the fact that those countries are fully dollarized. As argued in Mishkin and Savastano (2000), both under a currency board regime or under full dollarization there is a risk of asset confiscation, which has a long tradition in Latin American countries.[1]

Hence, giving up monetary autonomy and looking for a formal process of dollarization is not necessarily the best solution for Latin American countries. When credibility in the domestic currency disappears, outright dollarization is unavoidable and it comes either officially or de facto. However, this is a corner solution which is not necessarily the optimal one (Edwards 2001). Maintaining monetary autonomy has many advantages and may facilitate a process of macroeconomic adjustment through variations in both exchange rates and domestic interest rates. Provided that integration to international capital markets is high but less than full, there will be a fundamental trade-off between nominal stability and output stability, which implies that hard pegs or dollarization will represent a second-best solution (Mishkin and Savastano 2000).

Inflation Targeting and Countercyclical Monetary Policies

In contrast with hard pegs and dollarization, maintaining monetary autonomy within the context of an inflation-targeting strategy may help in making interest rates less procyclical and, under certain conditions, to undertake countercyclical monetary policies.

For instance, in the recent past, countries like Chile and Colombia have been able to take advantage of their monetary autonomy to help in stabilizing aggregate demand in a context of very adverse external conditions through some depreciation of the currency and lower domestic interest rates without risking the inflation target or the credibility of the central bank. This has been possible because inflation is already low, inflation targets have been achieved for several years, and macroeconomic disequilibria are being corrected. Interestingly enough, at least in the Colombian case, the ability of the central bank to act in a countercyclical way in the current situation is closely related to the fact that it gained credibility during the crisis of 1998–99 when, in a context of large macroeconomic disequilibria, it was forced to act in a highly procyclical way in order to keep confidence in the domestic currency.

The main challenge for Latin American central banks, therefore, is to enhance the credibility in domestic currencies. Inflation-rate targeting is a key element in this strategy and keeping low rates of inflation becomes a prerequisite to any role of those central banks in a countercyclical policy strategy. As far as an inflation targeting strategy takes into account the output gap as one of the determinants of inflation, it becomes in itself an strategy of output and aggregate demand stabilization. It is clear, however, that the optimal response of interest rates to changes in the output gap in the context of an inflation targeting strategy becomes particularly complex in the case of open economies (Svensson 2000). Moreover, as stressed in Mishkin and Savastano (2000), inflation targeting is likely to be a more effective strategy if it is phased in only after there has been some successful disinflation and credibility is built up.

Stabilizing Capital Flows

In any case, it is clear that the procyclical behaviour of domestic interest rates in Latin American countries is produced by the procyclicality of foreign capital flows (Ocampo 2001). Then, from a broader point of view, the main challenge of both national economic authorities and multilateral financial institutions is to at least reduce the degree of such procyclicality.

During the crises, domestic authorities cannot do much to reduce the procyclicality of foreign capital flows. When capital is flying out, any attempt to impose restrictions would be counterproductive. Under those circumstances, both fiscal and monetary policies must provide confidence and act in a contractionary and procyclical way. In those periods, the countercyclical role must be played by the multilateral financial institutions (MFIs). While trying to minimize the moral hazard problems that may be created by their intervention, the role of the MFI´s becomes

[1] For instance, in an article published in the *Financial Times*, Ricardo Haussman from Harvard University has suggested that a way out of the current Argentinean crisis would be to forcedly convert dollar deposits in domestic banks into domestic currency deposits at a devalued exchange rate.

crucial, either by providing alternative sources of credit, by giving guarantees to private lenders, or by trying to stabilize undue volatility in the price of emerging market bonds, as has been recently proposed.[2]

Still, there is a role for the domestic economic authorities in reducing the procyclicality of foreign capital flows and it is very important during the boom periods. In these periods domestic authorities should strengthen prudential financial regulation. In particular, it is in those periods, when the domestic currencies tend to appreciate and foreign-currency liabilities become more attractive, that the authorities should impose higher capital adequacy ratios on foreign-currency denominated loans given to firms with uncovered exchange rate risks. Also, in some cases, it may be justifiable to impose some kind of taxation on capital inflows, as was done in Chile and Colombia during the 1990s, in order to avoid a too sharp procyclical reduction in domestic interest rates and to discourage households and corporate borrowers from borrowing too much abroad during the boom period.

The rationale for the type of regulations mentioned above was expressed in a very clear way in a survey on globalization that was published in a recent issue of *The Economist*.[3] As they put it, the nonfinancial private sector of a country "may sometimes borrow amounts which seem individually prudent given certain macroeconomic assumptions—such as no devaluation of the currency—but which become collectively insupportable if such assumptions turn out to be wrong." Some elements that discourage capital inflows under those circumstances may be a better option than entirely free capital mobility. They would reduce the procyclicality of capital flows and enhance the ability of domestic monetary policies to act in a countercyclical way, thus contributing to both nominal and output stability in emerging economies.

[2] See, for example, Lerrick and Meltzer (2001).
[3] Globalisation and its critics. A survey of globalisation, *The Economist*, September 29, 2001.

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